

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 1998

OR

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

For the transition period from ----- to -----

Commission file number 1-6541

LOEWS CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

13-2646102

(State or other jurisdiction of
incorporation or organization)

(I.R.S. employer
identification no.)

667 MADISON AVENUE, NEW YORK, N.Y. 10021-8087

(Address of principal executive offices) (Zip Code)

(212) 521-2000

(Registrant's telephone number, including area code)

NOT APPLICABLE

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

Indicate by check mark whether the registrant (1) has filed all reports
required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of
1934 during the preceding 12 months (or for such shorter period that the
registrant was required to file such reports), and (2) has been subject to such
filing requirements for the past 90 days.

Yes X No

| Class | Outstanding at May 1, 1998 |
|-----------------------------|----------------------------|
| ----- | ----- |
| Common stock, \$1 par value | 115,000,000 shares |

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

Loews Corporation and Subsidiaries
Consolidated Condensed Balance Sheets

| (Amounts in millions of dollars) | March 31, 1998 | December 31, 1997 |
|--|-------------------|----------------------|
| ----- | | |
| Assets: | | |
| Investments: | | |
| Fixed maturities, amortized cost of \$31,094.4 and \$30,201.6 | \$31,558.3 | \$30,723.2 |
| Equity securities, cost of \$1,259.3 and \$1,102.6 | 1,384.6 | 1,163.3 |
| Other investments | 1,081.7 | 978.4 |
| Short-term investments | 8,019.6 | 8,754.2 |
| | ----- | |
| Total investments | 42,044.2 | 41,619.1 |
| Cash | 298.8 | 497.8 |
| Receivables-net | 13,913.7 | 13,325.9 |
| Property, plant and equipment-net | 2,591.4 | 2,590.2 |
| Deferred income taxes | 995.6 | 944.3 |
| Goodwill and other intangible assets-net | 754.0 | 751.4 |
| Other assets | 1,819.7 | 1,895.1 |
| Deferred policy acquisition costs of insurance subsidiaries | 2,291.1 | 2,141.7 |
| Separate Account business | 5,736.3 | 5,811.6 |
| | ----- | |
| Total assets | \$70,444.8 | \$69,577.1 |
| | ===== | |
| Liabilities and Shareholders' Equity: | | |
| Insurance reserves and claims | \$40,408.6 | \$39,497.4 |
| Payable to brokers | 1,806.2 | 1,559.2 |
| Securities sold under repurchase agreements | 545.9 | 152.7 |
| Long-term debt, less unamortized discount | 5,749.3 | 5,752.6 |
| Other liabilities | 4,212.0 | 4,749.1 |
| Separate Account business | 5,736.3 | 5,811.6 |
| | ----- | |
| Total liabilities | 58,458.3 | 57,522.6 |
| Minority interest | 2,457.1 | 2,389.4 |
| Shareholders' equity | 9,529.4 | 9,665.1 |
| | ----- | |
| Total liabilities and shareholders' equity . | \$70,444.8 | \$69,577.1 |
| | ===== | |

See accompanying Notes to Consolidated Condensed Financial Statements.

(In millions, except per share data)

Three Months Ended March 31,
1998 1997

Revenues:

| | | |
|--|------------|-----------|
| Insurance premiums: | | |
| Property and casualty | \$ 2,527.0 | \$2,470.5 |
| Life | 840.0 | 875.0 |
| Investment income, net of expenses | 630.6 | 615.4 |
| Investment (losses) gains | (350.6) | 28.9 |
| Manufactured products (including excise taxes of \$109.0 and \$110.1) | 596.7 | 541.1 |
| Other | 551.4 | 408.2 |
| Total | 4,795.1 | 4,939.1 |

Expenses:

| | | |
|--|---------|---------|
| Insurance claims and policyholders' benefits .. | 2,849.8 | 2,892.4 |
| Amortization of deferred policy acquisition costs | 588.3 | 520.3 |
| Cost of manufactured products sold | 234.6 | 237.2 |
| Selling, operating, advertising and administrative expenses | 1,056.0 | 791.3 |
| Interest | 93.8 | 74.8 |
| Total | 4,822.5 | 4,516.0 |

(27.4) 423.1

| | | |
|------------------------------------|--------|-------|
| Income tax (benefit) expense | (21.7) | 126.4 |
| Minority interest | 78.0 | 57.4 |

56.3 183.8

Net (loss) income \$ (83.7) \$ 239.3

Net (loss) income per share \$ (.73) \$ 2.08

Cash dividends per share \$.25 \$.25

Weighted average number of shares outstanding ... 115.0 115.0

See accompanying Notes to Consolidated Condensed Financial Statements.

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Loews Corporation and Subsidiaries
Consolidated Condensed Statements of Cash Flows

(Amounts in millions)

Three Months Ended March 31,
1998 1997

Operating Activities:

| | | |
|--|-----------|-----------|
| Net (loss) income | \$ (83.7) | \$ 239.3 |
| Adjustments to reconcile net (loss) income to net cash used by operating activities-net | 463.8 | 143.1 |
| Changes in assets and liabilities-net: | | |
| Reinsurance receivable | (47.0) | 160.5 |
| Other receivables | (743.8) | (384.6) |
| Deferred policy acquisition costs | (149.4) | (129.9) |
| Insurance reserves and claims | 916.1 | 574.2 |
| Other liabilities | (263.2) | (1,045.0) |
| Trading securities | (415.7) | (20.2) |
| Other-net | 21.0 | (41.1) |
| | (301.9) | (503.7) |

Investing Activities:

| | | |
|---|------------|-----------|
| Purchases of fixed maturities | (11,365.8) | (9,841.8) |
| Proceeds from sales of fixed maturities | 10,240.9 | 9,632.0 |
| Proceeds from maturities of fixed maturities .. | 676.1 | 603.2 |
| Change in securities sold under repurchase agreements | 393.2 | 1,746.8 |
| Purchases of equity securities | (307.0) | (408.9) |
| Proceeds from sales of equity securities | 192.5 | 300.5 |
| Change in short-term investments | 535.8 | (1,386.3) |
| Purchases of property, plant and equipment | (99.5) | (130.3) |
| Change in other investments | (125.7) | 53.3 |
| | ----- | ----- |
| | 140.5 | 568.5 |
| | ----- | ----- |
| Financing Activities: | | |
| Dividends paid to shareholders | (28.8) | (28.7) |
| Issuance of long-term debt | 297.7 | 395.3 |
| Principal payments on long-term debt | (301.6) | (212.2) |
| Net change in revolving line of credit | | (63.0) |
| Receipts credited to policyholders | 1.5 | 2.5 |
| Withdrawals of policyholder account balances .. | (6.4) | (6.3) |
| | ----- | ----- |
| | (37.6) | 87.6 |
| | ----- | ----- |
| Net change in cash | (199.0) | 152.4 |
| Cash, beginning of period | 497.8 | 305.7 |
| | ----- | ----- |
| Cash, end of period | \$ 298.8 | \$ 458.1 |
| | ===== | ===== |

See accompanying Notes to Consolidated Condensed Financial Statements.

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Loews Corporation and Subsidiaries Notes to Consolidated Condensed Financial Statements

(Dollars in millions, except per share data)

1. General:

Reference is made to the Notes to Consolidated Financial Statements in the 1997 Annual Report to Shareholders which should be read in conjunction with these consolidated condensed financial statements.

Comprehensive income

The Company adopted Statement of Financial Accounting Standard ("SFAS") No. 130, "Reporting Comprehensive Income." Comprehensive income includes all changes to shareholders' equity, including net (loss) income, except those resulting from investments by owners and distributions to owners. For the three months ended March 31, 1998 and 1997, comprehensive (loss) income totaled \$(106.9) and \$(87.4), respectively. Comprehensive (loss) income includes net (loss) income, unrealized appreciation (depreciation) and foreign currency translation gains or losses.

Net (loss) income per share

The Company adopted SFAS No. 128, "Earnings Per Share," which requires presentation of basic and diluted earnings per share for entities with complex capital structures. Basic earnings per share excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. The Company does not have any dilutive instruments related to its common shares. Accordingly, basic and diluted earnings per share are the same.

Reclassifications

Certain amounts applicable to prior periods have been reclassified to conform to the classifications followed in 1998.

2. Reinsurance:

CNA assumes and cedes insurance with other insurers and reinsurers and members of various reinsurance pools and associations. CNA utilizes reinsurance arrangements to limit its maximum loss, provide greater diversification of risk and minimize exposures on larger risks. The reinsurance coverages are tailored to the specific risk characteristics of each product line with CNA's retained amount varying by type of coverage.

Generally, reinsurance coverage for property risks is on an excess of loss, per risk basis. Liability coverages are generally reinsured on a quota share basis in excess of CNA's retained risk. Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability.

The ceding of insurance does not discharge the primary liability of the original insurer. CNA places reinsurance with other carriers only after careful review of the nature of the contract and a thorough assessment of the reinsurers' credit quality and claim settlement performance. Further, for carriers that are not authorized reinsurers in CNA's states of domicile, CNA receives collateral, primarily in the form of bank letters of credit, securing a large portion of the recoverables.

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The effects of reinsurance on earned premiums, are as follows:

| | Direct | Assumed | Ceded | Net | % Assumed |
|-----------------------------------|-----------|---------|---------|-----------|--------------|
| ----- | | | | | |
| Three Months Ended March 31, 1998 | | | | | |
| ----- | | | | | |
| Property and casualty | \$1,817.0 | \$373.0 | \$138.0 | \$2,052.0 | 18.2% |
| Accident and health | 1,090.0 | 78.0 | 91.0 | 1,077.0 | 7.2 |
| Life | 251.0 | 36.0 | 49.0 | 238.0 | 15.1 |
| ----- | | | | | |
| Total | \$3,158.0 | \$487.0 | \$278.0 | \$3,367.0 | 14.5% |
| ===== | | | | | |
| Three Months Ended March 31, 1997 | | | | | |
| ----- | | | | | |
| Property and casualty | \$2,164.0 | \$236.0 | \$228.0 | \$2,172.0 | 10.9% |
| Accident and health | 944.0 | 29.0 | 31.0 | 942.0 | 3.1 |
| Life | 227.0 | 29.0 | 24.0 | 232.0 | 12.5 |
| ----- | | | | | |
| Total | \$3,335.0 | \$294.0 | \$283.0 | \$3,346.0 | 8.8% |
| ===== | | | | | |

In the above table, life premium revenue is from long duration contracts and the property and casualty earned premium is from short duration contracts. Approximately three quarters of accident and health earned premiums are from short duration contracts.

Insurance claims and policyholders' benefits are net of reinsurance recoverable of \$179.0 and \$247.5 for the three months ended March 31, 1998 and 1997, respectively.

3. Receivables:

The Company's receivables are comprised of the following:

| | March 31, 1998 | December 31, 1997 |
|--|-------------------|----------------------|
| ----- | | |
| Reinsurance | \$ 5,773.0 | \$ 5,726.0 |
| Other insurance | 7,005.7 | 6,333.9 |
| Security sales | 553.4 | 755.8 |
| Accrued investment income | 445.5 | 422.8 |
| Other | 457.0 | 405.4 |
| ----- | | |
| Total | 14,234.6 | 13,643.9 |
| Less allowance for doubtful accounts and cash discounts | 320.9 | 318.0 |
| ----- | | |
| Receivables-net | \$13,913.7 | \$13,325.9 |
| ===== | | |

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4. Shareholders' equity:

| | March 31, 1998 | December 31, 1997 |
|---|-------------------|----------------------|
| Preferred stock, \$.10 par value, Authorized--100,000,000 shares | | |
| Common stock, \$1 par value: Authorized--400,000,000 shares | | |
| Issued and outstanding--115,000,000 shares . | \$ 115.0 | \$ 115.0 |
| Additional paid-in capital | 165.8 | 165.8 |
| Earnings retained in the business | 8,782.9 | 8,895.4 |
| Unrealized appreciation | 465.7 | 488.9 |
| | ----- | ----- |
| Total | \$9,529.4 | \$9,665.1 |
| | ===== | ===== |

5. Legal Proceedings and Contingent Liabilities:

INSURANCE RELATED

Fibreboard Litigation

CNA's primary property and casualty subsidiary, Continental Casualty Company ("Casualty"), has been party to litigation with Fibreboard Corporation ("Fibreboard") involving coverage for certain asbestos-related claims and defense costs (San Francisco Superior Court, Judicial Council Coordination Proceeding 1072). As described below, Casualty, Fibreboard, another insurer (Pacific Indemnity, a subsidiary of the Chubb Corporation), and a negotiating committee of asbestos claimant attorneys (collectively referred to as "Settling Parties") have reached a Global Settlement (the "Global Settlement") to resolve all future asbestos-related bodily injury claims involving Fibreboard, which is subject to court approval.

Casualty, Fibreboard and Pacific Indemnity have also reached an agreement (the "Trilateral Agreement") on a settlement to resolve the coverage litigation in the event the Global Settlement does not obtain final court approval.

On July 27, 1995, the United States District Court for the Eastern District of Texas entered judgment approving the Global Settlement Agreement and the Trilateral Agreement. As expected, appeals were filed as respects to both of these decisions. On July 25, 1996, a panel of the United States Fifth Circuit Court of Appeals in New Orleans affirmed the judgment approving the Global Settlement Agreement by a 2 to 1 vote and affirmed the judgment approving the Trilateral Agreement by a 3 to 0 vote. Petitions for rehearing by the panel and Suggestions for Rehearing by the entire Fifth Circuit Court of Appeals as respects to the decision on the Global Settlement Agreement were denied. Two petitions for certiorari were filed in the Supreme Court as respects the Global Settlement Agreement. On June 27, 1997, the Supreme Court granted these petitions, vacated the Fifth Circuit's judgment as respects to the Global Settlement Agreement, and remanded the matter to the Fifth Circuit for reconsideration in light of the Supreme Court's decision in *Amchem Products Co. v. Windsor*.

On January 27, 1998, a panel of the United States Fifth Circuit Court of Appeals again approved the Global Settlement Agreement by a 2 to 1 vote. Two sets of Objectors filed petitions for certiorari which were docketed on April

16 and 17, 1998, by the United States Supreme Court. The Settling Parties will file papers in opposition of the petitions on May 18, 1998.

No further appeal was filed with respect to the Trilateral Agreement; therefore, court approval of the Trilateral Agreement has become final.

Global Settlement Agreement - On April 9, 1993, Casualty and Fibreboard entered into an agreement pursuant to which, among other things, the parties agreed to use their best efforts to negotiate and finalize a global class action settlement with asbestos-related bodily injury and death claimants.

On August 27, 1993, the Settling Parties reached an agreement in principle for an omnibus settlement to resolve all future asbestos-related bodily

injury claims involving Fibreboard. The Global Settlement Agreement was executed on December 23, 1993. The agreement calls for contribution by Casualty and Pacific Indemnity of an aggregate of \$1,530.0 to a trust fund for a class of all future asbestos claimants, defined generally as those persons whose claims against Fibreboard were neither filed nor settled before August 27, 1993. An additional \$10.0 is to be contributed to the fund by Fibreboard. As indicated above, the Global Settlement approval has been approved by the Fifth Circuit a second time, but the Objectors have petitioned the Supreme Court for review of the decision. There is limited precedent with settlements which determine the rights of future personal injury claimants to seek relief.

Through March 31, 1998, Casualty, Fibreboard and plaintiff attorneys had reached settlements with respect to approximately 135,400 claims, for an estimated settlement amount of approximately \$1,600.0 plus any applicable interest. Final court approval of the Trilateral Agreement obligates Casualty to pay under these settlements. Approximately \$1,600.0 (including interest of \$182.0) was paid through March 31, 1998. Such payments have been partially recovered from Pacific Indemnity. Casualty may negotiate other agreements for unsettled claims.

Final court approval of the Trilateral Agreement and its implementation resolved Casualty's exposure with respect to the Fibreboard asbestos claims. Casualty does not anticipate further material exposure with respect to the Fibreboard matter, and subsequent adverse reserve adjustments, if any, are not expected to materially affect the results of operations or equity of the Company.

Tobacco Litigation -----

CNA's primary property/casualty subsidiaries have been named as defendants as part of a "direct action" lawsuit, Richard P. Ieyoub v. The American Tobacco Company, et al., filed by the Attorney General for the State of Louisiana, in state court, Calcasieu Parish, Louisiana. In that suit, filed against certain tobacco manufacturers and distributors (the "Tobacco Defendants") and over 100 insurance companies, the State of Louisiana seeks to recover medical expenses allegedly incurred by the State as a result of tobacco-related illnesses.

The original suit was filed on March 13, 1996, against the Tobacco Defendants only. The insurance companies were added to the suit in March 1997 under a "direct action" procedure in Louisiana. Under the direct action statute, the Louisiana Attorney General is pursuing liability claims against the Tobacco Defendants and their insurers in the same suit, even though none of the Tobacco Defendants has made a claim for insurance coverage.

In June of 1997, the United States District Court for the Western District of Louisiana, Lake Charles Division, granted a petition to remove this litigation to the federal district court. The district court's decision is currently on appeal to the United States Fifth Circuit Court of Appeals. During the pending appeal, all proceedings in state court and in the federal

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district court are stayed. Because of the uncertainties inherent in assessing the risk of liability at this very early stage of the litigation, management is unable to make a meaningful estimate of the amount or range of any loss that could result from an unfavorable outcome of the pending litigation. However, management believes that the ultimate outcome of the pending litigation should not materially affect the results of operations or equity of the Company.

Environmental Pollution and Asbestos -----

The CNA property and casualty insurance companies have potential exposures related to environmental pollution and asbestos claims.

Environmental pollution clean-up is the subject of both federal and state regulation. By some estimates, there are thousands of potential waste sites subject to clean-up. The insurance industry is involved in extensive litigation regarding coverage issues. Judicial interpretations in many cases have expanded the scope of coverage and liability beyond the original intent of the policies.

The Comprehensive Environmental Response Compensation and Liability Act of 1980 ("Superfund") and comparable state statutes ("mini-Superfund") govern the clean-up and restoration of abandoned toxic waste sites and formalize the concept of legal liability for clean-up and restoration by potentially responsible parties ("PRP's"). Superfund and the mini-Superfunds

(Environmental Clean-up Laws or "ECLs") establish mechanisms to pay for clean-up of waste sites if PRPs fail to do so, and to assign liability to PRPs. The extent of liability to be allocated to a PRP is dependent on a variety of factors. Further, the number of waste sites subject to clean-up is unknown. To date, approximately 1,300 clean-up sites have been identified by the Environmental Protection Agency on its National Priorities List ("NPL"). The addition of new clean-up sites to the NPL has slowed in recent years. Many clean-up sites have been designated by state authorities as well.

Many policyholders have made claims against various CNA insurance subsidiaries for defense costs and indemnification in connection with environmental pollution matters. CNA and the insurance industry are disputing coverage for many such claims. Key coverage issues include whether clean-up costs are considered damages under the policies, trigger of coverage, applicability of pollution exclusions and owned property exclusions, the potential for joint and several liability and definition of an occurrence. To date, courts have been inconsistent in their rulings on these issues.

A number of proposals to reform Superfund have been made by various parties. However, no reforms were enacted by Congress in 1997 and it is unclear as to what positions Congress or the Administration will take and what legislation, if any, will result. If there is legislation, and in some circumstances even if there is no legislation, the federal role in environmental clean-up may be significantly reduced in favor of state action. Substantial changes in the federal statute or the activity of the EPA may cause states to reconsider their environmental clean-up statutes and regulations. There can be no meaningful prediction of the pattern of regulation that would result.

Due to the inherent uncertainties described above, including the inconsistency of court decisions, the number of waste sites subject to clean-up, and the standards for clean-up and liability, CNA's ultimate liability for environmental pollution claims may vary substantially from the amount currently recorded.

As of March 31, 1998 and December 31, 1997, CNA carried approximately \$701.0 and \$773.0, respectively, of claim and claim expense reserves, net of reinsurance recoverables, for reported and unreported environmental pollution claims. The reserves relate to claims for accident years 1988 and prior, after

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which CNA adopted the Simplified Commercial General Liability coverage form which included an absolute pollution exclusion. There was no unfavorable reserve development for the three months ended March 31, 1998 and 1997.

CNA's insurance subsidiaries have exposure to asbestos claims, including those attributable to CNA's litigation with Fibreboard Corporation (see above). Estimation of asbestos claim reserves involves many of the same limitations discussed above for environmental pollution claims such as inconsistency of court decisions, specific policy provisions, allocation of liability among insurers, missing policies and proof of coverage. As of March 31, 1998 and December 31, 1997, CNA carried approximately \$1,300.0 and \$1,400.0, respectively, of claim and claim expense reserves, net of reinsurance recoverables, for reported and unreported asbestos-related claims. Unfavorable reserve development for the three months ended March 31, 1998 and 1997 totaled \$14.0 and \$12.0, respectively.

The following tables provide additional data related to CNA's environmental pollution and asbestos-related claims activity.

| | March 31, 1998 | | December 31, 1997 | |
|------------------------------------|----------------------------|-----------|----------------------------|-----------|
| | Environmental Pollution | Asbestos | Environmental Pollution | Asbestos |
| Reported Claims: | | | | |
| Gross revenues | \$318.0 | \$1,228.0 | \$ 279.0 | \$1,384.0 |
| Less reinsurance recoverable | (42.0) | (106.0) | (36.0) | (117.0) |
| Net reported claims | 276.0 | 1,122.0 | 243.0 | 1,267.0 |
| Net unreported claims | 425.0 | 178.0 | 530.0 | 133.0 |
| Net reserves | \$701.0 | \$1,300.0 | \$ 773.0 | \$1,400.0 |

The results of operations in future years may continue to be adversely affected by environmental pollution and asbestos claims and claim expenses. Management will continue to monitor these liabilities and make further adjustments as warranted.

NON-INSURANCE

Tobacco Litigation -- Lawsuits continue to be filed with increasing frequency against Lorillard and other manufacturers of tobacco products seeking damages for cancer and other health effects claimed to have resulted from an individual's use of cigarettes, addiction to smoking, or exposure to environmental tobacco smoke. Tobacco litigation includes claims brought by individual plaintiffs ("Conventional Product Liability Cases"); claims brought as class actions on behalf of a large number of individuals for damages allegedly caused by smoking ("Class Actions"); claims brought on behalf of governmental entities and others, including private citizens suing on behalf of taxpayers, labor unions, Indian Tribes and private companies, seeking, among other alleged damages, reimbursement of health care costs allegedly incurred as a result of smoking ("Reimbursement Cases"); and claims for contribution and/or indemnity of asbestos claims by asbestos manufacturers ("Claims for Contribution"). In addition, claims have been brought against Lorillard seeking damages resulting from exposure to asbestos fibers which had been incorporated, for a limited period of time, ending more than forty years ago, into filter material used in one brand of cigarettes manufactured by Lorillard ("Filter Cases").

In these actions, plaintiffs claim substantial compensatory, statutory and punitive damages in amounts ranging into the billions of dollars. These claims

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are based on a number of legal theories including, among other things, theories of negligence, fraud, misrepresentation, strict liability, breach of warranty, enterprise liability, civil conspiracy, intentional infliction of harm, violation of anti-trust laws and state consumer protection statutes, and failure to warn of the allegedly harmful and/or addictive nature of tobacco products.

On June 20, 1997, together with other companies in the United States tobacco industry, Lorillard entered into a Memorandum of Understanding to support the adoption of federal legislation and any necessary ancillary undertakings incorporating the features described in the proposed resolution attached to the Memorandum of Understanding (together, the "Proposed Resolution"). The Proposed Resolution can be implemented only by federal legislation. If enacted into law, the legislation would resolve many of the regulatory and litigation issues affecting the United States tobacco industry thereby reducing uncertainties facing the industry. Lorillard and other companies have announced that they will not seek ratification of proposed legislation that has been introduced in Congress because it would significantly modify the agreement reached on June 20, 1997. (See Item 1 - Lorillard, Inc. - "Proposed Resolution of Certain Regulatory and Litigation Issues" in the Company's annual report on Form 10-K for the year ended December 31, 1997.)

CONVENTIONAL PRODUCT LIABILITY CASES - There are approximately 615 cases filed by individual plaintiffs against manufacturers of tobacco products pending in the United States federal and state courts in which individuals allege they or their decedents have been injured due to smoking cigarettes, due to exposure to environmental tobacco smoke, or due to nicotine dependence. Lorillard is a defendant in approximately 200 of these cases. The Company is a defendant in 16 cases, eight of which have not been served.

Plaintiffs in these cases seek unspecified amounts in compensatory and punitive damages in many cases, and in other cases damages are stated to amount to as much as \$100.0 million in compensatory damages and \$600.0 million in punitive damages.

On March 19, 1998, the jury in *Dunn v. RJR Nabisco Holdings Corporation, et al.* (Superior Court, Delaware County, Indiana, filed May 28, 1993) returned a unanimous verdict in favor of the defendant cigarette manufacturers and their parent entities, including the Company, in the trial of a suit brought by the family of a woman who died of cancer, allegedly caused by exposure to environmental tobacco smoke. Plaintiffs have filed a motion seeking a new trial. The court has not ruled on the motion to date.

On September 26, 1997, a jury in the case of *Gordon v. R.J. Reynolds Tobacco Company, et al.* (Superior Court, Middlesex County, Massachusetts), returned a special verdict favorable to the defendants, which included Lorillard. The court entered judgment in favor of the defendants. Trial was

held on the limited issue of the cigarettes smoked by the decedent and the time period in which she smoked them. Plaintiff has filed a motion for new trial, which is pending.

During 1997, juries returned verdicts in favor of the defendants in trials in two smoking and health cases in which Lorillard was not a party, Connor v. R.J. Reynolds Tobacco Company (verdict returned May 5, 1997) and Karbiwnyk v. R.J. Reynolds Tobacco Company (verdict returned October 31, 1997) (both cases were tried in the Circuit Court of Duval County, Florida). Appeals are not pending in either case.

An attorney who represents plaintiffs in a class action pending in Illinois has filed a motion to consolidate and transfer all tobacco lawsuits pending in U.S. federal courts to the U.S. Judicial Panel for Multidistrict Litigation.

CLASS ACTIONS - There are 62 purported class actions pending against cigarette manufacturers and other defendants, including the Company. Four

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cases have not been served. Most of the suits seek class certification on behalf of residents of the states in which the cases have been filed, although some suits seek class certification on behalf of residents of multiple states. All but one of the purported class actions seek class certification on behalf of individuals who smoked cigarettes or were exposed to environmental tobacco smoke. One case seeks class certification on behalf of individuals who have paid insurance premiums to Blue Cross and Blue Shield organizations. Plaintiffs in a number of Reimbursement cases also seek certification as class actions (see Reimbursement Cases, below).

Theories of liability asserted in the purported class actions include a broad range of product liability theories, including those based on consumer protection statutes and fraud and misrepresentation. Plaintiffs seek damages in each case that range from unspecified amounts to the billions of dollars. Most plaintiffs seek punitive damages and some seek treble damages. Plaintiffs in many of the cases seek medical monitoring. Plaintiffs in several of the purported class actions are represented by a well-funded and coordinated consortium of over 60 law firms from throughout the United States. Lorillard is a defendant in 57 of the 62 cases seeking class certification. The Company is a defendant in 26 of the purported class actions, three of which has not been served. Many of the purported class actions are in the pre-trial, discovery stage.

Broin v. Philip Morris Companies, Inc., et al. (Circuit Court, Dade County, Florida, October 31, 1991). On October 10, 1997, the parties to this class action brought on behalf of flight attendants claiming injury as a result of exposure to environmental tobacco smoke executed a settlement agreement which was finally approved by the court on February 3, 1998. The settlement agreement requires Lorillard and three other cigarette manufacturers jointly to pay \$300.0 million in three annual installments to create and endow a research institute to study diseases associated with cigarette smoke. None of these payments are to be made until all appeals have been exhausted and judgment becomes final. The amount to be paid by Lorillard is to be based upon each of the four settling defendants' share of the United States market for the sale of cigarettes. Lorillard presently has approximately 8.8% of the cigarette market in the United States. Based on this calculation, Lorillard is expected to pay approximately \$26.0 million of the proposed settlement amount. The plaintiff class members are permitted to file individual suits, but these individuals may not seek punitive damages for injuries that arose prior to January 15, 1997 which enabled them to be members of the class. The defendants that executed the settlement agreement have paid a total of \$49.0 million as fees and expenses of the attorneys who represented plaintiffs. Certain of the absent class members objected to the settlement agreement and some have noticed an appeal from the February 3, 1998 order.

Castano, et al. v. The American Tobacco Company, Inc. et al. (U.S. District Court, Eastern District, Louisiana, March 29, 1994). This case was initiated as a class action on behalf of nicotine dependent smokers in the United States. During 1998, Lorillard Tobacco Company and certain other cigarette manufacturer defendants agreed with the plaintiffs to dismiss this action without prejudice and to toll the statute of limitations as to plaintiffs' claims. Lorillard Tobacco Company paid \$1.0 million to reimburse the costs and expenses of plaintiffs' counsel. This amount will be credited against any award of costs and expenses incurred in connection with this suit that plaintiffs' counsel may obtain in the future as a result of the federal legislation implementing the Proposed Resolution, or against any judgment or settlements that such counsel may obtain in the future in similar actions.

Granier v. The American Tobacco Company, et al. (U.S. District Court, Eastern District, Louisiana, filed September 26, 1994).

Engle v. R.J. Reynolds Tobacco Co., et al. (Circuit Court, Dade County, Florida, filed May 5, 1994). Class certification has been granted as to Florida citizens who allege they, or their survivors, have, have had or have

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died from diseases and medical conditions caused by smoking cigarettes. The Florida Supreme Court has denied defendants' appeal. Trial is scheduled to begin on July 6, 1998.

Norton v. RJR Nabisco Holdings Corporation, et al. (Superior Court, Madison County, Indiana, filed May 3, 1996). The Company is a defendant in the case.

Richardson v. Philip Morris Incorporated, et al. (Circuit Court, Baltimore City, Maryland, filed May 24, 1996). During January of 1998, the court granted plaintiffs' motion for class certification on behalf of Maryland residents who had, presently have, or died from diseases, medical conditions or injuries caused by smoking cigarettes or using smokeless tobacco products; nicotine dependent persons in Maryland who have purchased and used cigarettes and smokeless tobacco products manufactured by the defendants; and Maryland residents who require medical monitoring. Defendants have filed a petition for writ of mandamus or prohibition from the class certification order with the Maryland Court of Special Appeals.

Scott v. The American Tobacco Company, et al. (U.S. District Court, Eastern District, Louisiana, filed May 24, 1996). The Company is a defendant in the case. Class certification has been granted on behalf of Louisiana citizens who require medical monitoring. Defendants have noticed an appeal from the class certification order with the Louisiana Court of Appeals.

Small v. Lorillard Tobacco Company, Inc., et al., Hoskins v. R.J. Reynolds Tobacco Company, et al., Frosina v. Philip Morris Incorporated, et al., Hoberman v. Brown & Williamson Tobacco Corporation, et al., and Zito v. American Tobacco Company, et al. (Supreme Court, New York County, New York, filed June 19, 1996). Small is the only one of these cases to name Lorillard as a defendant. Small formerly was known as Mroczowski. Plaintiffs' motions for class certification on behalf of New York residents who are nicotine dependent has been granted. Defendants in the five actions have noticed appeals from the orders that granted class certification.

Reed v. Philip Morris Incorporated, et al. (Superior Court, District of Columbia, filed June 21, 1996). The court has denied plaintiff's motion for class certification.

Barnes v. The American Tobacco Company, et al. (U.S. District, Eastern District, Pennsylvania, filed August 8, 1996). The District Court has vacated its prior order that granted class certification on behalf of Pennsylvania smokers who require medical monitoring. The court also granted defendants' motion for summary judgment. Plaintiffs have noticed an appeal from both orders to the U.S. Court of Appeals for the Third Circuit.

Lyons v. The American Tobacco Company, et al. (U.S. District Court, Southern District, Alabama, filed August 8, 1996).

Chamberlain v. The American Tobacco Company, et al. (U.S. District Court, Northern District, Ohio, filed August 14, 1996). The Company is a defendant in the case.

Thompson v. American Tobacco Company, Inc., et al. (U.S. District Court, Minnesota, filed September 4, 1996). The Company is a defendant in the case.

Perry v. The American Tobacco Company, et al. (Circuit Court, Coffee County, Tennessee, filed September 30, 1996). Plaintiffs seek class certification on behalf of individuals who have paid medical insurance premiums to a Blue Cross and Blue Shield organization.

Connor v. The American Tobacco Company, et al. (Second Judicial District Court, Bernalillo County, New Mexico, filed October 10, 1996).

Ruiz v. The American Tobacco Company, et al. (U.S. District Court, Puerto

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Rico, filed October 23, 1996). The court denied plaintiffs' motion for class certification.

Hansen v. The American Tobacco Company, et al. (U.S. District Court,

Eastern District, Arkansas, filed November 4, 1996). The Company is a defendant in the case. Parties have completed briefing of plaintiffs' motion for class certification. The court has indicated to the parties that it will rule on the class certification motion without hearing argument.

McCune v. American Tobacco Company, et al. (Circuit Court, Kanawha County, West Virginia, filed January 31, 1997). The Company is a defendant in the case.

Baker v. American Tobacco Company, et al. (Circuit Court, Wayne County, Michigan, filed February 4, 1997).

Woods v. Philip Morris Incorporated, et al. (Circuit Court, McDowell County, West Virginia, filed February 4, 1997).

Green v. American Tobacco Company, et al. (U.S. District Court, Kansas, filed February 6, 1997). The Company is a defendant in the case.

Peterson v. American Tobacco Company, et al. (U.S. District Court, Hawaii, filed February 6, 1997). The Company is a defendant in the case.

Walls v. The American Tobacco Company, et al. (U.S. District Court, Northern District, Oklahoma, filed February 6, 1997).

Selcer v. R.J. Reynolds Tobacco Company, et al. (U.S. District Court, Nevada, filed March 3, 1997). The Company is a defendant in the case.

White v. Philip Morris, Inc. et al. (Chancery Court, Jefferson County, Mississippi, filed April 18, 1997). The Company is a defendant in the case.

Insolia v. Philip Morris Incorporated, et al. (U.S. District Court, Western District, Wisconsin, filed April 21, 1997).

Geiger v. The American Tobacco Company, et al. (Supreme Court, Queens County, New York, filed April 30, 1997). Plaintiffs' motion for class certification was granted on an interim basis and the court certified a class comprised of New York residents who allege lung cancer or throat cancer as a result of smoking cigarettes. Defendants have noticed an appeal from the class certification ruling to the Appellate Division of the New York Supreme Court.

Cole v. The Tobacco Institute, Inc., et al. (U.S. District Court, Eastern District, Texas, Texarkana Division, filed May 5, 1997).

Clay v. The American Tobacco Company, Inc., et al. (U.S. District Court, Southern District, Illinois, Benton Division, filed May 22, 1997).

Anderson v. The American Tobacco Company, Inc., et al. (U.S. District Court, Eastern District, Tennessee, filed May 23, 1997). The Company is a defendant in the case.

Taylor v. The American Tobacco Company, Inc., et al. (Circuit Court, Wayne County, Michigan, filed May 23, 1997).

Lyons v. Brown & Williamson Tobacco Corporation, et al. (U.S. District Court, Northern District, Georgia, filed May 27, 1997). The Company is a defendant in the case.

Cosentino v. Philip Morris Incorporated, et al. (Superior Court, Middlesex County, New Jersey, filed May 28, 1997).

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Kirstein v. American Tobacco Company, Inc., et al. (Superior Court, Camden County, New Jersey, filed May 28, 1997).

Tepper v. Philip Morris Incorporated, et al. (Superior Court, Bergen County, New Jersey, filed May 28, 1997).

Brown v. The American Tobacco Company, Inc., et al. (Superior Court, San Diego County, California, filed June 10, 1997).

Lippincott v. American Tobacco Company, Inc., et al. (Superior Court, Camden County, New Jersey, filed June 13, 1997).

Brammer v. R.J. Reynolds Tobacco Company, et al. (U.S. District Court, Southern District, Iowa, filed June 20, 1997). The Company is a defendant in the case.

Knowles v. The American Tobacco Company, et al. (U.S. District Court,

Eastern District, Louisiana, filed June 30, 1997). The Company is a defendant in the case.

Daley v. American Brands, Inc., et al. (U.S. District Court, Northern District, Illinois, filed July 7, 1997).

Piscitello v. Philip Morris, Incorporated, et al. (Superior Court, Middlesex County, New Jersey, filed July 28, 1997). The Company is a defendant in the case.

Azorsky v. R.J. Reynolds Tobacco Company, et al. (U.S. District Court, Western District, Pennsylvania, filed August 15, 1997).

McCauley v. Brown & Williamson Tobacco Corporation, et al. (U.S. District Court, Northern District, Georgia, filed August 15, 1997). The court entered an order sua sponte that dismissed plaintiffs' class action allegations.

Bush v. Philip Morris Incorporated, et al. (U.S. District Court, Eastern District, Texas, filed September 10, 1997).

Nwanze v. Philip Morris Companies Inc., et al. (U.S. District Court, Southern District, New York, filed September 29, 1997). The Company is a defendant in the case.

Badillo v. American Tobacco Company, et al. (U.S. District Court, Nevada, filed October 8, 1997). The Company is a defendant in the case.

Newborn v. Brown & Williamson Tobacco Corporation, et al. (U.S. District Court, Western District, Tennessee, filed October 9, 1997).

Young v. The American Tobacco Company, et al. (Civil District Court, Orleans Parish, Louisiana, filed November 12, 1997). The Company is a defendant in the case.

Aksamit v. Brown & Williamson Tobacco Corporation, et al. (U.S. District Court, South Carolina, filed November 20, 1997). The Company is a defendant in the case. Trial is scheduled to begin on August 20, 1998.

DiEnno v. Liggett Group, Inc., et al. (U.S. District Court, Nevada, filed December 22, 1997).

McCauley v. Brown & Williamson Tobacco Corporation, et al. (U.S. District Court, Southern District, Georgia, filed December 31, 1997). To date, none of the defendants have received service of process.

Herrera v. The American Tobacco Company, et al. (U.S. District Court, Central District, Utah, filed January 28, 1998). The Company is a defendant in

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the case.

Jackson v. Philip Morris Incorporated, et al. (U.S. District Court, Central District, Utah, filed on or about February 13, 1998). The Company is a defendant in the case.

Parsons v. AC&S, et al. (Circuit Court, Kanawha County, West Virginia, filed February 27, 1998). The Company is a defendant in the case.

Mendys v. Lorillard Tobacco Company, et al. (Circuit Court, Cook County, Illinois, filed March 17, 1998).

Daniels v. Philip Morris Companies, Inc., et al. (U.S. District Court, Southern District, California, filed April 2, 1998). The Company is a defendant in the case. To date, none of the defendants have received service of process.

Christensen v. Philip Morris Companies, Inc., et al. (U.S. District Court, Nevada, filed April 3, 1998). The Company is a defendant in the case. To date, none of the defendants have received service of process.

Avallone v. The American Tobacco Company, Inc., et al. (Superior Court, Atlantic County, New Jersey, filed April 23, 1998). The Company is a defendant in the case. To date, none of the defendants have received service of process.

REIMBURSEMENT CASES - Approximately 120 actions are pending in which governmental entities, private citizens, or other organizations, including labor unions and Indian Tribes, seek recovery of funds expended by them to provide healthcare to individuals with injuries or other health effects

allegedly caused by use of tobacco products or exposure to cigarette smoke. These cases are based on, among other things, equitable claims, including indemnity, restitution, unjust enrichment and public nuisance, and claims based on antitrust laws and state consumer protection acts. Plaintiffs in a number of these actions seek certification as class actions. Plaintiffs seek damages in each case that range from unspecified amounts to the billions of dollars. Most plaintiffs seek punitive damages and some seek treble damages. Plaintiffs in many of the cases seek medical monitoring. Lorillard is named as a defendant in all such actions. The Company is named as a defendant in 18 of them.

State Or Local Governmental Reimbursement Cases - To date, suits filed by 41 states, the Commonwealth of Puerto Rico, and the Republic of The Marshall Islands are pending. In addition, cities, counties or other local governmental entities have filed eight such suits. The Company is a defendant in 14 cases filed by state or local governmental entities. Since January 1, 1997, cases brought by Florida, Minnesota, Mississippi and Texas have been settled (see "Settlements of Reimbursement Cases"). Many of the pending Reimbursement Cases are in the pre-trial, discovery stage.

The governmental entities pursuing the Reimbursement Cases are doing so at the urging and with the assistance of well known members of the plaintiffs bar who have been meeting with attorneys general in other states to encourage them to file similar suits.

Moore v. The American Tobacco Company, et al. (Chancery Court, Jackson County, Mississippi, filed May 23, 1994). On July 2, 1997, Lorillard and other defendants entered into a Memorandum of Understanding with the State of Mississippi which settled the State's claims for monetary damages. See "Settlements of Reimbursement Cases" below.

State of Minnesota, et al. v. Philip Morris Incorporated, et al., (District Court, Ramsey County, Minnesota, filed August 17, 1994). Blue Cross and Blue Shield of Minnesota ("Blue Cross") also is plaintiff in the case. On May 8, 1998, the parties reached an agreement to settle the matter. See "Settlements

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of Reimbursement Cases" below.

McGraw v. The American Tobacco Company, et al. (Circuit Court, Kanawha County, West Virginia, filed September 20, 1994 by the West Virginia Attorney General and state agencies). The Company is a defendant in the case.

The State of Florida, et al. v. The American Tobacco Company, et al. (Circuit Court, Palm Beach County, Florida, filed February 21, 1995). The trial court granted the Company's motion to dismiss. The Florida Court of Appeal affirmed the order dismissing the Company. On August 25, 1997, Lorillard Tobacco Company and other defendants entered into a Memorandum of Understanding with the State of Florida which settled the State's claims for monetary damages. See "Settlements of Reimbursement Cases" below. The remaining claims have now been dismissed.

Commonwealth of Massachusetts v. Philip Morris Inc., et al. (Superior Court, Middlesex County, Massachusetts, filed December 19, 1995). The court has scheduled trial in this matter to begin on February 1, 1999.

Ieyoub v. The American Tobacco Company, et al. (U.S. District Court, Western District, Louisiana, filed March 13, 1996 by the Louisiana Attorney General). The Company is a defendant in the case.

The State of Texas v. The American Tobacco Company, et al. (U.S. District Court, Eastern District, Texas, filed March 28, 1996). On January 16, 1998, Lorillard Tobacco Company and other defendants entered into a Memorandum of Understanding with the State of Texas which settled the State's claims for monetary damages. See "Settlements of Reimbursement Cases" below. Certain Texas counties and some Texas hospital districts have filed motions to intervene and for declaratory judgment in order to contest the settlement. The court has not ruled on the motions to date.

State of Maryland v. Philip Morris Incorporated, et al. (Circuit Court, Baltimore City, Maryland, filed May 1, 1996).

State of Washington v. The American Tobacco Company, et al. (Superior Court, King County, Washington, filed June 5, 1996). The court has scheduled the case for trial on September 14, 1998.

City and County of San Francisco, et al. v. Philip Morris Incorporated, et al. (U.S. District Court, Northern District, California, filed June 6, 1996

by various California cities and counties).

State of Connecticut v. Philip Morris Incorporated, et al. (Superior Court, Litchfield District, Connecticut, filed July 18, 1996).

County of Los Angeles v. R.J. Reynolds Tobacco Company, et al. (Superior Court, San Diego County, filed August 5, 1996). The court has scheduled a bench trial to begin on February 5, 1999 in this matter and in two other cases that assert allegations that defendants violated certain provisions of the California Business and Professions Code. Immediately after the completion of the bench trial, the court will convene a jury as to the remainder of the plaintiff's claims in County of Los Angeles.

State of Arizona v. The American Tobacco Company, et al. (Superior Court, Maricopa County, Arizona, filed August 20, 1996). The court has scheduled the case for trial on March 4, 1999.

State of Kansas v. R.J. Reynolds Tobacco Company, et al. (District Court, Shawnee County, Kansas, filed August 20, 1996).

Kelley v. Philip Morris Incorporated, et al. (Circuit Court, Ingham County, Michigan, filed August 21, 1996 by the Attorney General of Michigan).

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State of Oklahoma, et al. v. R.J. Reynolds Tobacco Company, et al. (District Court, Cleveland County, Oklahoma, filed August 22, 1996). The Company is a defendant in the case. The court has scheduled the case for trial on November 12, 1998.

People of the State of California v. Philip Morris Incorporated, et al. (Superior Court, San Francisco County, California, filed September 5, 1996 by various California counties and cities and local chapters of various medical societies and associations). The court has scheduled the case for trial on March 1, 1999.

State of New Jersey v. R.J. Reynolds Tobacco Company, et al. (Superior Court, Middlesex County, New Jersey, filed September 10, 1996).

State of Utah v. R.J. Reynolds Tobacco Company, et al. (U.S. District Court, Central Division, Utah, filed September 30, 1996). The Company is a defendant in the case.

City of New York, et al. v. The Tobacco Institute, et al. (Supreme Court, New York County, filed October 17, 1996).

People of the State of Illinois v. Philip Morris, Inc., et al. (Circuit Court, Cook County, Illinois, filed November 12, 1996).

State of Iowa v. R.J. Reynolds Tobacco Company, et al. (District Court, Fifth Judicial District, Polk County, Iowa, filed November 27, 1996). The Company is a defendant in the case. The Supreme Court of Iowa has affirmed the trial court's order dismissing plaintiff's claims of deception, voluntary assumption of a special duty and indemnity. Plaintiff did not attempt to appeal the dismissal of its claim of unjust enrichment/restitution.

County of Erie v. The Tobacco Institute, Inc., et al. (Supreme Court, Erie County, New York, filed January 14, 1997).

State of New York v. The American Tobacco Company, et al. (Supreme Court, New York County, New York, filed January 21, 1997). The Company is a defendant in the case.

State of Hawaii v. Brown & Williamson Tobacco Corporation, et al. (Circuit Court, First Circuit, Hawaii, filed January 31, 1997). The Company is a defendant in the case.

State of Wisconsin v. Philip Morris Incorporated, et al. (Circuit Court, Dane County, Wisconsin, filed February 5, 1997).

State of Indiana v. Philip Morris Incorporated, et al. (Superior Court, Marion County, Indiana, filed February 19, 1997).

State of Alaska v. Philip Morris, Incorporated, et al. (Superior Court, First Judicial District, Alaska, filed April 14, 1997).

County of Cook v. Philip Morris, Incorporated, et al. (Circuit Court, Cook County, Illinois, filed April 18, 1997).

Commonwealth of Pennsylvania v. Philip Morris, Inc., et al. (Court of Common Pleas, Philadelphia County, Pennsylvania, filed April 23, 1997).

State of Arkansas v. The American Tobacco Company, et al. (Sixth Division, Chancery Court, Pulaski County, Arkansas, filed May 5, 1997).

State of Montana v. Philip Morris, Incorporated, et al. (First Judicial Court, Lewis and Clark County, Montana, filed May 5, 1997).

State of Ohio v. Philip Morris, Incorporated, et al. (Court of Common Pleas,

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Franklin County, Ohio, filed on May 8, 1997).

State of Missouri v. American Tobacco Company, Inc., et al. (Circuit Court, City of St. Louis, Missouri, filed May 12, 1997). The Company is a defendant in the case.

State of South Carolina v. Brown & Williamson Tobacco Corporation, et al. (Court of Common Pleas, Richland County, South Carolina, filed May 12, 1997). The Company is a defendant in the case.

State of Nevada v. Philip Morris, Incorporated, et al. (Second Judicial District, Washoe County, Nevada, filed May 21, 1997).

University of South Alabama v. The American Tobacco Company, et al. (U.S. District Court, Southern District, Alabama, filed May 23, 1997). The Company is a defendant in the case. Plaintiff noticed an appeal to the U.S. Court of Appeals for the Fifth Circuit from the trial court's order that dismissed the action.

State of New Mexico v. The American Tobacco Company, et al. (First Judicial District Court, Santa Fe County, New Mexico, filed May 27, 1997).

City of Birmingham, Alabama, and The Greene County Racing Commission v. The American Tobacco Company, et al. (U.S. District Court, Northern District, Alabama, filed May 28, 1997). The Company is a defendant in the case.

State of Vermont v. Philip Morris, Incorporated, et al. (Superior Court, Chittenden County, Vermont, filed May 29, 1997).

State of New Hampshire v. R.J. Reynolds Tobacco Company, et al. (Superior Court, Merrimack County, New Hampshire, filed June 4, 1997).

State of Colorado v. R.J. Reynolds Tobacco Co., et al. (District Court, City and County of Denver, Colorado, filed June 5, 1997).

State of Idaho v. Philip Morris, Inc., et al. (District Court, Fourth Judicial District, Ada County, Idaho, filed June 9, 1997).

State of Oregon v. The American Tobacco Company, et al. (Circuit Court, Multnomah County, Oregon, filed June 9, 1997).

People of the State of California v. Philip Morris, Inc., et al. (Superior Court, Sacramento County, California, filed June 12, 1997).

State of Maine v. Philip Morris, Incorporated, et al. (Superior Court, Kennebec County, Maine, filed June 17, 1997).

Rossello, et al. v. Brown & Williamson Tobacco Corporation, et al. (U.S. District Court, Puerto Rico, filed June 17, 1997). The Company is a defendant in the case.

State of Rhode Island v. American Tobacco Company, Inc., et al. (Superior Court, Providence, Rhode Island, filed June 17, 1997). The Company is a defendant in the case.

State of Georgia v. Philip Morris, Inc., et al. (Superior Court, Fulton County, Georgia, filed August 29, 1997).

Republic of the Marshall Islands v. The American Tobacco Company, et al. (High Court, Republic of the Marshall Islands, filed October 20, 1997). The Company is a defendant in the case.

State of South Dakota and South Dakota Department of Social Services v. Philip Morris, Inc., et al. (Circuit Court, Sixth Judicial Circuit, Hughes

County, South Dakota filed February 23, 1998).

Private Citizens' Reimbursement Cases - There are five suits pending in which plaintiffs are private citizens. Four of the suits have been filed by private citizens on behalf of taxpayers of their respective states, although governmental entities have filed a reimbursement suit in one of the four states. The Company is a defendant in three of the five pending private citizen Reimbursement Cases. Lorillard is a defendant in each of the cases. Each of these cases is in the pre-trial discovery stage.

Crozier v. The American Tobacco Company, et al. (Circuit Court, Montgomery County, Alabama, filed August 8, 1996). The Company is a defendant in the case. The suit is on behalf of taxpayers of Alabama. This case is now known as *Holmes v. The American Tobacco Company, et al.*

Coyne v. The American Tobacco Company, et al. (U.S. District Court, Northern District, Ohio, filed September 17, 1996). The Company is a defendant in the case. The suit is on behalf of taxpayers of Ohio. The court has granted defendants' motion to dismiss. The plaintiffs have noticed an appeal from the court's order granting a motion to dismiss.

Beckom v. The American Tobacco Company, et al. (U.S. District Court, Eastern District, Tennessee, filed May 8, 1997). The Company is a defendant in the case. The suit is on behalf of taxpayers of Tennessee.

Mason v. The American Tobacco Company, et al. (U.S. District Court, Northern District, Texas, filed December 23, 1997). The suit is on behalf of taxpayers of the U.S. as to funds expended by the Medicaid program.

The State of North Carolina, et al. v. The American Tobacco Company, et al. (U.S. District Court, Middle District, North Carolina, filed February 13, 1998).

Reimbursement Cases By Indian Tribes - Indian Tribes have filed five reimbursement suits in their tribal courts, two of which have been dismissed. Lorillard is a defendant in each of the cases. The Company is not named as a defendant in any of the five tribal suits filed to date. Each of the pending cases is in the pre-trial, discovery stage.

The Lower Brule Sioux Tribe v. The American Tobacco Company, et al. (Tribal Court, Lower Brule Sioux Tribe, filed on an unknown date, first amended complaint filed May 28, 1997).

Muscogee Creek Nation v. The American Tobacco Company, et al. (District Court, Muscogee Creek Nation, Okmulgee District, filed June 20, 1997).

Crow Creek Sioux Tribe v. The American Tobacco Company, et al. (Tribal Court, Crow Creek Sioux Tribe, filed September 14, 1997).

Reimbursement Cases By Labor Unions - Labor unions have filed approximately 58 reimbursement suits in various states in federal or state courts, although one has not been served to date. Lorillard is named as a defendant in each of the suits filed to date by unions. The Company is a defendant in one of the pending suits but has not received service of process to date. Each of these cases is in the pre-trial, discovery stage.

Stationary Engineers Local 39 Health and Welfare Trust Fund v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, California, filed April 25, 1997).

Iron Workers Local Union No. 17 Insurance Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, Ohio, Eastern Division, filed May 20, 1997). The court has scheduled trial in this matter to begin on February 22, 1999.

Northwest Laborers-Employers Health and Security Trust Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Western District, Washington, filed May 21, 1997). The court has granted plaintiffs' motion for class certification on behalf of "all existing jointly-administered and collectively bargained-for health and welfare trusts in [the State of] Washington, and/or the trustees of such entities, that have provided or paid for health care and/or addiction treatment costs or services for employees or other beneficiaries." The United States Court of Appeals for the Ninth Circuit has declined to review the ruling at this time.

Massachusetts Laborers Health and Welfare Fund v. Philip Morris Inc., et al. (U.S. District Court, Massachusetts, filed June 2, 1997).

Central Laborers Welfare Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, Illinois, filed on or about June 9, 1997).

Hawaii Health and Welfare Trust Fund for Operating Engineers v. Philip Morris, Inc., et al. (U.S. District Court, Hawaii, filed June 13, 1997).

Laborers Local 17 Health and Benefit Fund and The Transport Workers Union New York City Private Bus Lines Health Benefit Trust v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, New York, filed June 19, 1997).

Ark-La-Miss Laborers Welfare Fund v. Philip Morris, Inc., et al. (U.S. District Court, Eastern District, Louisiana, filed June 20, 1997).

Kentucky Laborers District Council Health and Welfare Trust Fund v. Hill & Knowlton, Inc., et al. (U.S. District Court, Western District, Kentucky, Louisville Division, filed June 20, 1997).

Oregon Laborers -- Employers Health and Welfare Trust Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Oregon, filed June 20, 1997). The court has scheduled the case for trial on an unspecified day during January 1999.

United Federation of Teachers Welfare Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, New York, filed June 25, 1997).

Connecticut Pipe Trades Health Fund and International Brotherhood of Electrical Workers Local 90 Benefit Plan v. Philip Morris, Inc., et al. (U.S. District Court, Connecticut, filed July 1, 1997).

Seafarers Welfare Plan and United Industrial Workers Welfare Plan v. Philip Morris, Inc., et al. (U.S. District Court, Maryland, Southern Division, filed July 2, 1997).

Laborers and Operating Engineers Utility Agreement Health and Welfare Trust Fund for Arizona v. Philip Morris Incorporated, et al. (U.S. District Court, Arizona, filed July 7, 1997).

West Virginia Laborers Pension Fund v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, West Virginia, Huntington Division, filed July 11, 1997).

Rhode Island Laborers Health and Welfare Fund v. Philip Morris Incorporated, et al. (U.S. District Court, Rhode Island, filed July 20, 1997).

Eastern States Health and Welfare Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, New York, filed July 28, 1997).

Asbestos Workers Local 53 Health and Welfare Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Eastern District, Louisiana, filed August

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15, 1997). This action has been consolidated with the case of Ark-La-Miss Laborers Welfare Fund.

Steamfitters Local Union No. 420 Welfare Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Eastern District, Pennsylvania, filed August 21, 1997). The court has granted defendants' motion to dismiss the case. The time for plaintiff to appeal the decision has not expired.

Construction Laborers of Greater St. Louis Welfare Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Eastern District, Missouri, filed September 2, 1997).

Arkansas Carpenters Health & Welfare Fund v. Philip Morris, Inc., et al. (U.S. District Court, Eastern District, Arkansas, filed September 4, 1997).

Southeast Florida Laborers District Council Health and Welfare Trust Fund v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, Florida, filed September 11, 1997). The court has granted defendants' motion to dismiss the case. The time for plaintiff to appeal the decision has not expired.

West Virginia--Ohio Valley Area International Brotherhood of Electrical Workers Welfare Fund v. The American Tobacco Company, et al. (U.S. District

Court, West Virginia, filed September 11, 1997).

Teamsters Union No. 142, Health and Welfare Trust Fund and Sheet Metal Workers Local Union No. 20 Welfare and Benefit Fund v. Philip Morris Incorporated, et al. (Circuit Court, St. Joseph County, Indiana, filed September 12, 1997).

Operating Engineers Local 12 Health and Welfare Trust v. American Tobacco Company, et al. (Superior Court, Los Angeles County, California, filed September 16, 1997).

Puerto Rican ILGWU Health & Welfare Fund v. Philip Morris Inc., et al. (U.S. District Court, Southern District, New York, filed September 17, 1997).

New Jersey Carpenters Health Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, New Jersey, filed September 25, 1997).

New Mexico and West Texas Multi-Craft Health and Welfare Trust Fund, et al. v. Philip Morris, Inc., et al. (Second Judicial District Court, Bernalillo County, New Mexico, filed October 10, 1997).

Central States Joint Board v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, Illinois, filed October 20, 1997).

International Brotherhood of Teamsters Local 734 v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, Illinois, filed October 20, 1997).

Texas Carpenters Health Benefit Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Eastern District, Texas, Beaumont Division, filed October 31, 1997).

United Food and Commercial Workers Unions and Employers Health and Welfare Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, Alabama, filed November 13, 1997).

B.A.C. Local 32 Insurance Trust Fund, et al. v. Philip Morris, Incorporated, et al. (U.S. District Court, Eastern District, Michigan, filed November 14, 1997).

Screen Actors Guild-Producers Health Plan, et al. v. Philip Morris, Inc., et al. (Superior Court, Los Angeles County, California, filed November 20, 1997).

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IBEW Local 25 Health and Benefit Fund v. Philip Morris, Inc. et al. (U.S. District Court, Southern District, New York, filed November 25, 1997).

IBEW Local 363 Welfare Fund v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, New York, filed November 25, 1997).

Local 138, 138A and 138B International Union of Operating Engineers Welfare Fund v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, New York, filed November 25, 1997).

Local 840, International Brotherhood of Teamsters Health and Insurance Fund v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, New York, filed November 25, 1997).

Long Island Council of Regional Carpenters Welfare Fund v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, New York, filed November 25, 1997).

Day Care Council - Local 205 D.C. 1707 Welfare Fund v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, New York, filed December 8, 1997).

Local 1199 Home Care Industry Benefit Fund v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, New York, filed December 8, 1997).

Local 1199 National Benefit Fund for Health and Human Services Employees v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, New York, filed December 8, 1997).

Operating Engineers Local 324 Health Care Fund, et al. v. Philip Morris, Inc., et al. (U.S. District Court, Michigan, filed December 30, 1997).

Carpenters & Joiners Welfare Fund, et al. v. Philip Morris Incorporated, et al. (U.S. District Court, Minnesota, filed December 31, 1997).

Steamfitters Local Union No. 614 Health & Welfare Fund, et al. v. Philip Morris, Inc., et al. (Circuit Court, Thirteenth Judicial District, Tennessee, filed January 7, 1998).

Belk, et al., Trustees of IBEW-NECA Local 505 Health and Welfare Fund v. Philip Morris, Inc., et al. (U.S. District Court, Southern District, Alabama, filed February 19, 1998). Plaintiffs have sought to voluntarily dismiss the action without prejudice. Defendants have opposed this request and have asked the court to enter an order dismissing the action with prejudice. The court has not ruled on either request to date.

National Asbestos Workers, et al. v. Philip Morris Incorporated, et al. (U.S. District Court, Eastern District, New York, filed February 27, 1998).

Milwaukee Carpenters, et al. v. Philip Morris, Incorporated, et al. (U.S. District Court, Eastern District, Wisconsin, filed March 4, 1998). To date, none of the defendants have received service of process.

Milwaukee Carpenters, et al. v. Philip Morris, Incorporated, et al. (Circuit Court, Milwaukee County, Wisconsin, filed March 30, 1998).

United Association of Plumbing and Pipefitters Industry Local 467, et al. v. Philip Morris Incorporated, et al. (U.S. District Court, Northern District, California).

Newspaper Periodical Drivers Local 921 San Francisco Newspaper Agency Health & Welfare Fund v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, California, filed April 15, 1998).

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Teamsters Benefit Trust v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, California, filed April 15, 1998).

United Association Local 159 Health and Welfare Trust Fund v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, California, filed April 15, 1998).

Bay Area Automotive Group Welfare Fund v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, California, filed April 16, 1998).

Pipe Trades District Council No. 36 Health & Welfare Trust Fund v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, California, filed April 16, 1998).

Sign, Pictorial and Display Industry Welfare Fund v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, California, filed April 16, 1998).

United Association Local No. 343 Health and Welfare Trust Fund v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, California, filed April 16, 1998).

San Francisco Newspaper Publishers and Northern California Newspaper Guild Health & Welfare Trust v. Philip Morris, Inc., et al. (U.S. District Court, Northern District, California, filed April 17, 1998).

Reimbursement Cases By Private Companies - Private companies have filed six Reimbursement Case to date. Lorillard is named as a defendant in each of the cases filed by private companies. The Company is not a defendant in the case filed by private companies.

Group Health Plan, Inc., et al. v. Philip Morris Incorporated, et al. (District Court, Second Judicial District, Ramsey County, Minnesota, filed March 11, 1998).

Williams and Drake Company v. The American Tobacco Company, et al. (U.S. District Court, Western District, Pennsylvania, filed March 23, 1998).

Conwed Corporation, et al. v. R.J. Reynolds Tobacco Company, et al. (District Court, Second Judicial District, Ramsey County, Minnesota, filed April 10, 1998).

Arkansas Blue Cross and Blue Shield, et al. v. Philip Morris, Incorporated, et al. (U.S. District Court, Northern District, Illinois, filed April 29, 1998).

Blue Cross and Blue Shield of New Jersey, Inc., et al. v. Philip Morris, Incorporated, et al. (U.S. District Court, Eastern District, New York, filed April 29, 1998).

Regence Blueshield, et al. v. Philip Morris, Incorporated, et al. (U.S. District Court, Western District, Washington, filed April 29, 1998).

CONTRIBUTION CLAIMS - In addition to the foregoing cases, seven cases are pending in which private companies seek recovery of funds expended by them to individuals whose asbestos disease or illness was alleged to have been caused in whole or in part by smoking-related illnesses. Three of the cases have not been served. Lorillard is named as a defendant in each action. The Company is named as a defendant in two of the cases, including one that has not been served. Each of these cases is in the pre-trial, discovery stage.

Raymark Industries v. R.J. Reynolds Tobacco Company, et al. (U.S. District Court, Middle District, Florida, filed September 15, 1997). The Company is a defendant in the case. To date, neither Lorillard nor the Company have

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received service of process.

Raymark Industries v. Brown & Williamson Tobacco Corporation, et al. (U.S. District Court, Northern District, Georgia, filed September 15, 1997). The Company is a defendant in the case.

Fibreboard Corporation and Owens-Corning v. The American Tobacco Company, et al. (Superior Court, Alameda County, California, filed December 11, 1997).

Keene Creditors Trust v. Brown & Williamson Tobacco Corporation, et al. (Supreme Court, New York County, New York, filed December 19, 1997). The Company is a defendant in the case.

Falise, et al., as Trustees of the Manville Personal Injury Settlement Trust v. The American Tobacco Company, et al. (U.S. District Court, Eastern District, New York, filed December 31, 1997).

H.K. Porter Company v. B.A.T. Industries, PLC, et al. (U.S. District Court, Southern District, New York, filed December 31, 1997). To date, none of the defendants have received service of process.

Raymark Industries v. R.J. Reynolds Tobacco Co., et al. (Circuit Court, Duval County, Florida, filed December 31, 1997). To date, none of the defendants have received service of process.

Raymark Industries v. The American Tobacco Company, et al. (U.S. District Court, Eastern District, New York, filed January 30, 1998). To date, none of the defendants have received service of process.

FILTER CASES - A number of cases have been filed against Lorillard seeking damages for cancer and other health effects claimed to have resulted from exposure to asbestos fibers which were incorporated, for a limited period of time, ending more than forty years ago, into the filter material used in one of the brands of cigarettes manufactured by Lorillard. Sixteen such cases are pending in federal and state courts. Allegations of liability include negligence, strict liability, fraud, misrepresentation and breach of warranty. Plaintiffs seek unspecified amounts in compensatory and punitive damages in many cases, and in other cases damages are stated to amount to as much as \$15.0 million in compensatory damages and \$100.0 million in punitive damages. In the one case of this type that has been tried during 1997, the jury returned a verdict in favor of Lorillard. Trials were held in three cases of this type during 1996. In two of the cases, the juries returned verdicts in favor of Lorillard. In the third case, the jury returned a verdict in favor of plaintiffs. The verdict, which Lorillard has appealed, requires Lorillard to pay the amount of one hundred forty thousand dollars, although the award subsequently was reduced to seventy thousand dollars.

Trials were held in three cases of this type during 1995. In two of the cases, the juries returned verdicts in favor of Lorillard. In the third case, the jury returned a verdict in favor of plaintiffs, which was upheld on appeal. The Company has paid the compensatory judgment award, trial costs and interest thereon in the amount of \$1.6 million on December 30, 1997. The United States Supreme Court denied the Company's petition for writ of certiorari as to the punitive damages award.

In addition to the foregoing litigation, one pending case, Cordova v. Liggett Group, Inc., et al. (Superior Court, San Diego County, California, filed May 12, 1992), alleges that Lorillard and other named defendants, including other manufacturers of tobacco products, engaged in unfair and fraudulent business practices in connection with activities relating to the Council for Tobacco Research-USA, Inc., of which Lorillard is a sponsor, in violation of a California state consumer protection law by misrepresenting

to or concealing from the public information concerning the health aspects of smoking. The court has scheduled a bench trial to begin on February 5, 1999 in

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this matter and in two other cases that assert allegations that defendants violated certain provisions of the California Business and Professions Code.

Additionally, another pending case, Mangini v. Brown & Williamson Tobacco Corporation, et al. (Superior Court, San Francisco County, California, filed March 26, 1998), alleges that Lorillard and other named defendants, which are other cigarette manufacturers, violated certain provisions of the California Business and Professions Code due to its advertising programs that purportedly target youth smokers and policies concerning usage of outdoor advertisements.

DOCUMENT DISCOVERY ISSUES - Plaintiffs in a number of the cases pending against the tobacco industry, including cases against Lorillard and the Company, have challenged the claims made by Lorillard and other companies in the tobacco industry that certain documents sought by plaintiffs are protected from disclosure by the attorney-client privilege, joint defense privilege and work product doctrine. These challenges include, among other things, allegations that such documents do not contain legal advice or were not prepared for litigation purposes and, thus, are not privileged or protected as attorney work product. Certain plaintiffs in these cases have also alleged that defendants' privileged documents should be discoverable pursuant to the so-called crime/fraud exception which negates the privilege as to documents found to have been related to and prepared in furtherance of an alleged crime or fraud. In addition, several plaintiffs have argued that defendants have "waived" their privileges as to a number of documents. Such arguments by plaintiffs generally pertain to certain industry documents which were subpoenaed by the House Commerce Committee (see discussion below).

Various courts have addressed these issues and have arrived at differing conclusions as to whether the privilege for some of defendants' documents should be maintained. Some of these rulings are final and, as a result, certain documents as to which defendants have claimed a privilege have been released to plaintiffs.

In addition, on December 5, 1997, certain documents as to which defendants had claimed privilege were provided to the Chairman of the House Commerce Committee in response to a subpoena. These documents were subsequently made available on the Internet.

On February 19, 1998, the Committee subpoenaed an additional approximately 39,000 documents which Lorillard and other companies in the tobacco industry have asserted to be privileged. These documents were the subject of a March 7, 1998 ruling in the Reimbursement Case brought by the State of Minnesota, in which the judge ordered that the documents should be released on the basis of the crime/fraud exception. Defendants exhausted their remedies through the state's judicial system as well as the U.S. Supreme Court. On April 6, 1998, the U.S. Supreme Court denied defendants' application for a Stay and, in accordance with the March 7, 1998 ruling of the district court, such documents were released to plaintiffs in Minnesota. Also on April 6, 1998 and pursuant to the February 19, 1998 subpoena, documents were submitted to the Committee. The Committee subsequently made available on the Internet the vast majority of those documents.

Under the Proposed Resolution, Lorillard and the other companies in the tobacco industry agreed to establish an industry-funded document depository to allow public viewing of certain industry documents. In recent Congressional testimony, representatives of the tobacco companies offered to make tens of millions of pages of documents public prior to the enactment of any comprehensive legislation to demonstrate their commitment to the principles set forth in the Proposed Resolution. On February 27, 1998, Lorillard and other companies in the tobacco industry posted on the Internet the first installment of these documents for public access. In addition, the court in the Reimbursement Case brought by the State of Minnesota has granted defendants' request to allow public access to the document depository established in that case. The publicly available materials will not include

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documents containing trade secret information, certain personnel and third party information, or documents for which attorney-client privilege or work product doctrine claims have been asserted.

Tobacco industry documents have generated extensive media coverage

recently and have become a focal point in the litigation. The Company cannot predict the effect disclosure of these documents may have on pending litigation or Congressional consideration of the Proposed Resolution.

SETTLEMENTS OF REIMBURSEMENT CASES - In furtherance of the Proposed Resolution, Lorillard and other companies in the United States tobacco industry (the "Settling Defendants") have settled Reimbursement Cases brought by the States of Mississippi, Florida, Texas and Minnesota. The Mississippi action was settled in July 1997, Florida was settled in September 1997, Texas was settled in January 1998 and Minnesota was settled in May of 1998. Claims of Blue Cross and Blue Shield of Minnesota asserted against the Settling Defendants together with the state's claims in its lawsuit were separately settled as well. These settlements resulted in a pre-tax charge to earnings of \$163.4 million in the third and fourth quarter of 1997 and \$142.4 million (including \$126.0 million related to the settlement of litigation in Minnesota) in the first quarter of 1998.

Under the Mississippi settlement agreement, the Settling Defendants paid \$170.0 million representing Mississippi's estimated share of the \$10.0 billion initial payment under the Proposed Resolution, and paid an additional \$15.0 million to reimburse Mississippi and its private counsel for out-of-pocket costs. The Settling Defendants also paid approximately \$62.0 million to support a pilot program aimed at reducing the use of tobacco products by persons under the age of eighteen. Lorillard's share of all the foregoing payments, approximately \$19.5 million, was charged to expense in 1997.

Beginning December 31, 1998, the Settling Defendants will pay Mississippi amounts based on its anticipated share of the annual industry payments under the Proposed Resolution. These payments, which (except for the payment with respect to 1998) will be adjusted as provided in the Proposed Resolution, are estimated to be \$68.0 million with respect to 1998 and will increase annually thereafter to an estimated \$136.0 million by 2003, continuing at that level thereafter, and will be allocated among the Settling Defendants in accordance with their relative unit volume of domestic tobacco product sales.

Under the Florida settlement agreement, the Settling Defendants paid \$550.0 million, representing Florida's estimated share of the \$10.0 billion initial payment under the Proposed Resolution, and also reimbursed Florida's expenses and those of its private counsel. The Settling Defendants also paid \$200.0 million to support a pilot program by Florida aimed at reducing the use of tobacco products by persons under the age of eighteen. Lorillard's share of all the foregoing payments, approximately \$59.5 million, was charged to expense in 1997.

On September 15, 1998, and annually thereafter on December 31, the Settling Defendants will make ongoing payments to Florida in the following estimated amounts - 1998: \$220 million; 1999: \$247.5 million; 2000: \$275 million; 2001: \$357.5 million; 2002: \$357.5 million; and each year thereafter \$440 million. These amounts are projected to approximate that portion of the annual industry payments under the Proposed Resolution which is contemplated to be paid to Florida. These payments (except for the payment with respect to 1998) will be adjusted as provided in the Proposed Resolution and will be allocated among the Settling Defendants in accordance with their relative unit volume of domestic tobacco product sales.

Under the Texas settlement agreement, the Settling Defendants agreed to pay Texas an up-front payment of \$725.0 million in 1998, representing Texas's estimated share of the \$10.0 billion initial payment under the Proposed Resolution, and agreed to reimburse Texas and its private counsel for expenses

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in the estimated amount of \$45.0 million. The Settling Defendants also agreed to pay Texas \$264.0 million to support a pilot program aimed at reducing the use of tobacco by persons under the age of eighteen. Lorillard's share of all of the foregoing payments, approximately \$84.4 million, was charged to expense in 1997. Several counties and hospital districts in the State of Texas have moved to intervene in this action to amend and/or limit the operation of the court's judgment approving the settlement. In addition, the Governor of Texas has also moved to intervene and has filed a notice of appeal with respect to the judgment in this action. It is unclear what effect these actions would have upon the Texas settlement agreement.

Beginning in November and December 1998, and on December 31 of each subsequent year, the Settling Defendants will pay Texas 7.25% of the annual industry payments contemplated to be paid to the states under the Proposed Resolution. These payments, which (except for the payments with respect to

1998) will be adjusted as provided in the Proposed Resolution, will be in the following estimated amounts - 1998: \$290.0 million; 1999: \$326.0 million; 2000: \$363.0 million; 2001: \$471.0 million; 2002: \$471.0 million; and 2003 and each year thereafter: \$580.0 million. These payments will be allocated among the Settling Defendants in accordance with their relative unit volume of domestic tobacco product sales.

Under the Minnesota settlement, the Settling Defendants agreed to pay to the State of Minnesota a series of six payments over five years as follows: \$240 million by September 5, 1998; \$220.8 million by January 4, 1999; \$242.6 million by January 3, 2000; \$242.6 million by January 2, 2001; \$242.6 million by January 2, 2002; and \$121.6 million by January 2, 2003. The last four of these payments will be adjusted for inflation, changes in domestic sales volume, and, under specified circumstances increases in net operating profits from domestic sales. Lorillard's share of the payment due in September 1998 will be \$17.5 million; all remaining payments will be allocated pro rata among the Settling Defendants in accordance with their relative unit volume of domestic cigarette sales.

In the event a Settling Defendant defaults on its obligation to make timely payment of the above amounts, the remaining Settling Defendants may, in their absolute discretion, pay the missing payment to the state. If the remaining defendants elect not to satisfy the missing payment, each Settling Defendant can be required by the state to pay its share of the remaining payments scheduled above within 30 days of the default, subject to inflation and volume adjustments. The Settlement Agreement does not obligate any Settling Defendant to pay the share of another Settling Defendant. A similar provision applies to Blue Cross pursuant to their Settlement Agreement.

In addition, beginning on December 31, 1998, and on December 31 of each subsequent year, the Settling Defendants will make ongoing payments to the State of Minnesota in the following aggregate amounts: 1998 = \$102.0 million; 1999 = \$114.8 million; 2000 = \$127.5 million; 2001 = \$165.8 million; 2002 = \$165.8 million; and each year thereafter: \$204.0 million. Beginning with the 1999 payment, each payment will be adjusted for inflation and changes in domestic sales volume. These payments will be allocated pro rata among the Settling Defendants in accordance with their relative unit volume of domestic cigarette sales. Settling Defendants also have agreed to fund national cigarette research and tobacco control programs at an annual aggregate cost of \$10.0 million over the next ten years, such payments to be allocated pro rata in accordance with the Settling Defendants' relative unit volume of domestic cigarette sales.

In the event that there is a challenge to any provision of the settlement with the state by anyone other than the Attorney General of the State of Minnesota, Blue Cross or a Settling Defendant ("a third-party challenge"), any amounts required to be paid by the Settling Defendants pursuant to the settlement will be paid into escrow. If, as a result of such a challenge, any of certain material terms of the settlement are modified or rendered

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unenforceable, the state and Settling Defendants will negotiate an equivalent or comparable substitute term or other appropriate credit or adjustment. In the event that the parties are unable to agree on such a substitute term or appropriate credit or adjustment, then the parties will submit the issue to the Court for resolution, subject to any available appeal rights. In the event that any third-party challenge is not made until after December 31, 1998, the payments due the state in September 1998 and in January of 1999 through 2003 will be payable directly to the state regardless of such challenge, while other payments due under the settlement will be paid into escrow pending resolution of the challenge. In the event that the Court determines that there has been a failure of consideration legally sufficient to warrant termination of the settlement with the state, then the settlement may be terminated by the adversely affected party. In the event of such termination, the state's lawsuit will be reinstated.

Under the Minnesota Settlement, the Settling Defendants have also agreed to pay Blue Cross and Blue Shield of Minnesota separate payments of \$160.0 million by September 5, 1998; \$79.2 million by January 4, 1999; \$57.5 million by January 3, 2000; \$57.5 million by January 2, 2001; \$57.5 million by January 3, 2002; and \$57.5 million by January 2, 2003. The last four payments will be subject to inflation and volume adjustments. All payments to be made after 1998 will be allocated according to the Settling Defendants' relative unit volume of domestic cigarette sales.

Settling Defendants also agreed with the State of Minnesota among other things: (i) not to oppose passage of specified future legislative proposals or administrative rules in Minnesota regarding youth tobacco use, but retained the right to challenge such laws or rules if adopted; (ii) not to facially challenge the enforceability or constitutionality of existing

Minnesota tobacco control laws or to support legislation that would pre-empt Minnesota's rights under the settlement; (iii) to disclose specified future payments for lobbying or related purposes in the state; (iv) to cease billboard and transit advertisements of tobacco products in Minnesota; and (v) not to make payments for tobacco product placement in movies nationwide. The Settling Defendants also agreed to the entry of a consent judgment enjoining them from (a) offering or selling non-tobacco services or merchandise in Minnesota bearing the name or logo of a tobacco brand; (b) making any material misstatement of fact regarding the health consequences of using tobacco products; (c) entering into any contract, combination or conspiracy to limit health information or research into smoking and health or product development; and (d) taking any action to target children in Minnesota in the advertising, promotion or marketing of cigarettes. The Settling Defendants also agreed to disband the Council for Tobacco Research-U.S.A. Inc., and to maintain the Minnesota document depository at an industry expense for at least ten years.

The Settling Defendants have agreed to pay reasonable attorney's fees of private contingency fee counsel of Mississippi, Florida and Texas as set by a panel of independent arbitrators. Each of these payments would be allocated among the Settling Defendants in accordance with their relative unit volume of domestic tobacco product sales and will be subject to an aggregate national annual cap of \$500.0 million. Certain of Florida's private contingency fee counsel have challenged the attorneys' fees provision set forth in the Florida settlement agreement, arguing that the settlement agreement has no effect on their rights under their contingency fee agreement with Florida. In November 1997, the court ordered all parties to comply with the provisions for obtaining attorneys' fees, as set forth in the settlement agreement. Certain contingency fee counsel are appealing this ruling. One of these contingency fee counsel has filed suit against certain companies in the tobacco industry, although not Lorillard, alleging, among other things, tortious interference with such counsel's contingency fee agreement with the State.

Under the Minnesota settlement, the Settling Defendants have, in addition, agreed to pay attorneys fees of private counsel for the State in the amount of \$440.8 million, payable in the following installments: \$74.8 million on

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September 5, 1998; \$100.0 million on January 31, 1999; \$100.0 million on April 15, 1999; \$100.0 million on January 31, 2000; and \$66.1 million on July 1, 2000. Settling Defendants also agreed to pay \$4.0 million in costs to the State's attorneys on May 18, 1998. In addition, Settling Defendants have agreed to pay attorneys fees of private counsel for Blue Cross in the amount of \$117.3 million, to be paid as follows: \$60.0 million on July 1, 1998; and \$57.3 million on September 4, 1998; as well as costs of \$4.0 million, payable on May 18, 1998. These payments will be allocated pro rata among the Settling Defendants' relative unit volume of domestic cigarette sales. The attorneys fee payments to be made pursuant to the Minnesota settlement are not subject to, and do not count against, the \$500 million annual cap on attorneys fees applicable to the Mississippi, Florida and Texas settlements.

If legislation implementing the Proposed Resolution or its substantial equivalent is enacted, the settlements with Mississippi, Florida and Texas will remain in place, but the terms of the federal legislation will supersede these settlement agreements (except for the terms of the pilot programs and payments thereunder, the initial payments and the annual payments with respect to 1998), and the other payments described above will be adjusted so that Mississippi, Florida and Texas will receive the same payments as they would receive under such legislation. The settlement with the State of Minnesota provides that enactment of federal tobacco-related legislation, if any, will not affect the payments required to be made pursuant to that settlement except as follows: if federal tobacco-related legislation resolving State Attorney General health care cost recovery actions is enacted on or before November 30, 2000, and if such legislation provides for payments by tobacco companies (whether by settlement payment, tax or any other means), all or part of which is made available to states, the State of Minnesota must elect to receive any funds that are (i) unrestricted as to their use, or (ii) are restricted to any form of health care or to any use related to tobacco (collectively "Federal Settlement Funds"), and the Settling Defendants will receive a dollar-for-dollar offset of Federal Settlement Funds against ongoing payments up to the full amount of such payments, provided however, that (i) there will be no offset on account of any federal program, subsidies, payments, credits or other aid to the state that are not conditioned or tied to the settlement of a state tobacco-related suit or the relinquishment of state tobacco-related claims; (ii) the state relinquishes no rights or benefits under the Settlement Agreement except for payments subject to the offset; (iii) there are no federally imposed preconditions to the receipt of Federal Settlement Funds

other than the settlement of any state tobacco-related lawsuit or the relinquishment of state tobacco-related claims, actions or expenditures related to tobacco, including but not limited to, education, cessation, control or enforcement, or actions or expenditures related to health care; (iv) if the Settling Defendants enter into any pre-verdict settlement agreement of similar litigation brought by a non-federal governmental plaintiff that does not require such an offset, the foregoing offset will be null and void; and (v) if the Settling Defendants enter into any pre-verdict settlement agreement of similar litigation brought by a non-federal governmental plaintiff that has an offset term more favorable to the plaintiff, the Settlement Agreement will, at the option of the state, be revised to include a comparable term. Nothing in the Settlement Agreement will reduce the total amounts payable to the state thereunder beyond the amount of Federal Settlement Funds actually received by Minnesota.

If the Settling Defendants enter into any future pre-verdict settlement agreement of similar litigation on terms more favorable to a non-federal governmental plaintiff, the settlement with the State of Minnesota will not otherwise be revised except to the extent such future settlement agreement provides for joint and several liability for monetary payments, for a parent company guaranty or other credit assurance, or for the implementation of different non-economic tobacco-related public health measures.

Counsel for Lorillard have to date been contacted by counsel for the States of Texas, Florida and Mississippi seeking to discuss the issue of what effect,

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if any, the Minnesota settlement has upon the terms of the prior settlements with those states pursuant to the "most favored nation" provision of those prior state settlements. That provision provides that, in the event the Settling Defendants enter into a subsequent pre-verdict settlement with a non-federal governmental entity on terms more favorable to such entity than the terms of the prior state settlement (after due consideration of relevant differences in population or other appropriate factors), the terms of the prior state settlement will be revised to provide treatment at least as relatively favorable. Lorillard cannot presently determine what the result of any discussions with Texas, Florida or Mississippi regarding the Most Favored Nation provision may be, nor can it determine what the result of any litigation with any of those states concerning that issue may be. A determination of this issue adverse to Lorillard could result in an obligation on the part of Lorillard to make additional substantial payments to one or more of those states. The Company cannot estimate at this time the effect such claims may have on the Company's results of operations or financial condition.

If the federal legislation implementing the Proposed Resolution or its substantial equivalent is enacted, the parties contemplate that Mississippi, Florida and Texas and any other state that has made an exceptional contribution to secure resolution of these matters (excluding Minnesota) may apply to a panel of independent arbitrators for reasonable compensation for its efforts in securing the Proposed Resolution. The Settling Defendants have agreed not to oppose applications for \$75.0 million by Mississippi, \$250.0 million by Florida and \$329.5 million by Texas, subject to a nationwide annual cap for all such payments of \$100.0 million. There is no such provision in the Minnesota settlement.

Finally, the settlement agreements provide that they are not an admission or concession or evidence of any liability or wrongdoing on the part of any party, and were entered into by the Settling Defendants solely to avoid the further expense, inconvenience, burden and uncertainty of litigation.

LIGGETT SETTLEMENT - Liggett Group, Inc. and its parent company, Brooke Group, Ltd., Inc. ("Liggett"), and the Attorneys General for a total of 40 states, have announced that they have reached agreements (the "Liggett Settlements") to settle the reimbursement claims made by those states. The proposed settlements reportedly will require Liggett: to make one-time payments to each of the settling states in an amount of as much as \$1.0 million; to pay to the settling states an aggregate percentage of as much as 30% of its pre-tax profits annually for the next 25 years; to acknowledge that cigarette smoking is addictive (Liggett has supplemented the warning notices it places on its cigarette packages to reflect that acknowledgment); to acknowledge that cigarette smoking causes disease; to acknowledge that cigarette companies have targeted marketing programs towards minors; and to cooperate in suits against the other cigarette manufacturers by releasing Liggett documents to the Attorneys General and to allow its employees to testify in these matters. The Liggett Settlements also purport to be on behalf of "all persons who, prior to or during the term of [the Liggett Settlements], have smoked cigarettes or have used other tobacco products and have suffered or claim to have suffered injury as a consequence thereof."

Pursuant to the Liggett Settlements described above, Liggett has submitted numerous documents from its files to courts and defendants in several of the Reimbursement Cases and in other cases as well. Liggett has also served descriptive logs of such documents on counsel for plaintiffs and defendants in those cases. Defendants have reviewed the Liggett logs and the Liggett documents to determine which Liggett documents are subject to a joint-defense privilege claim by other defendants.

DEFENSES - One of the defenses raised by Lorillard in certain cases is preemption by the Federal Cigarette Labeling and Advertising Act (the "Labeling Act"). In the case of Cipollone v. Liggett Group, Inc., et al., the United States Supreme Court, in a plurality opinion issued on June 24, 1992,

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held that the Labeling Act as enacted in 1965 does not preempt common law damage claims but that the Labeling Act, as amended in 1969, does preempt claims against tobacco companies arising after July 1, 1969, which assert that the tobacco companies failed to adequately warn of the alleged health risks of cigarettes, sought to undermine or neutralize the Labeling Act's mandatory health warnings, or concealed material facts concerning the health effects of smoking in their advertising and promotion of cigarettes. The Supreme Court held that claims against tobacco companies based on fraudulent misrepresentation, breach of express warranty, or conspiracy to misrepresent material facts concerning the alleged health effects of smoking are not preempted by the Labeling Act. The Supreme Court in so holding did not consider whether such common law damage actions were valid under state law. The effect of the Supreme Court's decision on pending and future cases against Lorillard and other tobacco companies will likely be the subject of further legal proceedings. Additional litigation involving claims such as those held to be preempted by the Supreme Court in Cipollone could be encouraged if legislative proposals to eliminate the federal preemption defense, pending in Congress since 1991, are enacted. It is not possible to predict whether any such legislation will be enacted.

Lorillard believes that it has a number of defenses to pending cases, in addition to defenses based on preemption described above, and Lorillard will continue to maintain a vigorous defense in all such litigation. These defenses, where applicable, include, among others, statutes of limitations or repose, assumption of the risk, comparative fault, the lack of proximate causation, and the lack of any defect in the product alleged by a plaintiff. Lorillard believes that some or all of these defenses may, in many of the pending or anticipated cases, be found by a jury or court to bar recovery by a plaintiff. Application of various defenses, including those based on preemption, are likely to be the subject of further legal proceedings in the Class Action cases and in the Reimbursement Cases.

Other Legal Proceedings: In September 1997, a purported class action was commenced by private plaintiffs in Alabama state court alleging that the U.S. tobacco companies and others conspired to fix cigarette prices in Alabama, that agreements leading to price increases were reached during the negotiations leading to the Proposed Resolution, and that prices were increased pursuant to the alleged conspiracy in 1997 (Mosley, et al. v. Philip Morris Companies Inc., et al.). The parties have settled this action for a payment by defendants in an aggregate amount approximating sixty thousand dollars to cover costs incurred by plaintiff's counsel.

Department of Justice Investigation - Early in 1994, the Energy and Commerce Subcommittee on Health and the Environment of the U.S. House of Representatives (the "Subcommittee") launched an oversight investigation into tobacco products, including possible regulation of nicotine-containing cigarettes as drugs. During the course of such investigation, the Subcommittee held hearings at which executives of each of the major tobacco manufacturers testified. Following the November 1994 elections, the incoming Chairman of the Energy and Commerce Committee indicated that this investigation by the Subcommittee would not continue, and on December 20, 1994, the outgoing majority staff of the Subcommittee issued two final reports. One of these reports questioned the scientific practices of what it characterized as the tobacco industry's "long-running campaign" related to ETS, but reached no final conclusions. The second report asserted that documents obtained from American Tobacco Company, a competitor of Lorillard's, "reflect an intense research and commercial interest in nicotine."

The U.S. Department of Justice is investigating allegations of perjury in connection with the testimony provided by tobacco industry executives, including Lorillard executives, to the Subcommittee in April 1994. Lorillard has not received any request for documents or testimony. It is impossible at this time to predict the outcome of this investigation.

In 1996 Lorillard responded to a grand jury subpoena for documents in connection with a grand jury investigation commenced in 1992 by the United States Attorney's Office for the Eastern District of New York regarding possible fraud by Lorillard and other tobacco companies relating to smoking and health research undertaken or administered by the Council for Tobacco Research - USA, Inc. There have been no requests for any testimony by any Lorillard personnel. At the present time, Lorillard is unable to predict whether the United States Attorney's Office will ultimately determine to bring any proceeding against Lorillard. An adverse outcome of this investigation could result in criminal, administrative or other proceedings against Lorillard.

In March 1996, the Company and Lorillard each received a grand jury subpoena duces tecum from the United States Attorney's Office for the Southern District of New York seeking documents, advertisements or related materials distributed by the Company and Lorillard to members of the general public relating to, among other things, the health effects of cigarettes, nicotine or tobacco products, the addictiveness of such products, and Congressional hearings relating to cigarettes or the tobacco industry. The Company and Lorillard responded to the subpoena. The Company and Lorillard were informed in the latter part of 1996 that responsibility for this investigation has been transferred from the United States Attorney's Office for the Southern District of New York to the United States Department of Justice in Washington, D.C. It is impossible at this time to predict the ultimate outcome of this investigation.

While Lorillard intends to defend vigorously all smoking and health related litigation which may be brought against it, it is not possible to predict the outcome of any of this litigation. Litigation is subject to many uncertainties, and it is possible that some of these actions could be decided unfavorably.

Many of the recent developments in relation to smoking and health discussed above have received wide-spread media attention including the release of documents by the industry. These developments may reflect adversely on the tobacco industry and could have adverse effects on the ability of Lorillard and other cigarette manufacturers to prevail in smoking and health litigation.

Except for the effect of the Proposed Resolution if implemented as described above, management is unable to make a meaningful estimate of the amount or range of loss that could result from an unfavorable outcome of pending litigation. It is possible that the Company's results of operations or cash flows in a particular quarterly or annual period or its financial position could be materially affected by an unfavorable outcome of certain pending litigation.

Other Litigation -- The Company and its subsidiaries are also parties to other litigation arising in the ordinary course of business. The outcome of this other litigation will not, in the opinion of management, materially affect the Company's results of operations or equity.

6. In the opinion of Management, the accompanying consolidated condensed financial statements reflect all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position as of March 31, 1998 and December 31, 1997 and the results of operations and changes in cash flows for the three months ended March 31, 1998 and 1997, respectively.

Results of operations for the first three months of each of the years is not necessarily indicative of results of operations for that entire year.

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

Liquidity and Capital Resources:

Insurance

Property and casualty and life insurance operations are conducted through subsidiaries of CNA Financial Corporation ("CNA"). CNA is an 84% owned subsidiary of the Company.

For the first three months of 1998, statutory surplus of the property and casualty insurance subsidiaries was approximately \$7.0 billion, compared to approximately \$7.1 billion on December 31, 1997. The statutory surplus of the life insurance subsidiaries remained at approximately \$1.2 billion.

The liquidity requirements of CNA have been met primarily by funds generated from operating, investing and financing activities. The principal cash flow sources of CNA's property and casualty and life insurance subsidiaries are premiums, investment income, and sales and maturities of investments. The primary operating cash flow uses are payments for claims, policy benefits and operating expenses.

For the first three months of 1998, CNA's operating activities reflect net negative cash flows of approximately \$240.6 million, compared to negative cash flows of \$737.5 million in 1997. CNA had substantially lower operating cash flow in 1997, primarily due to claim payments resulting from the settlement of the Fibreboard litigation.

Net cash flows from operations are invested in marketable securities. Investment strategies employed by CNA's insurance subsidiaries consider the cash flow requirements of the insurance products sold and the tax attributes of the various types of marketable investments.

CNA and the insurance industry are exposed to liability for environmental pollution, primarily related to toxic waste site clean-up. See Note 5 of the Notes to Consolidated Condensed Financial Statements for further discussion of environmental pollution exposures.

On January 8, 1998, CNA issued \$150.0 million principal amount of 6.45% senior notes due January 15, 2008 and \$150.0 million principal amount of 6.95% senior notes due January 15, 2018. The net proceeds were used to pay down bank loans drawn under a revolving credit facility. Concurrent with the reduction in bank debt, CNA terminated \$300.0 million notional amount of interest rate swaps.

On April 15, 1998, CNA issued \$500.0 million principal amount of 6.50% senior notes due April 15, 2005. The net proceeds were used to refinance the existing bank debt outstanding under CNA's revolving credit facility and to refinance a portion of CNA's outstanding commercial paper.

Cigarettes - - - - -

Lorillard, Inc. and subsidiaries ("Lorillard"). Lorillard, Inc. is a wholly owned subsidiary of the Company.

Lorillard and other cigarette manufacturers continue to be confronted with an increasing level of litigation and regulatory issues.

The volume of lawsuits against Lorillard and other manufacturers of tobacco

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products seeking damages for cancer and other health effects claimed to have resulted from an individual's use of cigarettes, addiction to smoking, or exposure to environmental tobacco smoke has increased substantially through 1997 and in 1998. See Note 5 of the Notes to Consolidated Condensed Financial Statements. In a number of cases, the Company is named as a defendant. Tobacco litigation includes claims brought by individual plaintiffs and claims brought as class actions on behalf of a large number of individuals for damages allegedly caused by smoking; and claims brought on behalf of governmental entities, private citizens, or other organizations seeking reimbursement of health care costs allegedly incurred as a result of smoking. In addition, claims have been brought against Lorillard seeking damages resulting from exposure to asbestos fibers which had been incorporated, for a limited period of time, ending more than forty years ago, into filter material used in one brand of cigarettes manufactured by Lorillard. In the foregoing actions, plaintiffs claim substantial compensatory and punitive damages in amounts ranging into the billions of dollars.

In 1997, Lorillard, together with other companies in the United States tobacco industry, reached agreements to settle certain tobacco related litigation. See "Settlements of Reimbursement Cases" and "Broin v. Philip Morris Companies, Inc. et al." in Note 5 of the Notes to Consolidated Condensed Financial Statements.

FDA Regulations

The Food and Drug Administration ("FDA") has published regulations (the "FDA Regulations") severely restricting cigarette advertising and promotion and limiting the manner in which tobacco products can be sold. The FDA premised its

regulations on the need to reduce smoking by underage youth and young adults. The FDA Regulations include:

- (i) Regulations making unlawful the sale by retail merchants of cigarettes to anyone under age 18. These regulations also require retail merchants to request proof of age for any person under age 27 who attempts to purchase cigarettes.
- (ii) Regulations limiting all cigarette advertising to a black and white, text only format in most publications and outdoor advertising such as billboards, regulations prohibiting billboards advertising cigarettes within 1,000 feet of a school or playground, banning the use of cigarette brand names, logos and trademarks on premium items and prohibiting the furnishing of any premium item in consideration for the purchase of cigarettes or the redemption of proofs-of-purchase coupons.
- (iii) Regulations prohibiting the use of cigarette brand names to sponsor sporting and cultural events.

Lorillard and other cigarette manufacturers have filed a lawsuit, *Coyne Beahm, Inc., et al. v. United States Food & Drug Administration, et al.*, in the United States District Court for the Middle District of North Carolina challenging the FDA's assertion of jurisdiction over cigarettes. The Court granted, in part, and denied, in part, plaintiffs' motion for summary judgment. The Court held that if an adequate factual foundation is established, the FDA has the authority to regulate tobacco products as medical devices under the Federal Food, Drug & Cosmetic Act, may impose restrictions regarding access to tobacco products by persons under the age of 18, and may impose labeling requirements on tobacco products' packaging. The Court, however, also held that the FDA is not authorized to regulate the promotion or advertisement of tobacco products. The Court also stayed the effective date for the FDA Regulations relating to advertising and promotion of tobacco products, but allowed the access restrictions to take effect as of February 27, 1997. Both the plaintiffs and the defendants have filed an appeal of the District Court's ruling to the Fourth Circuit Court of Appeals, and oral arguments are scheduled to be heard by that Court on June 8, 1998.

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Proposed Resolution of Certain Regulatory and Litigation Issues

On June 20, 1997, Lorillard, together with other companies in the United States tobacco industry, entered into a Memorandum of Understanding to support the adoption of federal legislation and any necessary ancillary undertakings, incorporating the features described in the proposed resolution attached to the Memorandum of Understanding (together, the "Proposed Resolution"). The Proposed Resolution would permit extensive regulation of the industry by the FDA and would impose large monetary obligations on the industry to be paid to the federal government and to the states. The Proposed Resolution would require the manufacturers to sign private contracts, or Protocols, which embody significant restrictions on the industry's commercial free speech advertising. In return, the Proposed Resolution would resolve much of the industry's litigation and establish a rational litigation system for future lawsuits. The Proposed Resolution, by the nature of its terms, could be implemented only by federal legislation. Incorporated by reference into this filing is the discussion of the Proposed Resolution in the Company's annual report on Form 10-K for the year ended December 31, 1997.

Since the Proposed Resolution was announced, it has been the subject of intense review and criticism by the White House, the public health community, and other interested parties. Certain members of Congress have offered, or indicated that they intend to offer, alternative legislation. No bill introduced would adopt the Proposed Resolution as agreed to. Over 50 bills have been introduced in Congress regarding the issues raised in the Proposed Resolution, including bills seeking more stringent regulation of tobacco products by the Food and Drug Administration and more punitive monetary payments by the companies. One particular bill initially introduced by Senator John McCain from Arizona, has been approved by the Senate Commerce Committee on April 1, 1998, by a 19-1 vote, as approved, the "McCain bill."

The McCain bill includes, among other things, provisions regarding FDA regulation, licensing of tobacco manufacturers and retailers, surcharges against the industry for failure to achieve underage smoking reduction goals, advertising restrictions and labeling requirements, industry payments, smoking restrictions, civil liability limitations, a method for determining the amount and payment of attorneys' fees, and public disclosure of industry documents.

Monetary Penalties: Under the McCain bill, five companies, including Lorillard, would be responsible for the initial lump sum payment of \$10.0 billion. Lorillard's share would be 7.1% of the \$10.0 billion payment. Annual payments would begin in the calendar year following enactment. The base figures

would be: \$14.4 billion in Year 1, \$15.4 billion in Year 2, \$17.7 billion in Year 3, \$21.0 billion in Year 4, \$23.6 billion in Year 5, and \$21.0 billion in Year 6 and thereafter. The first six years of payments will not be adjusted for volume reductions. The annual payments are to be allocated among manufacturers on the basis of relative domestic sales volume.

Surcharges for Failure to Achieve Underage Smoking Reduction Goals: The McCain bill imposes substantial surcharges on the industry if statutorily required reductions in underage smoking are not achieved within specified time periods. There is an annual cap of \$3.5 billion, and assessments are not tax deductible. If the usage reduction target is missed by more than 20 percentage points, the company or companies that manufacture the missed brands automatically lose their annual liability caps included in the bill.

Civil Liability: The McCain bill includes a \$6.5 billion cap on yearly civil liability payments. The McCain civil liability payments are not adjusted for volume declines, and are not credited against the annual monetary payments discussed above. The cap system settles all addiction claims, all claims brought by State Attorneys General, and lawsuits brought by states, counties, cities and other political entities (except for the United States). The McCain bill includes no limits on punitive damages for alleged past conduct or for post-Act conduct that does not comply with the Act. Class actions would remain available under the

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legislation. There are numerous ways that a participating manufacturer could lose these very limited civil liability protections.

Advertising Restrictions: The McCain bill would enact into law the FDA Regulations discussed above, and goes beyond the FDA in that it imposes additional restrictions on advertising through a Protocol mechanism that manufacturers would be required to sign in order to receive the benefit of the bill's limited civil liability restrictions.

FDA Regulation: Under the McCain bill, tobacco products would be regulated pursuant to a separate chapter of the Food, Drug and Cosmetic Act. The agency would have authority to immediately require additional testing or modification of a tobacco product if the agency finds that it would protect public health. This includes the authority to ban tobacco products without approval from Congress.

Environmental Tobacco Smoke ("ETS"): The McCain bill would establish national standards for any building (other than restaurants (non-fast food), bars, private clubs, hotel rooms and common areas, casinos, bingo parlors, tobacco shops and prisons) regularly entered by 10 or more individuals at least one day per week. Federal, state or local laws that provide greater protection from ETS would not be pre-empted.

On April 18, 1998, Lorillard, along with the other signatory companies to the Proposed Resolution, announced a withdrawal from the legislative process to enact a comprehensive tobacco settlement. Lorillard remains committed to the Proposed Resolution, but does not believe that the current political process in Washington can produce legislation that is fair to the industry.

For information with respect to these matters, as well as with respect to discussions regarding an attempt to achieve a comprehensive legislative resolution to litigation and regulatory issues affecting the United States tobacco industry, see Note 5 of the Notes to Consolidated Condensed Financial Statements.

Proposed Excise Tax Increases

The United States federal excise tax on cigarettes is presently \$12 per 1,000 cigarettes (\$0.24 per pack of 20 cigarettes). In early August of 1997, the United States Congress approved and the President signed into law an increase in the federal excise tax on cigarettes of \$7.50 per 1,000 cigarettes (\$0.15 per pack of 20 cigarettes). This increase is phased in at a rate of \$5.00 per 1,000 cigarettes in the year 2000 and an additional \$2.50 per 1,000 cigarettes in the year 2002. Various states have proposed, and certain states have recently passed, increases in their state tobacco excise taxes. Such actions may adversely affect Lorillard's volume, operating revenues and operating income.

Hotels - - - - -

Loews Hotels Holding Corporation and subsidiaries ("Loews Hotels"). Loews Hotels Holding Corporation is a wholly owned subsidiary of the Company.

Funds from operations continue to exceed operating requirements. Loews Hotels has entered into an agreement with the owners of the Universal Florida resort to

develop hotels at the resort. Capital expenditures in relation to the Universal Florida hotel project are expected to be funded by a combination of equity contributions by the development partners and mortgages. Loews Hotels expects to obtain its share of the equity contributions for the development and acquisition of hotels (anticipated to amount to approximately \$138.0 million during the next three years for existing development projects) under arrangements with the Company.

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Offshore Drilling - - - - -

Diamond Offshore Drilling, Inc. and subsidiaries ("Diamond Offshore"). Diamond Offshore Drilling, Inc. is a 50.3% owned subsidiary of the Company.

Diamond Offshore continues to benefit from increased demand and from the tight supply of major offshore drilling rigs worldwide. These conditions are due, in part, to the impact of technological advances, including 3-D seismic, horizontal drilling, and subsea completion procedures, on oil and gas exploration and development economics. To address the current tight supply situation, customers seek to contract rigs for term commitments (as opposed to contracts for the drilling of a single well or a group of wells) in many cases, and often will pay for upgrades and modifications necessary for more challenging drilling locations in order to assure rig availability. Diamond Offshore seeks to have a foundation of long-term contracts with a reasonable balance of short-term or well-to-well contracts to minimize risk while participating in the benefit of increasing dayrates in a rising market.

For the first three months of 1998, Diamond Offshore's cash provided by operating activities amounted to \$119.9 million, compared to \$73.7 million in 1997. The significant improvement in operating cash flow reflects the current conditions in the offshore drilling industry, namely improved dayrates and an increasing number of term contracts for rigs in certain markets.

Diamond Offshore continues to enhance its fleet to meet customer demand for diverse drilling capabilities, including those required for deep water and harsh environment operations. Diamond Offshore expects to spend approximately \$108.5 million during 1998 for rig upgrades. Diamond Offshore expended \$20.3 million, including capitalized interest expenses, for significant rig upgrades during the three months ended March 31, 1998. The rig upgrade projects include the conversion of an accommodation vessel to a semisubmersible drilling unit capable of operating in harsh environments and ultra-deep water. Upon completion of the conversion, the rig will begin a five year commitment in the Gulf of Mexico, which is anticipated to commence in late 1999. In addition, leg strengthening and other modifications for another jack-up rig operating in the Gulf of Mexico are anticipated to be completed in the first half of 1998. Diamond Offshore has also budgeted \$126.7 million for 1998 capital expenditures associated with its continuing rig enhancement program, spare equipment and other corporate requirements. These expenditures include purchases of anchor chain, drill pipe, riser, and other drilling equipment. During the first quarter of 1998, \$16.8 million was expended on this program.

The cash required to fund rig upgrades and Diamond Offshore's continuing rig enhancement program is anticipated to be provided by its operating cash flow, as well as available cash on hand.

Diamond Offshore completed the upgrade of the Ocean Clipper I in July 1997, however, the drillship has continued to experience certain subsea system difficulties primarily associated with new technology for operations in deep water as well as difficulties with the vessel's thrusters. While the drillship is operating under its drilling contract in the Gulf of Mexico, Diamond Offshore continues to participate in developing design revisions that will provide long-term benefits to the affected systems. Results of operations are likely to be adversely impacted by additional downtime from such difficulties, but Diamond Offshore cannot predict the extent of such adverse impact.

In February 1998, a fire was detected in the engine room of the Ocean Victory, which was operating in the Gulf of Mexico. Although the fire was contained and extinguished, damage was done to the power and electrical systems aboard the rig. The rig is currently in the shipyard for necessary repairs, which are expected to be completed by mid-1998. Diamond Offshore expects that its insurance will cover the cost of such repairs, however the loss of revenue during the repair period is not covered by insurance. As a result, the loss of revenues will reduce Diamond

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Offshore's results of operations for 1998.

The ability to minimize costs and downtime is critical to Diamond Offshore's

results of operations. The improved opportunities for the offshore contract drilling industry worldwide have resulted in increased demand for and a shortage of experienced personnel and equipment, including drill pipe and riser, necessary on offshore drilling rigs. Diamond Offshore does not consider the shortage of such personnel and equipment currently to be a material factor in its business. However, because of the increased demand for oil field services, a significant increase in costs, including compensation and training, may occur if present trends continue for an extended period. In addition, because of periodic inspections required by certain regulatory agencies, 15 of Diamond Offshore's rigs will be in the shipyard for a portion of 1998. At March 31, 1998, five of these 15 inspections were completed and one was in progress. Diamond Offshore intends to focus on returning these rigs to operations as soon as reasonably possible, in order to minimize the downtime and associated loss of revenues.

In addition, the recent improvement in the current results of operations and prospects for the offshore contract drilling industry as a whole has led to increased rig construction and enhancement programs by Diamond Offshore's competitors. A significant increase in the supply of technologically advanced rigs capable of drilling in deep water may have an adverse effect on the average operating dayrates for Diamond Offshore's rigs, particularly its more advanced semisubmersible units, and on the overall utilization level of Diamond Offshore's fleet. In such case, Diamond Offshore's results of operations would be adversely affected.

The offshore contract drilling industry historically has been highly competitive and cyclical and although not currently a material factor in Diamond Offshore's markets, weak commodity prices, economic problems in countries outside the United States, or a number of other influencing factors could curtail spending by oil and gas companies and possibly depress the offshore drilling industry. Therefore, Diamond Offshore cannot predict whether and, if so, to what extent, current market conditions will continue.

Watches and Clocks

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Bulova Corporation and subsidiaries ("Bulova"). Bulova Corporation is a 97% owned subsidiary of the Company.

Funds from operations continue to exceed operating requirements. Bulova's cash and cash equivalents, and investments amounted to \$47.0 million at March 31, 1998, as compared to \$29.1 million at December 31, 1997. Funds for other capital expenditures and working capital requirements are expected to be provided from operations.

Investments:

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Investment activities of non-insurance companies include investments in fixed income securities, equity securities including short sales, derivative instruments and short-term investments. Equity securities, which are considered part of the Company's trading portfolio, short sales and derivative instruments are marked to market and reported as investment gains or losses in the income statement. The remaining securities are carried at fair value with a net unrealized loss of \$4.0 and \$3.2 million at March 31, 1998 and December 31, 1997, respectively.

The Company enters into short sales and invests in certain derivative instruments for a number of purposes, including: (i) for its asset and liability management activities, (ii) for income enhancements for its portfolio management strategy, and (iii) to benefit from anticipated future movements in the underlying markets that Company management expects to occur. If such movements do

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not occur or if the market moves in the opposite direction from what management expects, significant losses may occur.

Monitoring procedures include senior management review of daily detailed reports of existing positions and valuation fluctuations to ensure that open positions are consistent with the Company's portfolio strategy.

The credit exposure associated with these instruments is generally limited to the positive market value of the instruments and will vary based on changes in market prices. The Company enters into these transactions with large financial institutions and considers the risk of nonperformance to be remote.

The Company does not believe that any of the derivative instruments utilized by it are unusually complex or volatile, nor do these instruments contain imbedded leverage features which would expose the Company to a higher degree of risk. See "Results of Operations" and "Quantitative and Qualitative Disclosures

about Market Risk" for additional information with respect to derivative instruments, including recognized gains and losses on these instruments. See also Note 4 of the Notes to Consolidated Financial Statements in the 1997 Annual Report on Form 10-K.

Insurance - - - - -

A summary of CNA's general account fixed maturity securities portfolio and short-term investments, at carrying value, are as follows:

| | March 31, 1998 | December 31, 1997 | Change in Unrealized Gains (Losses) |
|---|-------------------|----------------------|--|
| ----- | | | |
| (In millions) | | | |
| Fixed income securities: | | | |
| U.S. Treasury securities and obligations of government agencies . | \$12,373.0 | \$12,980.0 | \$ (37.0) |
| Asset-backed securities | 5,370.0 | 4,804.0 | (8.0) |
| Tax exempt securities | 5,148.0 | 4,724.0 | (37.0) |
| Taxable | 6,906.0 | 7,040.0 | 24.0 |
| ----- | | | |
| Total fixed income securities .. | 29,797.0 | 29,548.0 | (58.0) |
| Stocks | 982.0 | 814.0 | 62.0 |
| Short-term and other investments..... | 5,926.0 | 5,829.0 | (34.0) |
| Derivative security investments | 11.0 | 12.0 | |
| ----- | | | |
| Total | \$36,716.0 | \$36,203.0 | \$ (30.0) |
| ===== | | | |
| Short-term investments: | | | |
| Commercial paper | \$ 2,064.0 | \$ 1,850.0 | |
| Security repurchase collateral | 548.0 | 154.0 | |
| Escrow | 990.0 | 1,065.0 | |
| Others | 1,293.0 | 1,815.0 | |
| Other investments | 1,042.0 | 957.0 | |
| ----- | | | |
| Total short-term and other investments | \$ 5,937.0 | \$ 5,841.0 | |
| ===== | | | |

CNA's general account investment portfolio is managed to maximize after tax

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investment return, while minimizing credit risks, with investments concentrated in high quality securities to support its insurance underwriting operations.

CNA has the capacity to hold its fixed maturity portfolio to maturity. However, securities may be sold as part of CNA's asset/liability strategies or to take advantage of investment opportunities generated by changing interest rates, tax and credit considerations, or other similar factors. Accordingly, the fixed maturity securities are classified as available for sale.

CNA invests from time to time in certain derivative financial instruments primarily to reduce its exposure to market risk (principally interest rate, equity price and foreign currency risk). CNA also uses derivatives to mitigate the risk associated with its indexed group annuity contract by purchasing S&P 500 futures contracts in a notional amount equal to the original customer deposit.

CNA considers its derivatives as being held for purposes other than trading. Derivative securities, except for interest rate swaps associated with certain corporate borrowings, are recorded at fair value at the reporting date with changes in market value reflected in investment gains and losses. The interest rate swaps on corporate borrowings are accounted for on the accrual basis with the related income or expense recorded as an adjustment to interest expense.

The general account portfolio consists primarily of high quality (BBB or higher) marketable fixed maturity securities, approximately 95.6% of which are rated as investment grade. At March 31, 1998, tax exempt securities and short-term investments excluding collateral for securities sold under repurchase agreements, comprised approximately 14.0% and 11.8%, respectively, of the general account's total investment portfolio compared to 13.1% and 13.1%, respectively, at December 31, 1997. Historically, CNA has maintained short-term

assets at a level that provided for liquidity to meet its short-term obligations, as well as reasonable contingencies and anticipated claim payout patterns. Short-term investments at both March 31, 1998 and December 31, 1997 are substantially higher than historical levels in anticipation of additional Fibreboard-related claim payments. The increase in short-term investments at March 31, 1998 compared to December 31, 1997, is due to increased collateral related to security repurchase transactions. Collateral for securities sold under repurchase agreements increased \$394.0 million to \$548.0 million. At March 31, 1998, the major components of the short-term investment portfolio consist primarily of high grade commercial paper and U.S. Treasury bills.

As of March 31, 1998, the market value of CNA's general account investments in fixed maturities was \$29.8 billion and was greater than amortized cost by approximately \$470.0 million. This compares to a market value of \$29.5 billion and \$528.0 million of net unrealized investment gains at December 31, 1997. The gross unrealized investment gains and losses for the fixed maturity securities portfolio at March 31, 1998, were \$579.0 and \$109.0 million, respectively, compared to \$644.0 and \$116.0 million, respectively, at December 31, 1997. The decline in unrealized investment gains is attributable, in large part, to CNA taking advantage of favorable market conditions by selling securities and recognizing investment gains.

Net unrealized investment gains on general account fixed maturities at March 31, 1998 include net unrealized investment gains on high yield securities of \$31.0 million, compared to net unrealized investment losses of \$2.0 million at December 31, 1997. High yield securities are bonds rated as below investment grade by bond rating agencies, plus private placements and other unrated securities which, in the opinion of management, are below investment grade (below BBB). Fair values of high yield securities in the general account decreased \$200.0 million to approximately \$1.3 billion at March 31, 1998 when compared to December 31, 1997.

At March 31, 1998, total Separate Account cash and investments amounted to approximately \$5.6 billion with taxable fixed maturity securities representing approximately 80% of the Separate Accounts' portfolios. Approximately 70.6% of

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Separate Account investments are used to fund guaranteed investments for which CNA's life insurance affiliate guarantees principal and a specified return to the contract holders. The duration of fixed maturity securities included in the guaranteed investment portfolio are matched approximately with the corresponding payout pattern of the liabilities of the guaranteed investment contracts. The fair value of all fixed maturity securities in the guaranteed investment portfolio was \$3.6 billion at March 31, 1998 and \$3.8 billion at December 31, 1997. At March 31, 1998, amortized cost was less than fair value by approximately \$88.0 million, as compared to approximately \$71.0 million at December 31, 1997. The gross unrealized investment gains and losses for the guaranteed investment fixed maturity securities portfolio at March 31, 1998 were \$102.0 and \$14.0 million, respectively, as compared to an unrealized gain of \$87.0 million and an unrealized loss of \$16.0 million at December 31, 1997.

Carrying values of high yield securities in the guaranteed investment portfolio were \$220.0 and \$310.0 million at March 31, 1998 and December 31, 1997, respectively. Net unrealized investment losses on high yield securities held in such Separate Accounts were \$2.0 million at March 31, 1998, compared to \$1.0 million at December 31, 1997.

High yield securities generally involve a greater degree of risk than that of investment grade securities. Expected returns should, however, compensate for the added risk. The risk is also considered in the interest rate assumptions in the underlying insurance products. At March 31, 1998, CNA's concentration in high yield bonds, including Separate Accounts, was approximately 2.8% of its total assets. In addition, CNA's investment in mortgage loans and investment real estate are substantially below the industry average, representing less than one quarter of one percent of its total assets.

Included in CNA's fixed maturity securities at March 31, 1998 (general and guaranteed investment portfolios) are \$7.7 billion of asset-backed securities, consisting of approximately 36.5% in collateralized mortgage obligations ("CMO's"), 28.4% in corporate asset-backed obligations, 24.6% in corporate mortgage backed security pass thru obligations, and 10.5% in U.S. government agency issued pass-through certificates. The majority of CMO's held are corporate mortgaged backed securities, which are actively traded in liquid markets and are priced by broker-dealers. At March 31, 1998, the fair value of asset-backed securities exceeded the amortized cost by approximately \$119.0 million compared to \$114.0 million at December 31, 1997. CNA limits the risks associated with interest rate fluctuations and prepayment by concentrating its CMO investments in early planned amortization classes with relatively short principal repayment windows.

At March 31, 1998, 43.1% of the general account's fixed maturity securities portfolio was invested in U.S. government securities, 33.1% in other AAA rated securities and 13.0% in AA and A rated securities. CNA's guaranteed investment fixed maturity securities portfolio is comprised of 4.4% U.S. government securities, 63.2% in other AAA rated securities and 13.9% in AA and A rated securities. These ratings are primarily from Standard and Poor's (95.6% of the general account and 93.8% of the guaranteed investment fixed maturity account).

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Results of Operations:

- - - - -

Revenues decreased by \$144.0 million, or 2.9%, and net income decreased by \$323.0 million, for the three months ended March 31, 1998 as compared to the prior year. The following table sets forth the major sources of the Company's consolidated revenues and net (loss) income.

| | Three Months Ended March 31, | |
|---|---------------------------------|------------------|
| | 1998 | 1997 |
| | (In millions) | |
| Revenues (a): | | |
| Property and casualty insurance | \$3,299.6 | \$3,075.3 |
| Life insurance | 1,029.8 | 1,041.4 |
| Cigarettes | 575.7 | 516.4 |
| Hotels | 48.5 | 45.9 |
| Offshore drilling | 292.6 | 207.5 |
| Watches and clocks | 32.3 | 30.1 |
| Investment (loss) income-net (non-insurance companies) | (481.1) | 26.5 |
| Other and eliminations-net | (2.3) | (4.0) |
| | <u>\$4,795.1</u> | <u>\$4,939.1</u> |
| Net (loss) income (a): | | |
| Property and casualty insurance | \$ 168.3 | \$ 120.7 |
| Life insurance | 41.5 | 34.7 |
| Cigarettes | 22.1 | 79.5 |
| Hotels | 1.5 | .2 |
| Offshore drilling | 37.8 | 26.8 |
| Watches and clocks | 2.3 | 1.5 |
| Investment (loss) income-net (non-insurance companies) | (315.1) | 14.5 |
| Corporate interest expense | (22.3) | (15.8) |
| Unallocated corporate expense and other-net | (19.8) | (22.8) |
| | <u>\$ (83.7)</u> | <u>\$ 239.3</u> |

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(a) Includes investment (losses) gains as follows:

| | Three Months Ended March 31, | |
|---------------------------------------|---------------------------------|----------------|
| | 1998 | 1997 |
| Revenues: | | |
| Property and casualty insurance | \$ 134.6 | \$ 18.3 |
| Life insurance | 48.2 | 29.1 |
| Investment (loss) income-net | (533.4) | (18.5) |
| | <u>\$(350.6)</u> | <u>\$ 28.9</u> |
| Net (loss) income: | | |
| Property and casualty insurance | \$ 72.3 | \$ 10.1 |
| Life insurance | 25.7 | 14.9 |
| Investment (loss) income-net | (346.7) | (13.9) |

Insurance
- - - - -

Property and casualty revenues, excluding investment gains, increased by \$108.0 million, or 3.5%, for the three months ended March 31, 1998, as compared to the same period a year ago.

Property and casualty premium revenues increased by \$56.5 million, or 2.3%, for the three months ended March 31, 1998, from the prior year's comparable period. The increase is attributable to higher involuntary risk earned premiums of approximately \$138.0 million and an increase in personal lines premiums of approximately \$42.0 million, partially offset by lower commercial lines premiums of approximately \$116.0 million. Involuntary risk premium for the first quarter of 1997 was \$(75) million, reflecting reductions in estimates of premium for 1996 and prior periods, primarily in the workers' compensation line of business. The decrease in involuntary risk premium in 1997, stemmed from a greater willingness on the part of the involuntary market, including CNA, to write these types of risks. The increase in personal lines continues the trend seen in 1997 and is attributable to growth in private passenger automobile business and individual long-term care. The decrease in commercial lines is primarily due to a decrease in accident and health business. Net investment income decreased by \$8.0 million, or 1.7%, for the three months ended March 31, 1998, compared with the same period in the prior year, due to lower yielding investments. The bond segment of the investment portfolio yielded 6.4% in the first quarter of 1998 compared with 6.7% for the same period a year ago.

Life insurance revenues, excluding investment gains, decreased by \$30.7 million, or 3.0%, as compared to the same period a year ago. Life premium revenues decreased by \$35.0 million, or 4.0%, for the three months ended March 31, 1998. The decline reflects lower premiums from CNA's Federal Employees Health Benefit Plan ("FEHBP") and reduced individual annuities, partially offset by growth in term business. The decrease in individual annuity premiums is mainly due to a shift in marketing efforts towards more profitable products. The decrease in FEHBP premiums is the result of lower claims submitted during the first three months of 1998 as compared to the same period for 1997. Life net investment income increased by \$6.0 million, or 5.7%, for the three months ended March 31, 1998, compared to the same period a year ago, due to a larger asset base generated from increased cash flows. The bond segment of the life investment portfolio yielded approximately 6.9% and 6.8% in the three months ended March 31, 1998 and 1997, respectively.

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Property and casualty underwriting losses for the three months ended March 31, 1998 were \$288.0 million, compared to \$293.2 million for the same period in 1997. The decrease in operating income stems primarily from reduced investment income, including a reduction in tax exempt interest and dividends which was partially offset by lower catastrophe losses. Pre-tax catastrophe losses were approximately \$24.0 million in the first quarter of 1998 as compared to \$31.0 million in 1997.

The components of CNA's investment gains are as follows:

| | Three Months Ended March 31, | |
|-----------------------------------|---------------------------------|--------|
| | 1998 | 1997 |
| | ----- | |
| | (In millions) | |
| Bonds: | | |
| U.S. Government..... | \$ 50.0 | \$ 5.9 |
| Taxable | 29.0 | .5 |
| Asset-backed..... | 13.0 | 6.8 |
| Tax exempt | 16.0 | 10.4 |
| | ----- | ----- |
| Total bonds..... | 108.0 | 23.6 |
| Stocks..... | (4.0) | 29.7 |
| Derivative instruments | (7.0) | 3.3 |
| Separate Accounts and other | 86.0 | 9.4 |
| | ----- | ----- |
| Total investment gains | \$183.0 | \$66.0 |
| | ===== | ===== |

CNA's primary property and casualty subsidiary, Continental Casualty Company ("Casualty"), is party to litigation with Fibreboard Corporation ("Fibreboard") involving coverage for certain asbestos-related claims and defense costs (see Note 5 of the Notes to Consolidated Condensed Financial Statements).

Cigarettes

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Revenues increased by \$59.3 or 11.5% and net income declined by \$57.4 million, or 72.2%, respectively, for the three months ended March 31, 1998 as compared to the corresponding period of the prior year.

The increase in revenues is primarily composed of an increase of approximately \$58.1 million, or 11.3%, due to higher average unit prices, partially offset by a decrease of approximately \$4.9 million, or 1.0%, reflecting lower unit sales volume for the three months ended March 31, 1998, as compared to the prior year.

Net income for the three months ended March 31, 1998 includes a pre-tax charge of \$126.0 million (\$75.3 million after taxes) to reflect the settlement of tobacco litigation in Minnesota. Excluding this charge, net income would have increased by \$17.9 million, or 22.5%, as a result of the improved revenues, partially offset by higher legal expenses and costs associated with the settlement of certain tobacco related litigation.

Lorillard's unit sales volume declined by 2.2%, while Newport's sales volume increased by 2.3%, for the quarter ended March 31, 1998, as compared to the corresponding period of the prior year. Newport, a full price brand, accounted for 78.2% of Lorillard's unit sales. Discount brand sales have decreased from an average of 31.4% of industry sales during 1994 to an average of 27.0% during

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1997. At March 31, 1998, they represented 26.8% of industry sales.

Hotels

- -----

Revenues and net income increased by \$2.6 and \$1.3 million for the three months ended March 31, 1998, as compared to the prior year, due primarily to higher overall average room rates and increased occupancy rates at the New York hotels. These increases were partially offset by lower results from the Loews Monte Carlo hotel.

Offshore drilling

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Revenues and net income increased by \$85.1 and \$11.0 million, or 41.0% and 41.0%, respectively, for the three months ended March 31, 1998, as compared to the prior year.

Revenues from semisubmersible rigs increased by \$64.7 million, or 31.2%, for the three months ended March 31, 1998. The revenue increase is due to higher dayrates (\$57.1 million) and increased utilization rates (\$23.8 million) recognized by semisubmersible rigs located in the North Sea and the Gulf of Mexico. These increases were partially offset by revenues foregone (\$14.6 million) during mandatory inspections. Revenues from jackup rigs increased by \$16.5 million, or 8.0%, due to improvements in dayrates, primarily in the Gulf of Mexico (\$20.5 million).

Net income for the three months ended March 31, 1998 increased due primarily to the higher revenues discussed above, partially offset by increased operating costs associated with mandatory inspections and additional repairs during the three months ended March 31, 1998.

Watches and Clocks

- -----

Revenues and net income increased by \$2.2 and \$.8 million, or 7.3% and 53.3%, respectively, for the three months ended March 31, 1998 as compared to the prior year, due primarily to increased watch unit prices and sales volume. Net income also benefited from an increased gross profit percentage attributable to a favorable product sales mix, partially offset by higher advertising costs.

Other

- -----

Revenues and net income decreased by \$505.9 and \$333.1 million, respectively, for the three months ended March 31, 1998 as compared to the prior year.

The components of investment gains (losses) included in Investment (loss) income-net are as follows:

| | Three Months Ended March 31, | |
|--|---------------------------------|----------|
| | 1998 | 1997 |
| | ----- | |
| | (In millions) | |
| Revenues: | | |
| Derivative instruments (1) | \$(378.6) | \$(23.3) |
| Short-term investments, primarily U.S. government securities | (8.7) | 1.0 |
| Equity securities, including short positions (1) | (146.6) | (14.0) |
| Other | .5 | 17.8 |
| | ----- | |
| | (533.4) | (18.5) |
| Income tax benefit | 186.7 | 6.5 |
| Minority interest | | (1.9) |
| | ----- | |
| Net loss | \$(346.7) | \$(13.9) |
| | ===== | |

(1) Includes losses on short sales, equity index futures and options aggregating \$542.3 and \$46.2 for the three months ended March 31, 1998 and 1997, respectively. The Company continues to maintain these positions and has experienced additional significant losses since March 31, 1998.

Exclusive of securities transactions, revenues increased \$9.0 million, or 22.0%, for the three months ended March 31, 1998 due primarily to higher interest income. Net loss increased by \$.3 million, or 2.9%, for the three months ended March 31, 1998 due primarily to higher interest expenses, partially offset by the increased interest income.

Year 2000 Issue

- - - - -

Most of the Company's older computer programs were written using two digits rather than four to define the applicable year. As a result, those computer programs contain time-sensitive software that recognize a date using "00" as the year 1900 rather than the year 2000. This could cause a system failure or miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions, send invoices, or engage in similar normal business activities.

The Company has completed an assessment of the scope of this problem and is working to modify or replace the affected software so that its computer systems will function properly with respect to dates in the year 2000 and thereafter. The total Year 2000 project cost is estimated at approximately \$70.0 to \$80.0 million. To date, the Company has incurred and expensed approximately \$35.0 million.

The project is estimated to be completed not later than December 31, 1998, which is prior to any anticipated impact on its operating systems. The Company believes that with modifications to existing software and conversions to new software, the Year 2000 issue will not pose significant operational problems for its computer systems. However, if such modifications and conversions are not made, or are not completed timely, the Year 2000 issue could have a material impact on the operations of the Company. In addition, due to the interdependent

nature of computer systems, the Company may be adversely impacted depending upon whether it or other entities not affiliated with the Company (vendors and business partners) address this issue successfully. In addition, property and casualty insurance subsidiaries may have an underwriting exposure related to the Year 2000. Although CNA has not received any claims for coverage from its policyholders based on losses resulting from Year 2000 issues, there can be no assurance that policyholders will not suffer losses of this type and seek compensation under CNA's insurance policies. If any claims are made, coverage, if any, will depend on the facts and circumstances of the claim and the provisions of the policy. At this time, CNA is unable to determine whether the adverse impact, if any, in connection with the foregoing circumstances would be material.

The cost of the project and the date on which the Company believes it will complete the Year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events, including the continued availability of certain resources and other factors. However, there can be no guarantee that these estimates will be achieved and actual results could differ materially from those anticipated. Specific factors that might cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area, the ability to locate and correct all relevant computer codes, and similar uncertainties.

Accounting Standards -----

In December 1997, the AICPA's Accounting Standards Executive Committee issued SOP 97-3, "Accounting by Insurance and Other Enterprises for Insurance-Related Assessments," which provides guidance on accounting by all entities that are subject to insurance-related assessments. It requires that entities recognize liabilities for insurance-related assessments when all of the following criteria have been met: an assessment has been imposed or a probable assessment will be imposed; the event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements; and the amount of the assessment can be reasonably estimated. This SOP is effective for fiscal years beginning after December 15, 1998. The Company is currently evaluating the effects of this SOP on its accounting for insurance-related assessments.

In February 1998, the FASB issued SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits." This Statement standardizes disclosure requirements for pension and other postretirement benefits to the extent practicable, requires additional information on changes in benefit obligations and fair values of plan assets that will facilitate financial analysis, and eliminates certain disclosures that are no longer useful to users of financial statements. It also suggests combined formats for presentation of pension and other postretirement benefit disclosures. The Statement supersedes the disclosure requirements of a number of earlier opinions of the FASB and does not address measurement or recognition. It is effective for fiscal years beginning after December 15, 1997. The Company is currently evaluating the effects of this Statement on its benefit plan disclosures.

In March 1998, the AICPA's Accounting Standards Executive Committee issued SOP 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," which provides guidance on accounting for costs of computer software developed or obtained for internal use and for determining whether computer software is for internal use. For purposes of this SOP, internal-use software is software acquired, internally developed or modified solely to meet the entity's internal needs for which no substantive plan exists or is being developed to market the software externally during the software's development or modification. Accounting treatment for costs associated with software developed or obtained for internal use, as defined by this SOP, is based upon a number of factors, including the point in time during the project that costs are incurred as well as the types of costs incurred. This SOP is effective for financial statements for fiscal years beginning after December 15, 1998. The Company is currently evaluating the effects of this SOP.

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Forward-Looking Statements -----

When included in this Report, the words "believes," "expects," "intends," "anticipates," "estimates," and analogous expressions are intended to identify forward-looking statements. Such statements inherently are subject to a variety of risks and uncertainties that could cause actual results to differ materially from those projected. Such risks and uncertainties include, among others, general economic and business conditions, competition, changes in financial markets (interest rate, currency, commodities and stocks), changes in foreign, political, social and economic conditions, regulatory initiatives and compliance with governmental regulations, judicial decisions and rulings in smoking and health litigation, the impact of bills introduced in Congress in relation to tobacco operations, implementation of the Proposed Resolution, changes in foreign and domestic oil and gas exploration and production activity, customer preferences and various other matters, many of which are beyond the Company's control. These forward-looking statements speak only as of the date of this Report. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statement contained herein to reflect any change in the Company's expectations with regard thereto or any change in events, conditions or circumstances on which any statement is based.

Item 3. Quantitative and Qualitative Disclosures about Market Risk. -----

Loews Corporation is a large diversified financial services company. As such, it has significant amounts of financial instruments that involve market risk. The Company's measure of market risk exposure represents an estimate of the change in fair value of its financial instruments. Changes in the trading portfolio would be recognized as net losses in the income statement. Market risk exposure is presented for each class of financial instrument held by the Company at March 31, assuming immediate adverse market movements of the magnitude described below. The Company believes that the various rates of adverse market movements represent a measure of exposure to loss under hypothetically assumed adverse conditions. The estimated market risk exposure represents the hypothetical loss to future earnings and does not represent the maximum possible loss nor any expected actual loss, even under adverse conditions, because actual adverse fluctuations would likely differ. In addition, since the Company's investment portfolio is subject to change based on its portfolio management strategy as well as in response to changes in the market, these estimates are not necessarily indicative of the actual results which may occur.

The following tables present the Company's market risk by category (equity markets, interest rates, foreign currency exchange rates and commodity prices) on the basis of those entered into for trading purposes and other than trading purposes.

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Trading portfolio:

March 31, 1998

| Category of risk exposure: | Fair Value Asset (Liability) | Market Risk |
|-----------------------------|---------------------------------|----------------|
| (In millions) | | |
| Equity markets (1): | | |
| Equity securities | \$ 209.3 | \$ 52.8 |
| Options purchased | 193.3 | (177.1) |
| Options written | (18.9) | (3.3) |
| Futures | | (263.7) |
| Short sales | (996.8) | (249.2) |
| Commodities: | | |
| Oil (2): | | |
| Energy purchase obligations | (11.6) | (6.5) |
| Gold (3): | | |
| Options purchased | 10.3 | (10.3) |
| Options written | (3.4) | 3.4 |
| Other (4) | | (10.4) |

Note: The calculation of estimated market risk exposure is based on assumed adverse changes in the underlying reference price or index of (1) an increase in equity prices of 25%, (2) a decline in oil prices of 20%, (3) an increase in gold prices of 20% and (4) a decrease of 10%. Adverse changes on options which differ from those presented above would not necessarily result in a proportionate change to the estimated market risk exposure.

The most significant areas of market risk in the Company's trading portfolio result from positions held in S&P futures contracts, short sales of certain equity securities and put options purchased on the S&P 500 index. The Company enters into these positions primarily to benefit from anticipated future movements in the underlying markets that Company management expects to occur. If such movements do not occur or if the market moves in the opposite direction from what management expects, significant losses may occur. The Company continues to maintain these positions and has experienced additional significant losses since March 31, 1998.

Exposure to market risk is managed and monitored by senior management. Senior management approves the overall investment strategy employed by the Company and has responsibility to ensure that the investment positions are consistent with that strategy and the level of risk acceptable to it. The Company may manage risk by buying or selling instruments or entering into offsetting positions.

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Other than trading portfolio:

March 31, 1998

| Category of risk exposure: | Fair Value Asset (Liability) | Market Risk |
|---|---------------------------------|----------------|
| (In millions) | | |
| Equity market (1): | | |
| Equity securities: | | |
| CNA Financial general accounts (a) | \$ 982.0 | \$ (263.0) |
| CNA Financial separate accounts | 225.0 | (56.0) |
| Equity index futures, separate accounts (b) | | (200.0) |
| Interest rate (2): | | |
| Fixed maturities (a) | 31,558.3 | (1,484.0) |
| Short-term investments (a) | 8,019.6 | (6.0) |
| Interest rate swaps | (1.0) | 13.0 |
| Separate Accounts: | | |
| Fixed maturities | 4,490.0 | (205.0) |
| Short-term investments | 737.0 | (1.0) |
| Long-term debt | (5,841.1) | |

Note: The calculation of estimated market risk exposure is based on assumed adverse changes in the underlying reference price or index of (1) a decrease in equity prices of 25% and (2) an increase in interest rates of 100 basis points.

- (a) Certain securities are denominated in foreign currencies. Assuming a 20% decline in the underlying exchange rates would result in an aggregate foreign currency exchange rate risk of \$(298.0).
- (b) This market risk would be offset by decreases in liabilities to customers under variable insurance contracts.

Equity Price Risk - The Company has exposure to equity price risk as a result of its investment in equity securities and equity derivatives. Equity price risk results from changes in the level or volatility of equity prices which affect the value of equity securities or instruments which derive their value from such securities or indexes. Equity price risk was measured assuming an instantaneous 25% change in the underlying reference price or index from its level at March 31, 1998, with all other variables held constant.

Interest Rate Risk - The Company has exposure to interest rate risk, arising from changes in the level or volatility of interest rates or the shape and slope of the yield curve. The Company attempts to mitigate its exposure to interest rate risk by utilizing instruments such as interest rate swaps, interest rate caps, commitments to purchase securities, options, futures and forwards. The Company monitors its sensitivity to interest rate risk by evaluating the change in its financial assets and liabilities relative to fluctuations in interest rates. The evaluation is made using an instantaneous parallel yield curve shift of varying magnitude on a static balance sheet to determine the effect such a change in rates would have on the Company's market value at risk and the resulting effect on shareholders' equity. The analysis presents the sensitivity of the market value of the Company's financial instruments to selected changes in market rates and prices which the Company believes are reasonably possible over a one-year period.

The analysis assumes that the composition of the Company's interest sensitive assets and liabilities existing at the beginning of the period remains constant

over the period being measured and also assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the time to maturity. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Accordingly the analysis may not be indicative of, is not intended to, and does not provide a precise forecast of the effect of changes of market interest rates on the Company's earnings or shareholders' equity. Further, the computations do not contemplate any actions the Company could undertake in response to changes in interest rates.

The Company's long-term debt, including interest rate swap agreements, as of March 31, 1998 is denominated in U.S. Dollars. The Company's debt has been primarily issued at fixed rates, and as such, interest expense would not be impacted by interest rate shifts.

The sensitivity analysis assumes an instantaneous shift in market rates increasing 100 basis points from their levels at March 31, 1998, with all other variables held constant.

Foreign Exchange Risk - Foreign exchange rate risk arises from the possibility that changes in foreign currency exchange rates will impact the value of financial instruments. The Company has foreign exchange exposure when it buys or sells foreign currencies or financial instruments denominated in a foreign currency. This exposure is mitigated by the Company's asset/liability matching strategy and through the use of futures for those instruments which are not matched. The Company's foreign transactions are primarily denominated in Canadian Dollars, British Pounds, German Deutschmarks and Japanese Yen. The sensitivity analysis also assumes an instantaneous 20% change in the foreign currency exchange rates versus the U.S. Dollar from their levels at March 31, 1998, with all other variables held constant.

Commodity Price Risk - The Company has exposure to commodity price risk as a result of its investments in energy purchase obligations, gold options and other investments. Commodity price risk results from changes in the level or volatility of commodity prices that impact instruments which derive their value from such commodities. Commodity price risk was measured assuming an instantaneous change of 20% and 10% in the value of the underlying commodities.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

1. CNA is involved in various lawsuits involving environmental pollution claims and litigation with Fibreboard Corporation. Information involving such lawsuits is incorporated by reference to Note 5 of the Notes to Consolidated Condensed Financial Statements in Part I.

2. Lorillard is involved in various lawsuits involving tobacco products seeking damages for cancer and other health effects claimed to have resulted from the use of cigarettes or from exposure to tobacco smoke. Information involving such lawsuits is incorporated by reference to Note 5 of the Notes to Consolidated Condensed Financial Statements in Part I.

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Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits--

- (10.1) State of Minnesota Settlement Agreement and Stipulation for Entry of Consent Judgment.
- (10.2) State of Minnesota Consent Judgment.
- (10.3) State of Minnesota Settlement Agreement and Release.
- (10.4) Agreement to Pay State of Minnesota Attorneys' Fees and Costs.
- (10.5) Agreement to Pay Blue Cross and Blue Shield of Minnesota Attorneys' Fees and Costs.
- (10.6) State of Minnesota State Escrow Agreement.
- (27.1) Financial Data Schedule for the three months ended March 31, 1998.

(b) Current reports on Form 8-K--

The Company filed a report on Form 8-K on February 3, 1998 stating that together with other companies in the United States tobacco industry, the Company's subsidiary, Lorillard Tobacco Company, entered into a Comprehensive Settlement Agreement and Release with the State of Texas to settle and resolve with finality all present and future economic claims by the State and its subdivisions relating to the use of or exposure to tobacco products.

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SIGNATURES

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

LOEWS CORPORATION

(Registrant)

Dated: May 15, 1998

By /s/ Peter W. Keegan

PETER W. KEEGAN
Senior Vice President and
Chief Financial Officer
(Duly authorized officer
and principal financial
officer)

STATE OF MINNESOTA

DISTRICT COURT

COUNTY OF RAMSEY

SECOND JUDICIAL DISTRICT

THE STATE OF MINNESOTA,
BY HUBERT H. HUMPHREY III,
ITS ATTORNEY GENERAL,

Case Type: Other Civil
Court File No. C1-94-8565

and

BLUE CROSS AND BLUE SHIELD
OF MINNESOTA,

Plaintiffs,

vs.

PHILIP MORRIS INCORPORATED,
R.J. REYNOLDS TOBACCO COMPANY,
BROWN & WILLIAMSON TOBACCO
CORPORATION, B.A.T. INDUSTRIES
P.L.C., BRITISH-AMERICAN TOBACCO
COMPANY LIMITED, BAT (U.K. &
EXPORT) LIMITED, LORILLARD
TOBACCO COMPANY, THE AMERICAN
TOBACCO COMPANY, LIGGETT GROUP,
INC., THE COUNCIL FOR TOBACCO
RESEARCH-U.S.A., INC., and THE
TOBACCO INSTITUTE, INC.,

Defendants.

SETTLEMENT AGREEMENT AND STIPULATION

FOR ENTRY OF CONSENT JUDGMENT

THIS SETTLEMENT AGREEMENT AND RELEASE ("Settlement Agreement") is made as of the date hereof, by and among the parties hereto, as indicated by their signatures below, to settle

and resolve with finality all claims of the State of Minnesota relating to the subject matter of this action which have been or could have been asserted by the State of Minnesota.

WHEREAS, the State of Minnesota, through its Attorney General Hubert H. Humphrey III, and Blue Cross and Blue Shield of Minnesota, commenced this action on August 17, 1994, asserting various claims for monetary, equitable and injunctive relief on behalf of the State of Minnesota and Blue Cross and Blue Shield of Minnesota against certain tobacco manufacturers and others as Defendants;

WHEREAS, the Defendants have denied each and every one of Plaintiffs' allegations of unlawful conduct or wrongdoing and have asserted a number of defenses to Plaintiffs' claims, which defenses have been contested by Plaintiffs;

WHEREAS, the parties hereto wish to avoid the further expense, delay, inconvenience, burden and uncertainty of continued litigation of this matter (including appeals from any verdict), the State of Minnesota and the Settling Defendants have agreed to settle this litigation pursuant to terms which will achieve for the State of Minnesota (and thus for the people of the State of Minnesota) significant funding for the advancement of public health, the implementation of important tobacco-related public health measures in Minnesota, as well as funding for national research dedicated to studying and significantly reducing the use of Tobacco Products by youth;

WHEREAS, the State of Minnesota and Settling Defendants have agreed to settle this lawsuit on terms set forth in this Settlement Agreement and Stipulation for Entry of Consent Judgment and the attached Consent Judgment;

WHEREAS, the parties have further agreed to jointly petition the Court for approval of the Consent Judgment, on the grounds that settlement would be in the

NOW, THEREFORE, BE IT KNOWN THAT, in consideration of the payments to be made by the Settling Defendants, the dismissal and release of claims by the State of Minnesota and such other consideration as described herein, the sufficiency of which is hereby acknowledged, the parties hereto, acting by and through their authorized agents, memorialize and agree as follows:

I. GENERAL PROVISIONS

A. Jurisdiction. The State and the Settling Defendants acknowledge that

this Court has jurisdiction over the subject matter of this action and over each of the parties to this Settlement Agreement, and that this Court shall retain jurisdiction for the purposes of implementing and enforcing this Settlement Agreement. The parties hereto agree to present any disputes under this Settlement Agreement, including without limitation any claims for breach or enforcement of this Settlement Agreement, exclusively to this Court. The Court may, upon the State's application, enter a Consent Judgment in the form attached hereto as Exhibit A. The cumulative terms of this Settlement Agreement and Stipulation for Entry of Consent Judgment, and the attached Consent Judgment, may be referred to for convenience as this "Agreement" or "Settlement Agreement."

B. Voluntary Agreement of the Parties. The State and the Settling

Defendants acknowledge and agree that this Settlement Agreement is voluntarily entered into by all parties hereto as the result of arm's-length negotiations during which all such parties were represented by counsel. The State and Settling Defendants understand that Congress may enact legislation dealing with some of the issues addressed in this Agreement. Settling Defendants and their assigns, affiliates, agents, and successors hereby waive any right to challenge this Agreement or the Consent Judgment, directly or through third parties, on the ground that any term hereof is unconstitutional, outside the power

or jurisdiction of the Court, preempted by or in conflict with any current or future federal legislation (except where non-economic terms of future federal legislation are irreconcilable).

C. Definitions.

For the purposes of this Settlement Agreement and attached Consent Judgment, the following terms shall have the meanings set forth below:

1. "State" or "State of Minnesota" means the State of Minnesota acting by and through its Attorney General;

2. "Blue Cross" means BCBSM, Inc., d/b/a Blue Cross and Blue Shield of Minnesota, and all of its administrators, representatives, employees, directors, officers, agents, attorneys, parents and divisions;

3. "Settling Defendants" means those Defendants in this action that are signatories hereto;

4. "Defendants" means Philip Morris Incorporated, R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation, B.A.T Industries P.L.C., British-American Tobacco Company Limited, BAT (U.K. and Export) Limited, Lorillard Tobacco Company, The American Tobacco Company, The Council for Tobacco Research-U.S.A., Inc., and the Tobacco Institute, Inc. and their successors and assigns;

5. "Consumer Price Index" shall mean the Consumer Price Index for All Urban Consumers, for the most recent twelve-month period for which such percentage information is available as published by the Bureau of Labor Statistics of the U.S. Department of Labor.

6. "Court" means the District Court of the State of Minnesota, County of Ramsey, Second Judicial District;

7. "Market Share" means a Settling Defendant's respective share of sales of cigarettes by unit for consumption in the United States during (i) with respect to payments made pursuant to Paragraph II.D. of this Settlement Agreement, the calendar year ending on the date on which the payment at issue is due, regardless of when such payment is made, and (ii)

with respect to all other payments made pursuant to this Settlement Agreement, the calendar year immediately preceding the year in which the payment at issue is due, regardless of when such payment is made;

8. "Cigarettes" means any product which contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains (i) any roll of tobacco wrapped in paper or in any substance not containing tobacco; or (ii) tobacco, in any form, that is functional in the product, which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette; or (iii) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in subparagraph (i) of this paragraph;

9. "Smokeless Tobacco" means any powder that consists of cut, ground, powdered, or leaf tobacco that contains nicotine and that is intended to be placed in the oral cavity;

10. "Tobacco Products" means Cigarettes and Smokeless Tobacco;

11. "Billboards" includes billboards, as well as all signs and placards in arenas and stadiums, whether open-air or enclosed. "Billboards" does not include (1) any advertisements

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placed on or outside the premises of retail establishments which sell tobacco products, or any retail point-of-sale; and (2) billboards or advertisements in connection with the sponsorship by the Defendants of any entertainment, sporting or similar event, such as NASCAR, that appears in the State of Minnesota as part of a national or multi-state tour;

12. "Children" or "youth" means persons under the age of 18;

13. "Depository," unless otherwise specified, means the Minnesota document depository established by the Court's Order dated June 16, 1995. "Depositories" includes both the Minnesota depository and the Guildford, U.K. document depository established by the Court's Order dated September 6, 1995;

14. "Transit Advertisements" means advertising on private or public vehicles and all advertisements placed at, on or within any bus stop, taxi stand, waiting area, train station, airport or any similar location. "Transit Advertisements" does not include any advertisements placed on or outside the premises of retail establishments licensed to sell Tobacco Products or any retail point-of-sale;

15. "Special State Counsel" means Robins, Kaplan, Miller & Ciresi L.L.P. or a successor, if any; and

16. "Final Approval" means the date on which this Settlement Agreement and the form of State Escrow Agreement are approved by the Court. At the time of such approval, the settlement between the parties is final.

II. SETTLEMENT PAYMENTS

A. Settlement Receipts. The payments to be made by the Settling

Defendants under this Settlement Agreement are in satisfaction of all of the State of Minnesota's claims for damages

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incurred by the State in the year of such payment or earlier years related to the subject matter of this action, including, without limitation, claims for equitable and injunctive relief, claims for health care expenditures and claims for punitive damages, except that no part of any payment under this Settlement Agreement is made in settlement of an actual or potential liability for a fine, penalty (civil or criminal) or enhanced damages.

B. Settlement Payments to the State of Minnesota. Each Settling Defendant

severally shall cause to be paid to an account designated in writing by the State of Minnesota in accordance with and subject to paragraph II.E. of this Settlement Agreement, the following amounts: the amount listed for it in Schedule A hereto, such amount representing its share of \$240,000,000, to be paid on or before September 5, 1998; pro rata in proportion to its Market Share, its share of \$220,800,000, to be paid on or before January 4, 1999; pro rata in proportion to its Market Share, its share of \$242,550,000, to be paid on or

before January 3, 2000; pro rata in proportion to its Market Share, its share of \$242,550,000, to be paid on or before January 2, 2001; pro rata in proportion to its Market Share, its share of \$242,550,000, to be paid on or before January 2, 2002; and pro rata in proportion to its Market Share, its share of \$121,550,000, to be paid on or before January 2, 2003. The payments made by the Settling Defendants pursuant to this Paragraph shall be adjusted upward by the greater of 3% or the Consumer Price Index applied each year on the previous year, beginning with the payment due to be made on or before January 3, 2000. The payments due to be made by the Settling Defendants pursuant to this Paragraph on or before January 3, 2000, on or before January 2, 2001, on or before January 2, 2002, and on or before January 2, 2003, will also be decreased or increased, as the case may be, in accordance with the formula for adjustments of payments as set forth in Appendix A. The payments due to be made by the Settling Defendants pursuant to this Paragraph

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on or before September 5, 1998, and on or before January 4, 1999, shall not be subject to inflation escalation and volume adjustments described in the preceding sentences.

In the event that any of the Settling Defendants fails to make any payment required of it pursuant to this Paragraph (a "Defaulting Defendant") by the applicable date set forth in this paragraph II.B. (a "Missed Payment"), the State of Minnesota shall provide notice to each of the Settling Defendants of such non-payment. The Defaulting Defendant shall have 15 days after receipt of such notice to pay the Missed Payment, together with interest accrued from the original applicable due date at the prime rate as published in the Wall Street Journal on the latest publication date on or before the date of default plus 3%. If the Defaulting Defendant does not make such payment within such 15-day period, the State of Minnesota shall provide notice to each of the Settling Defendants of such continued non-payment. Any or all of the Settling Defendants (other than the Defaulting Defendant) shall thereafter have 15 days after receipt of such notice to elect (in such Settling Defendant's or such Settling Defendants' sole and absolute discretion) to pay the Missed Payment, together with interest accrued from the original applicable due date at the prime rate as published in the Wall Street Journal on the latest publication date on or before the date of default plus 3%. In the event that the State of Minnesota does not receive the Missed Payment, together with such accrued interest, within such additional 15-day period, all payments required to be made by each of the respective Settling Defendants pursuant to this Paragraph shall at the end of such additional 15-day period be accelerated and shall immediately become due and owing to the State of Minnesota from each Settling Defendant pro rata in proportion to its Market Share; provided, however, that any such accelerated payments (a) shall all be adjusted upward by the greater of (i) the rate of 3% per annum or (ii) the actual total percent change in the CPI, in either instance for the period between January 1

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of the year in which the acceleration of payments pursuant to this Paragraph occurs and the date on which such accelerated payments are due pursuant to this subsection, and (b) shall all immediately be adjusted in accordance with the formula for adjustments of payments set forth in Appendix A.

Nothing in this Paragraph shall be deemed under any circumstance to create any obligation on the part of any Settling Defendant to pay any amount owed or payable to the State of Minnesota by any other Settling Defendant. All obligations of the Settling Defendants pursuant to this Paragraph are intended to be and shall remain several, and not joint.

C. Public Health Foundation. The Attorney General will propose, and the

Settling Defendants have agreed not to oppose, that the Legislature appropriate to a foundation one-half the payments due in September 1998, and in January of the years 1999 through 2003, to be used for such activities as the directors of the foundation may determine will diminish the human and economic consequences of tobacco use. It is contemplated that the directors of the foundation will include public representatives, and representatives of such groups as the American Lung Association, Minnesota Chapter; the University of Minnesota School of Public Health; the Minnesota SmokeFree 2000 Coalition; the American Cancer Society, Minnesota Division; the American Heart Association, Minnesota Chapter; the Association for Non-Smokers' Rights--Minnesota; and the Mayo Clinic Nicotine Dependence Center.

D. Annual Payments. Each of the Settling Defendants agrees that,

beginning on December 31, 1998, and annually thereafter on December 31st of each year after 1998 (subject to final adjustment within 30 days), it shall severally cause to be paid to an account designated in writing by the State of Minnesota in accordance with and subject to paragraph II.E. of this Settlement

Agreement, pro rata in proportion to its respective Market Share, its share of 2.55% of the following amounts (in billions):

| Year | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | thereafter |
|-----------|------|--------|------|--------|--------|------|------------|
| - ---- | 1 | 2 | 3 | 4 | 5 | 6 | |
| Amount | \$4B | \$4.5B | \$5B | \$6.5B | \$6.5B | \$8B | \$8B |
| - - - - - | | | | | | | |

The payments made by Settling Defendants pursuant to this Paragraph shall be adjusted upward by the greater of 3% or the Consumer Price Index applied each year on the previous year, beginning with the annual payment due on December 31, 1999. Such payments will also be decreased or increased, as the case may be, beginning with the annual payment due on December 31, 1999, in accordance with the formula for adjustments of payments set forth in Appendix A.

E. Payment of Settlement Proceeds. Any payment made pursuant to this

Settlement Agreement shall be made to an account designated in writing by the State of Minnesota or the Court, as applicable; provided that after Final Approval, if the Court's approval is challenged by any third party, payments due to be made shall be paid into a special escrow account (the "State Escrow Account"), and held in escrow pursuant to this Section V.B. and the State Escrow Agreement.

F. Adjustments in Event of Federal Legislation. The enactment of federal

tobacco-related legislation shall not affect the payments required by this Agreement except as follows:

1. If federal tobacco-related legislation providing for the resolution or other disposition of State Attorney General actions brought against tobacco companies is enacted on or before November 30, 2000, and if such legislation provides for payment(s) by tobacco companies (whether by settlement payment, tax or any other means), all or part of which is made available to States, the State of Minnesota shall elect to receive any funds that are (i)

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unrestricted as to their use, or (ii) are restricted to any form of health care or to any use related to tobacco (collectively "Federal Settlement Funds"), and Settling Defendants shall receive a dollar-for-dollar offset up to the full amount of payments required under Section II.D of this Agreement for any and all Settlement Funds received by the State of Minnesota, until all Federal Settlement Funds provided however:

a. There shall be no offset to payments required by this Agreement on account of any federal program, subsidies, payments, credits or other aid to the State which are not conditioned or tied to the settlement of a state tobacco-related suit or the relinquishment of state tobacco-related claims;

b. The State relinquishes no rights or benefits under this Agreement except for payments subject to the offset;

c. There are no federally imposed preconditions to the receipt of Federal Settlement Funds other than (i) the settlement of any state tobacco-related lawsuit or the relinquishment of state tobacco-related claims, (ii) actions or expenditures related to tobacco, including but not limited to, education, cessation, control or enforcement, or (iii) actions or expenditures related to health care;

d. If Settling Defendants enter into any pre-verdict settlement agreement (subsequent to the date of this Agreement) of similar litigation brought by a non-federal governmental plaintiff which does not require such an offset, this Section is null and void;

e. If Settling Defendants enter into any pre-verdict settlement agreement (subsequent to the date of this Agreement) of similar litigation brought by a non-

federal governmental plaintiff which has an offset term more favorable to the plaintiff, this Settlement Agreement shall, at the option of the Office of the Attorney General of the State of Minnesota, be revised to include a comparable term.

2. Nothing in this section is intended to or shall reduce the total amounts payable to the State under this Agreement by Settling Defendants beyond the amount of Federal Settlement Funds actually received by the State of Minnesota.

III. DISMISSAL OF CLAIMS AND RELEASES

A. State of Minnesota's Dismissal of Claims. Upon approval of this

Settlement Agreement by the Court, the Court shall enter a Final Judgment dismissing with prejudice all claims as to all Defendants.

This Agreement resolves all claims between the State and the Defendants, except for issues pending before the court pertaining to the discoverability or production of documents for which the Defendants reserve their rights of appeal.

B. State of Minnesota's Release and Discharge. Upon Final Approval, the

State of Minnesota shall release and forever discharge all Defendants and their present and former parents, subsidiaries (whether or not wholly owned) and affiliates, and their respective divisions, organizational units, officers, directors, employees, representatives, insurers, suppliers, agents, attorneys and distributors (and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing) from any and all manner of civil claims, demands, actions, suits and causes of action, damages whenever incurred, liabilities of any nature whatsoever, including civil penalties, as well as costs, expenses and attorneys' fees, known or unknown, suspected or unsuspected, accrued or unaccrued, whether legal, equitable or statutory ("Claims") that the State

of Minnesota (including any of its past, present or future administrators, representatives, employees, officers, attorneys, agents, representatives, officials acting in their official capacities, agencies, departments, commissions, and divisions, and whether or not any such person or entity participates in the settlement), whether directly, indirectly, representatively, derivatively or in any other capacity, ever had, now has or hereafter can, shall or may have, as follows:

a. for past conduct, as to any Claims relating to the subject matter of this action which have been asserted or could be asserted now or in the future in this action or a comparable Federal action by the State; and

b. for future conduct, only as to monetary Claims directly or indirectly based on, arising out of or in any way related to, in whole or in part, the use of or exposure to Tobacco Products manufactured in the ordinary course of business, including without limitation any future claims for reimbursement for health care costs allegedly associated with use of or exposure to Tobacco Products;

(such past and future Claims hereinafter referred to as the "Released Claims"); provided, however, that the foregoing shall not operate as a release of any person, party or entity (whether or not a signatory to this Agreement) as to any of the obligations undertaken in this Agreement in connection with a monetary breach or default of this Agreement.

The State of Minnesota hereby covenants and agrees that it shall not hereafter sue or seek to establish civil liability against any person or entity covered by the release provided under Paragraph III.B based, in whole or in part, upon any of the Released Claims, and the State of Minnesota agrees that this covenant and agreement shall be a complete defense to any such civil action or proceeding.

C. Settling Defendants' Release and Discharge. Upon Final Approval,

Settling Defendants shall release and forever discharge the State of Minnesota (including any of its past, present or future administrators, representatives, employees, officers, attorneys, agents, representatives, officials acting in their official capacities, agencies, departments, commissions, and divisions, and whether or not any such person or entity participates in the settlement)

from any and all manner of civil claims, demands, actions, suits and causes of action, damages whenever incurred, liabilities of any nature whatsoever, including costs, expenses, penalties and attorneys' fees, known or unknown, suspected or unsuspected, accrued or unaccrued, whether legal, equitable or statutory, arising out of or in any way related to, in whole or in part, the subject matter of the litigation of this lawsuit, that Settling Defendants (including any of their present and former parents, subsidiaries, divisions, affiliates, officers, directors, employees, witnesses (fact or expert), representatives, insurers, agents, attorneys and distributors and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing, and whether or not any such person participates in the settlement), whether directly, indirectly, representatively, derivatively or in any other capacity, ever had, now has or hereafter can, shall or may have.

D. Limited Most-Favored Nation Provision. In partial consideration for

the monetary payments to be made by the Settling Defendants pursuant to this Settlement Agreement, the State of Minnesota agrees that if the Settling Defendants enter into any future pre-verdict settlement agreement of other similar litigation brought by a non-federal governmental plaintiff on terms more favorable to such non-federal governmental plaintiff than the terms of this Settlement Agreement (after due consideration of relevant differences in population or other appropriate factors), the terms of this Settlement Agreement shall not be revised except as follows: to the extent, if any, such other

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pre-verdict settlement agreement includes terms that provide (a) for joint and several liability among the Settling Defendants with respect to monetary payments to be made pursuant to such agreement; (b) a guarantee by the parent company of any of the Settling Defendants or other assurances of payment or creditors' remedies with respect to monetary payments to be made pursuant to such agreement; or (c) for the implementation of non-economic tobacco-related public health measures different from those contained in this Settlement Agreement, then this Settlement Agreement shall, at the option of the Office of the Attorney General of the State of Minnesota, be revised to include terms comparable to such terms.

IV. DEFENDANTS' ASSURANCES

A. Settling Defendants agree not to directly or indirectly, including through any third party or affiliate:

1. Oppose the passage of those future Minnesota legislative proposals or administrative rules intended by their terms to reduce tobacco use by children listed on Schedule B. (The foregoing does not prohibit Settling Defendants from resisting enforcement of, or suing for declaratory or injunctive relief with respect to any such legislation or rule on any grounds.)

2. Facially challenge the enforceability or constitutionality of existing Minnesota laws or rules relating to tobacco control, including, but not limited to, Minnesota Statutes Section 461.17 regarding the disclosure of certain ingredients in cigarettes; Minnesota Statutes Sections 461.12, et. seq., and 609.685 regarding the sale of tobacco to minors; Minnesota Statutes Section 325F.77 regarding the distribution of samples; and Minnesota Statutes Section 144.411 et. seq. regarding clean indoor air.

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3. Support in Congress or any forum, legislation, rules or policies which would preempt, override, or abrogate or diminish the State's rights or recoveries under this Agreement. Except as specifically provided in the foregoing sentence, nothing in this Agreement shall be deemed to restrain the parties from advocating terms of any national settlement or taking any other positions on issues relating to tobacco. The State and its attorneys specifically reserve the right to continue to litigate or advocate for additional document disclosure beyond that ordered by the Ramsey County District Court, in any forum outside of Minnesota.

4. Settling Defendants' obligation to produce documents in discovery pertaining to enactment or repeal of, or opposition to, state legislation or state executive action relating to tobacco in Minnesota is extended beyond August 17, 1994, to the date of this Agreement, with Settling Defendants required to produce these documents within thirty (30) days of the date of this Agreement.

B. Disclosure of Payments Likely to Affect Public Policy.

1. Each Settling Defendant shall disclose to the Office of the Attorney General and the Office of the Governor, at the times and in the manner provided below, information about the following payments:

a. Any payment to a "lobbyist" or "principal" within the meaning of Minnesota Statutes, Section 10A.01, subdivisions 11 and 28, if Settling Defendant knows or has reason to know that the payment will be used, directly or indirectly, to influence legislative or administrative action, or the official action of state or local government in Minnesota in any way relating to Tobacco Products or their use.

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b. Any payment to a third party, if the Settling Defendant knows the payment is partly in consideration for the third party attending, offering testimony at, or participating before a state or local government hearing in Minnesota in any way relating to Tobacco Products or their use; and

c. Any payment (other than a "political contribution" under Minn. Stat. Section 10.01, subd. 7, or 2 USC Section 431(8)(A)) to, or for the benefit of, a state or local official in Minnesota, whether made directly by a defendant or indirectly through an employee acting in the scope of his employment, affiliate, lobbyist, or other agent acting under the substantial control of a defendant.

2. Disclosures required under this section shall be filed with the Office of the Attorney General and with the Office of the Governor on the first day of January, April, July and October of each year for any and all payments made through the first day of the previous month and shall be transmitted in electronic format or such format as the attorney general may require, with the following information:

a. The name, address, telephone number and e-mail address of the recipient.

b. The amount of each payment described in Paragraph B(1).

c. The aggregate amount of all payments described in Paragraph B(1) to the recipient in the calendar year.

3. Information filed under this section is "public data" within the meaning of the Minnesota Government Data Practices Act.

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C. Settling Defendants agree to discontinue all Billboards and Transit Advertisements of Tobacco Products in the State. Settling Defendants shall use their best efforts in cooperation with the State to identify all such Billboards that are located within 1000 feet of any public or private school or playground in the State, and shall provide the State with a preliminary list of the location of all Billboards and stationary Transit Advertisements within 30 days from the date hereof, such list to be finalized within an additional 15 days. Settling Defendants shall, at the earlier of the expiration of applicable contracts or four months from the date the final list is supplied to the State, remove all Billboards and Transit Advertisements for Tobacco Products from within the State, leaving the space unused or used for advertising unrelated to Tobacco Products; or at the option of the State of Minnesota, will allow the State, at its expense, to substitute for the remaining term of the contract, alternative advertising intended to discourage the use of Tobacco Products by children and their exposure to second-hand smoke. The parties also agree to secure the expedited removal of up to 50 Billboards or stationary Transit Advertisements for Tobacco Products designated by the State within 30 days after their designation. Each Settling Defendant which has Billboard advertising in the State shall provide the Court and the Attorney General, or his designee, with the name of a contact person to whom the State may direct inquiries during the time such Billboards and Transit Advertisements are being eliminated, from whom the State may obtain periodic reports as to the progress of their elimination and who will be responsible for ensuring that appropriate action is taken to remove any Billboards that have not been timely eliminated.

D. Settling Defendants shall not make, in the connection with any motion picture made in the United States, or cause to be made any payment, direct or indirect, to any person to use, display, make reference to, or use as a prop any cigarette, cigarette package, advertisement for

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cigarettes, or any other item bearing the brand name, logo, symbol, motto,

selling message, recognizable color or pattern of colors, or any other indicia of product identification identical or similar to, or identifiable with, those used for any brand of domestic tobacco products.

E. On and after December 31, 1998, Settling Defendants shall permanently cease marketing, licensing, distributing, selling or offering, directly or indirectly, including by catalogue or direct mail, in the State of Minnesota, any service or item (other than tobacco products or any item of which the sole function is to advertise tobacco products) which bears the brand name (alone or in conjunction with any other word), logo, symbol, motto, selling message, recognizable color or pattern of colors, or any other indicia of product identification identical or similar to, or identifiable with, those used for any brand of domestic tobacco products.

F. Settling Defendants and the Law Firm of Robins, Kaplan, Miller & Ciresi L.L.P. ("RKM&C") have reached a separate agreement for the payment of the State's costs and attorneys fees. In consideration for said agreement, RKM&C has released the State from its obligation to pay costs and attorneys fees under the Special Attorney Appointment dated May 23, 1994.

V. MISCELLANEOUS PROVISIONS

A. Representations of Parties. The respective parties hereto hereby

represent that this Settlement Agreement has been duly authorized and, upon execution, will constitute a valid and binding contractual obligation, enforceable in accordance with its terms, of each of the parties hereto. The State represents that all of its outside counsel that have represented it in this action are, by and through their authorized representatives, signatores to this Settlement Agreement.

B. Court Approval. The Parties agree to submit this Settlement Agreement

to the Court for its review and approval on Friday, May 8, 1998. If the Court declines to approve this Settlement

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Agreement, the Blue Cross Settlement Agreement, the form of State Escrow Agreement, and the form of Blue Cross Escrow Agreement, the matter will be immediately submitted to the jury. If the Court, as a condition of approval or otherwise, requires any change in the Agreements which any signatory is unwilling to make, the case will be immediately submitted to the jury. If before the Court approves the Agreements, any third-party seeks to intervene for the purpose of opposing the Settlement Agreement, the Blue Cross Settlement Agreement, the State Escrow Agreement, and the Blue Cross Escrow Agreement, any Party at its sole election, may withdraw from this Agreement, after first giving notice to the Court and all of the Parties before the jury is dismissed, and submit the case to the jury. If the Court approves the Settlement Agreement as submitted, the Agreement will be final and binding upon all Parties.

In the event that there is a challenge to any provision of this Settlement Agreement by anyone other than the Attorney General of the State of Minnesota as of the date of this Agreement, BCBS or Settling Defendants ("a third-party challenge") after Final Approval, any amounts required to be paid by Settling Defendants pursuant to this Settlement Agreement shall be paid into escrow pursuant to the State Escrow Agreement. If, as a result of such a challenge, any material term of Sections II, III, IV of this Settlement Agreement is modified or rendered unenforceable, the parties shall negotiate an equivalent or comparable substitute term or other appropriate credit or adjustment. In the event that the parties are unable to agree on such a substitute term or appropriate credit or adjustment, then the parties will submit the issue to the Court for resolution, subject to any available appeal rights. In the event that any third-party challenge is made after December 31, 1998, any payments due under Paragraph II.B. shall be made to the State according to the terms of this Settlement Agreement, and only those payments due under Paragraph II.D. shall be placed into escrow as provided above.

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In the event that the Court determines that there has been a failure of consideration legally sufficient to warrant termination of this Settlement Agreement, then this Settlement Agreement may be terminated by the party adversely affected. In the event of such termination, the action will be reinstated and all decisions of the trial court, and any party's appeal or other rights with respect thereto, will have the same force and effect as if this Settlement Agreement had never been entered into.

C. Obligations Several, Not Joint. All obligations of the Settling

Defendants pursuant to this Settlement Agreement are intended to be and shall

remain several, and not joint.

D. Headings. The headings of the paragraphs of this Settlement Agreement

are not binding and are for reference only and do not limit, expand or otherwise
affect the contents of this Settlement Agreement.

E. No Determination or Admission. This Settlement Agreement and any

proceedings taken hereunder are not intended to be and shall not in any event be
construed as, or deemed to be, an admission or concession or evidence of any
liability or any wrongdoing whatsoever on the part of any party hereto or any
person covered by the releases provided under paragraphs III.B. and C. hereof.
The Settling Defendants specifically disclaim and deny any liability or
wrongdoing whatsoever with respect to the allegations and claims asserted
against them in this action and enter into this Settlement Agreement solely to
avoid the further expense, inconvenience, burden and uncertainty of litigation.

F. Non-Admissibility. The settlement negotiations resulting in this

Settlement Agreement have been undertaken by the parties hereto in good faith
and for settlement purposes only, and neither this Settlement Agreement nor any
evidence of negotiations hereunder shall be offered or received

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in evidence in this action, or any other action or proceeding, for any purpose
other than in an action or proceeding arising under this Settlement Agreement.

G. Amendment; Waiver. This Settlement Agreement may be amended only by a

written instrument executed by the Attorney General and the Settling Defendants.
The waiver of any rights conferred hereunder shall be effective only if made by
written instrument executed by the waiving party. The waiver by any party of any
breach of this Settlement Agreement shall not be deemed to be or construed as a
waiver of any other breach, whether prior, subsequent or contemporaneous, of
this Settlement Agreement.

H. Notices. All notices or other communications to any party to this

Settlement Agreement shall be in writing (and shall include telex, telecopy or
similar writing) and shall be given to the respective parties hereto at the
following addresses. Any party hereto may change the name and address of the
person designated to receive notice on behalf of such party by notice given as
provided in this paragraph.

For the State of Minnesota:

Hubert H. Humphrey III
Attorney General
102 State Capitol
St. Paul, MN 55155
Fax: 612.297.4193

with copies to:

Michael V. Ciresi
Robins, Kaplan, Miller & Ciresi L.L.P.
2800 LaSalle Plaza
800 LaSalle Avenue
Minneapolis, MN 55402-2015
Fax: 612.339.4181

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Chief Deputy Attorney General
State of Minnesota
102 State Capitol
St. Paul, MN 55155
Fax: 612.297.4193

For Philip Morris Incorporated:

MARTIN J. BARRINGTON
Philip Morris Incorporated
120 Park Avenue
New York, NY 10017-5592
Fax: 212.907.5399

With a copy to:

Meyer G. Koplow
Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, NY 10019
Fax: 212.403.2000

For R.J. Reynolds Tobacco Company:

Charles A. Blixt
General Counsel
R.J. Reynolds Tobacco Company
401 North Main Street
Winston-Salem, NC 27102
Fax: 910.741.2998

With a copy to:

Arthur F. Golden
Davis Polk & Wardwell
450 Lexington Avenue
New York, NY 10017
Fax: 212.450.4800

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For Brown & Williamson Tobacco Corporation:

F. Anthony Burke
Brown & Williamson Tobacco Corporation
200 Brown & Williamson Tower
401 South Fourth Avenue
Louisville, KY 40202
Fax: 502.568.7297

With a copy to:

Stephen R. Patton
Kirkland & Ellis
200 East Randolph Dr.
Chicago, IL 60601
Fax: 312.861.2200

For Lorillard Tobacco Company:

Arthur J. Stevens
Lorillard Tobacco Company
714 Green Valley Road
Greensboro, NC 27408
Fax: 910.335.7707

I. Cooperation. The parties hereto agree to use their best efforts and to

cooperate with each other to cause this Settlement Agreement to become effective, to obtain all necessary approvals, consents and authorizations, if any, and to execute all documents and to take such other action as may be appropriate in connection therewith. Consistent with the foregoing, the parties hereto agree that they will not directly or indirectly assist or encourage any challenge to this Settlement Agreement by any other person. All parties hereto agree to support the integrity and enforcement of the terms of this Settlement Agreement.

J. Governing Law. This Settlement Agreement shall be governed by the laws

of the State of Minnesota, without regard to the conflicts of law rules of such state.

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K. Construction. None of the parties hereto shall be considered to be the

drafter of this Settlement Agreement or any provision hereof for the purpose of any statute, caselaw or rule of interpretation or construction that would or

might cause any provision to be construed against the drafter hereof.

L. Severability. Subject to the provisions of Paragraph V.B., the terms

of this Agreement are severable. If any term of this Agreement is found to be unlawful, the remaining terms shall remain in full force and effect, and the parties agree to negotiate a substitute term of equivalent value.

M. Intended Beneficiaries. This action was brought by the State of

Minnesota, through its Attorney General, and by Blue Cross to recover certain monies and to promote the health and welfare of the people of Minnesota. No portion of this Settlement Agreement shall provide any rights to, or be enforceable by, any person or entity that is neither a party hereto nor a person encompassed by the releases provided in paragraphs III.B. and C. of this Settlement Agreement. Except as expressly provided in this Settlement Agreement, no portion of this Settlement Agreement shall bind any non-party or determine, limit or prejudice the rights of any such person or entity. None of the rights granted or obligations assumed under this Settlement Agreement by the parties hereto may be assigned or otherwise conveyed without the express prior written consent of all of the parties hereto.

N. Counterparts. This Settlement Agreement may be executed in

counterparts. Facsimile or photocopied signatures shall be considered as valid signatures as of the date hereof, although the original signature pages shall thereafter be appended to this Settlement Agreement.

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IN WITNESS WHEREOF, the parties hereto, through their fully authorized representatives, have agreed to this Comprehensive Settlement Agreement and Release as of this 8th day of May, 1998.

STATE OF MINNESOTA, acting by and through
Hubert H. Humphrey III, its duly elected and
authorized Attorney General

By: /s/ Hubert H. Humphrey III

Hubert H. Humphrey III
Attorney General

By: /s/ Lee E. Sheehy

Lee E. Sheehy
Chief Deputy Attorney General

By: /s/ Eric A. Johnson

Eric A. Johnson
Executive Assistant to the Attorney General

By: /s/ Thomas F. Pursell

Thomas F. Pursell
Senior Counsel to the Attorney General

By: /s/ D. Douglas Blanke

D. Douglas Blanke
Director of Consumer Policy

COUNSEL TO THE STATE OF MINNESOTA

By: /s/ Michael V. Ciresi

Michael V. Ciresi
Robins, Kaplan, Miller & Ciresi L.L.P.

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PHILIP MORRIS INCORPORATED

By: /s/ Meyer G. Koplow

Meyer G. Koplow
Counsel

By: /s/ Martin J. Barrington

Martin J. Barrington
General Counsel

R.J. REYNOLDS TOBACCO COMPANY

By: /s/ D. Scott Wise

D. Scott Wise
Counsel

By: /s/ Charles A. Blixt

Charles A. Blixt
General Counsel

BROWN & WILLIAMSON TOBACCO CORPORATION

By: /s/ Stephen R. Patton

Stephen R. Patton
Counsel

By: /s/ F. Anthony Burke

F. Anthony Burke
Vice President and General Counsel

LORILLARD TOBACCO COMPANY

By: /s/ Arthur J. Stevens

Arthur J. Stevens
Senior Vice President & General Counsel

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SCHEDULE A

AMOUNTS PAYABLE BY SETTLING DEFENDANTS ON OR
BEFORE SEPTEMBER 5, 1998 PURSUANT TO
PARAGRAPH II.B. OF THE SETTLEMENT AGREEMENT

| | |
|---|----------------|
| Date | 9/5/98 |
| ----- | |
| Settling Defendants | |
| ----- | |
| Philip Morris Incorporated..... | \$ 163,200,000 |
| R.J. Reynolds Tobacco Company..... | \$ 16,320,000 |
| Brown & Williamson Tobacco Corporation..... | \$ 42,960,000 |
| Lorillard Tobacco Company..... | \$ 17,520,000 |
| Total Amount..... | \$ 240,000,000 |

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SCHEDULE B

Potential Future Legislation to Reduce Tobacco Use by Children

- . Legislation to expand the self-service-sale restrictions of the youth access to tobacco law and to remove the current exception for sales of cigars.
- . Legislation to clarify the current youth access law provision on vending machines, making clear that machines equipped with automatic locks or that use tokens are vending machines within the meaning of the law.

Legislation providing enhanced or coordinated funding for enforcement efforts under sales-to-minors provisions of the criminal code or the youth access statute and ordinances.

Legislation to encourage or support the use of technology to increase effectiveness of age-of-purchase laws, such as, without limitation, the use of programmable scanners or scanners to read drivers' licenses.

Legislation or rules restricting the wearing, carrying or display of tobacco indicia in school-related settings, including, without limitation, in school facilities, on school premises, or in connection with school-sponsored activities.

Legislation to create or stiffen non-monetary incentives for youth not to smoke, such as expansion of youth community service programs.

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APPENDIX A

FORMULA FOR CALCULATING

STATE OF MINNESOTA VOLUME ADJUSTMENTS

Any payment that by the terms of the Settlement Agreement is to be adjusted pursuant to this Appendix (the "Applicable Base Payment") shall be adjusted pursuant to this Appendix in the following manner:

(A) in the event the aggregate number of units of Tobacco Products sold domestically by the Settling Defendants in the Applicable Year (as defined hereinbelow) (the "Actual Volume") is greater than the aggregate number of units of Tobacco Products sold domestically by the Settling Defendants in 1997 (the "Base Volume"), the Applicable Base Payment shall be multiplied by the ratio of the Actual Volume to the Base Volume;

(B) in the event the Actual Volume is less than the Base Volume,

(i) the Applicable Base Payment shall be multiplied by the ratio of the Actual Volume to the Base Volume, and the resulting product shall be divided by 0.98; and

(ii) if a reduction of the Applicable Base Payment results from the application of subparagraph (B)(i) of this Appendix, but the Settling Defendants' aggregate net operating profits from domestic sales of Tobacco Products for the Applicable Year (the "Actual Net Operating Profit") is greater than the Settling Defendants' aggregate net operating profits from domestic sales of Tobacco Products in 1997 (the "Base Net Operating Profit") (such Base Net Operating Profit being adjusted upward by the greater of the rate of 3% per annum or the actual total percent change in the Consumer Price Index, in either instance for the period between January 1, 1998 and the date on which the payment at issue is made), then the amount by which the Applicable Base Payment is reduced by the application of

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subparagraph (B)(i) shall be reduced (but not below zero) by 2.55% of 25% of such increase in such profits. For purposes of this Appendix, "net operating profits from domestic sales of Tobacco Products" shall mean net operating profits from domestic sales of Tobacco Products as reported to the United States Securities and Exchange Commission ("SEC") for the Applicable Year or, in the case of a Settling Defendant that does not report profits to the SEC, as reported in financial statements prepared in accordance with generally accepted accounting principles and audited by a nationally recognized accounting firm. The determination of the Settling Defendants' aggregate net operating profits from domestic sales of Tobacco Products shall be derived using the same methodology as was employed in deriving such Settling Defendants' aggregate net operating profits from domestic sales of Tobacco Products in 1997. Any increase in an Applicable Base Payment pursuant to this subparagraph B(ii) shall be payable within 120 days after the date that the payment at issue was required to be made.

(C) "Applicable Year" means (i) with respect to the payments made pursuant to paragraph II.D of the Settlement Agreement, the calendar year ending on the date on which the payment at issue is due, regardless of when such payment is made; and (ii) with respect to all other payments made

pursuant to this Settlement Agreement, the calendar year immediately preceding the year in which the payment at issue is due, regardless of when such payment is made.

STATE OF MINNESOTA

DISTRICT COURT

COUNTY OF RAMSEY

SECOND JUDICIAL DISTRICT

THE STATE OF MINNESOTA,
BY HUBERT H. HUMPHREY III,
ITS ATTORNEY GENERAL,

Case Type: Other Civil
Court File No. C1-94-8565

and

BLUE CROSS AND BLUE SHIELD
OF MINNESOTA,

Plaintiffs,

vs.

CONSENT JUDGMENT

PHILIP MORRIS INCORPORATED,
R.J. REYNOLDS TOBACCO COMPANY,
BROWN & WILLIAMSON TOBACCO
CORPORATION, B.A.T. INDUSTRIES
P.L.C., BRITISH-AMERICAN TOBACCO
COMPANY LIMITED, BAT (U.K. &
EXPORT) LIMITED, LORILLARD
TOBACCO COMPANY, THE AMERICAN
TOBACCO COMPANY, LIGGETT GROUP,
INC., THE COUNCIL FOR TOBACCO
RESEARCH-U.S.A., INC., and THE
TOBACCO INSTITUTE, INC.,

Defendants.

WHEREAS, the State of Minnesota, by its Attorney General, Hubert H. Humphrey III, and Blue Cross and Blue Shield of Minnesota filed their Complaint herein on August 17, 1994, and their Second Amended Complaint on January 6, 1998;

EXHIBIT A

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WHEREAS, Defendants have contested the claims in the Plaintiffs' Complaint and Second Amended Complaint;

WHEREAS, the parties recognize that Congress is considering national tobacco legislation and have agreed to settle this case on a basis which acknowledges possible federal legislation, but which guarantees to the people of Minnesota the relief granted herein;

WHEREAS, Settling Defendants, in the Settlement Agreement and Stipulation for Entry of Consent Judgment, have waived as specified therein their right to challenge the terms of this Consent Judgment as being superseded or preempted by future Congressional enactments; and

WHEREAS, the Attorney General believes the entry of this Consent Judgment is appropriate and in the public interest;

NOW THEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED AS FOLLOWS:

I. JURISDICTION AND VENUE

The Court has jurisdiction over the subject matter of this action and over the Settling Defendants under Minn. Stat. SECTIONS 8.31, 325D.15, 325D.45, 325D.58, 325F.70 and 484.01 (1994). Venue is proper in Ramsey County pursuant to Minn. Stat. SECTIONS 325D.65 and 542.09 (1994) in that Settling Defendants do business in Ramsey County.

II. DEFINITIONS

The definitions set forth in the Settlement Agreement and Stipulation for Entry of Consent Judgment ("Settlement Agreement") are incorporated by reference herein.

III. APPLICABILITY

This Consent Judgment applies only to Settling Defendants in their corporate capacity acting through their respective successors and assigns, directors, officers, employees, agents, subsidiaries, divisions, or other internal organizational units of any kind or any other entities acting in concert or participation with them. The remedies and penalties in Sections XD. and E. herein for a violation of this Consent Judgment shall apply only to Settling Defendants, and shall not be imposed or assessed against any employee, officer or director of Settling Defendants or other person or entity as a consequence of such a violation, and there shall be no jurisdiction under this Consent Judgment to do so.

IV. EFFECT ON THIRD PARTIES

This Consent Judgment is not intended to and does not vest standing in any third party with respect to the terms hereof, or create for any person other than the parties hereto a right to enforce the terms hereof.

V. INJUNCTIVE RELIEF

Settling Defendants are permanently enjoined from:

A. On and after December 31, 1998, marketing, licensing, distributing, selling or offering, directly or indirectly, including by catalogue or direct mail, in the State of Minnesota, any service or item (other than tobacco products or any item the sole function of which is to advertise tobacco products) which bears the brand name (alone or in conjunction with any other word), logo, symbol, motto, selling message, recognizable color or pattern of colors, or any other indicia or product identification identical or similar to, or identifiable with, those used for any domestic brand of tobacco products.

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B. Making any material misrepresentation of fact regarding the health consequence of using any tobacco product, including any tobacco additives, filters, paper or other ingredients. Nothing in this paragraph shall limit the exercise of any First Amendment right or any defense or position which persons bound by this Consent Judgment may assert in any judicial, legislative, or regulatory forum.

C. Entering into any contract, combination or conspiracy between or among themselves, which has the purpose or effect of: (1) limiting competition in the production or distribution of information about the health hazards or other consequences of the use of their products; (2) limiting or suppressing research into smoking and health; or (3) limiting or suppressing research into, marketing, or development of new products.

D. Taking any action, directly or indirectly, to target children in Minnesota in the advertising, promotion, or marketing of cigarettes, or taking any action the primary purpose of which is to initiate, maintain or increase the incidence of underage smoking in Minnesota.

VI. DISSOLUTION OF DEFENDANT COUNCIL FOR TOBACCO RESEARCH

Settling Defendants represent that they have the authority to effectuate the following and will do so within 90 days of this Agreement: The Council for Tobacco Research-U.S.A. Inc. shall cease all operations except as necessary to comply with existing grants or contracts and to continue its defense of other lawsuits and will be disbanded and dissolved within a reasonable time period thereafter. To the extent not required elsewhere in this Consent Judgment, the Council for Tobacco Research shall forward all smoking and health research in its possession or control to the Food and Drug Administration subject to appropriate confidentiality protection required by contracts between the Council for Tobacco Research and any third party. Defendants shall preserve all other records

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of the Council for Tobacco Research which relate in any way to issues raised in this or any other Attorney General lawsuit. Defendants may not reconstitute the Council for Tobacco Research or its function in any form.

VII. PUBLIC ACCESS TO DOCUMENTS AND COURT FILES

A. The Court's previous Protective Orders are hereby dissolved with respect to all documents, including the 4A and 4B indices and the privilege logs, which have been produced to the Plaintiffs and for which Defendants have

made no claim of privilege or Category II trade secret protection. Such documents shall be made available to the public at the Depository, in the manner provided as follows:

1. The public shall be given access to all non-privileged documents contained in the Minnesota Depository, including all documents set forth in Paragraph VII.A. above.

2. Plaintiffs and Settling Defendants shall meet with representatives of the current Minnesota Depository administrators, Smart Legal Assistance and Merrill Corporation, and/or other appropriate persons, to discuss staffing issues and the procedures that should be implemented to continue the operation of the Minnesota Depository, thereby to ensure broad and orderly access to these documents.

3. Category II documents shall be returned to the Defendants as soon as practical, provided that Defendants, upon receiving appropriate assurances of trade secret protection from the Food and Drug Administration, shall forward a copy of the Category II documents bearing the Bates numbers from this action to said agency. Plaintiffs shall retain the Bates stamp numbers of all Category II documents produced in this case.

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B. The documents produced in this case are not "government data" under the Minnesota Government Data Practices Act.

C. For documents upon which a privilege was claimed and found not to exist, including any briefs, memoranda and other pleadings filed by the parties which include reference to such documents, Plaintiffs may seek court approval to make such documents available to the public, provided that any such request be made to the Court within 45 days of the date of entry of this Consent Judgment.

D. Defendant British-American Tobacco Company Limited shall maintain and operate the Guildford Depository for a period of ten years. Defendant British-American Tobacco Company Limited shall have the option of maintaining such depository at its current location or at an appropriate alternative location. All documents, except those identified in Paragraph VII.A.3 above, which were selected by plaintiffs from the Guildford Depository in response to the Plaintiffs' discovery requests shall be moved to and retained at the Minnesota Depository.

E. The Minnesota Depository shall be maintained and operated at Settling Defendants' sole expense, in the manner set forth above for ten years after the date hereof, or such longer period as may be provided in federal legislation for a national document depository. At the end of such period, or sooner, at the State's discretion, the documents shall be transferred to the State Archives or other appropriate state body, where they shall remain available for historical and research purposes. The parties and the Depository staff shall cooperate with the State Archivist or such other state officials as may be involved in transferring the documents to the custody of the State.

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F. Settling Defendants shall provide to the State for the Depository a copy of all existing CD-ROMs of documents produced in this action that do not contain any privileged or work-product documents or information, to be placed in the Depository.

G. Defendants shall produce to the Depository all documents produced by such defendants in other United States smoking and health litigation but not previously produced in Minnesota, within 30 days of their production in such other litigation, provided Defendants do not claim privilege with respect to such documents, and provided such documents are not subject to any protective order.

VIII. EQUITABLE RELIEF: NATIONAL RESEARCH; DEPOSIT OF FUNDS.

A. In furtherance of the equitable relief sought by the State, pursuant to the Court's equitable powers to shape appropriate injunctive relief, in light of the public health interests demonstrated by the evidence in this case, and pursuant to the agreement of the parties:

1. Consistent with the Prayer for Relief in the State's Complaint and Amended Complaints that the Defendants fund cessation programs in the State of Minnesota, the amount due in December, 1998 (\$102 million), pursuant to the Settlement Agreement, Section II.D, shall be deposited into a separate cessation account and used to offer smoking cessation opportunities to Minnesota smokers, and shall be administered as ordered by the Court.

2. In addition to other money paid under this Consent Judgment and the

Settlement Agreement and Stipulation for Entry of Consent Judgment, each Settling Defendant shall pay pro rata in proportion to its Market Share, on or before June 1, 1998, and no later than June 1 of each succeeding year through and including June 1, 2007, its share of

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\$10 million into a national research account, to be administered as ordered by the Court. The parties envision that approximately 70% of the \$100 million total will be used for research grants relating to the elimination of tobacco use by children, and 30% for program implementation, evaluation and other tobacco control purposes; provided, however, the administrator of the national research account may, in its discretion, change the allocation.

3. The State shall submit a plan for the administration and authorized uses of the funds payable under this section within 45 days of the date of entry of this Consent Judgment.

4. Monies payable under this section and Section V.B. of the Settlement Agreement shall be deposited in interest bearing accounts at a bank to be designated by the Commissioner of Finance. Settling Defendants' payment of the amounts set forth above are Settling Defendants' sole obligation under this section.

B. Except as specified in this section and Section V.B of the Settlement Agreement, all monies payable under Sections II.B. and D. of the Settlement Agreement between the parties shall be deposited into the general fund of the State of Minnesota.

IX. FINAL DISPOSITION

This Consent Judgment resolves all claims set forth in the State's Second Amended Complaint against Defendants, which are hereby dismissed with prejudice, and shall constitute the final disposition of this action.

X. MISCELLANEOUS PROVISIONS

A. Jurisdiction of this case is retained for the purpose of enforcement and enabling the continuing proceedings contemplated herein. Any party to this Consent Judgment may apply to this

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Court at any time for such further orders and directions as may be necessary or appropriate for the construction and enforcement of this Consent Judgment.

B. This Consent Judgment is not intended to be and shall not in any event be construed as, or deemed to be, an admission or concession or evidence of personal jurisdiction or any liability or any wrongdoing whatsoever on the part of any Defendant. The Defendants specifically disclaim any liability or wrongdoing whatsoever with respect to the claims and allegations asserted against them in this action and Settling Defendants have stipulated to entry of this Consent Judgment solely to avoid the further expense, inconvenience, burden and risk of litigation.

C. Except as provided in Section III.D. of the Settlement Agreement and Stipulation for Entry of Consent Judgment, this Consent Judgment shall not be modified unless the party seeking modification demonstrates, by clear and convincing evidence, that it will suffer irreparable harm from new and unforeseen conditions; provided, however, that the provisions of Section III of this Consent Judgment shall in no event be subject to modification. Changes in the economic conditions of the parties shall not be grounds for modification. It is intended that Settling Defendants will comply with this Consent Judgment as originally entered, even if Settling Defendants' obligations hereunder are greater than those imposed under current or future law. Therefore, a change in law that results, directly or indirectly, in more favorable or beneficial treatment of any one or more of the Settling Defendants shall not support modification of this Consent Judgment.

D. In enforcing this Consent Judgment the Attorney General shall have the discovery powers of Minn. Stat. SECTION 8.31 (1996), as amended. Any Settling Defendant which violates this Consent Judgment shall be subject to contempt and to the remedies provided in Minn. Stat. SECTION 8.31 (1996), as amended. In addition, in any proceeding which results in a finding that a Settling

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Defendant violated this Consent Judgment, the responsible Settling Defendant or Settling Defendants shall pay the State's costs and attorneys' fees incurred in such proceeding.

E. The remedies in this Consent Judgment are cumulative and in addition to any other remedies the State may have at law or equity. Nothing herein shall be construed to prevent the State from bringing any action for conduct not released hereunder, even though that conduct may also violate this Consent Judgment.

LET JUDGMENT BE ENTERED ACCORDINGLY.

Dated:

KENNETH J. FITZPATRICK
Judge of District Court

JUDGMENT

Pursuant to the foregoing Consent Judgment, judgment is hereby entered accordingly.

Dated:

Court Administrator

STATE OF MINNESOTA

DISTRICT COURT

COUNTY OF RAMSEY

SECOND JUDICIAL DISTRICT

THE STATE OF MINNESOTA,

Court File No. C1-94-8565

BY HUBERT H. HUMPHREY, III,
ITS ATTORNEY GENERAL,

and

BLUE CROSS AND BLUE SHIELD
OF MINNESOTA,

Plaintiffs,

vs.

PHILIP MORRIS INCORPORATED,
R.J. REYNOLDS TOBACCO COMPANY,
BROWN & WILLIAMSON TOBACCO
CORPORATION, B.A.T. INDUSTRIES
P.L.C., BRITISH-AMERICAN TOBACCO
COMPANY LIMITED, BAT (U.K. &
EXPORT) LIMITED, LORILLARD
TOBACCO COMPANY, THE
AMERICAN TOBACCO COMPANY,
LIGGETT GROUP, INC., THE
COUNCIL FOR TOBACCO RESEARCH
U.S.A., INC. and THE TOBACCO
INSTITUTE, INC.,

Defendants.

SETTLEMENT AGREEMENT AND RELEASE

THIS SETTLEMENT AGREEMENT AND RELEASE ("Settlement Agreement") is made as of the date hereof, by and among the parties hereto, as indicated by their signatures below, to settle and resolve with finality all claims of BCBSM, Inc. d/b/a Blue Cross and Blue Shield of

Minnesota ("Blue Cross") relating to the subject matter of this action which have been or could have been asserted by Blue Cross and Blue Shield of Minnesota.

WHEREAS, Blue Cross is a nonprofit health service plan corporation organized pursuant to Minnesota Statutes Chapter 62C, and as such fulfills a variety of health related functions in the State of Minnesota;

WHEREAS, the general purposes of Blue Cross under its enabling legislation and its Articles of Incorporation is "to make possible wide, economic and timely availability of hospital, medical surgical, dental and other health services for the people of Minnesota and others" and "advance public health and the art and science of hospital, medical and health care under the laws of the State of Minnesota;"

WHEREAS, Blue Cross in recognition and furtherance of its statutory mandate and charter, and the State of Minnesota, through its Attorney General, Hubert H. Humphrey III, commenced this action on August 17, 1994, asserting various claims for monetary and injunctive relief on behalf of Blue Cross and the State of Minnesota against certain tobacco manufacturers and others as Defendants;

WHEREAS, Blue Cross brought this action with the objectives of seeking disclosure of cigarette industry knowledge about Tobacco Products to help better inform the public and banning the marketing of Tobacco Products to children;

WHEREAS, Blue Cross has achieved disclosure of millions of cigarette industry documents that shall hereafter be available to the public in the Minnesota depository;

WHEREAS, Blue Cross has, by this action, sought to affect conduct of Defendants, including:

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- . to refrain from opposition to Minnesota legislative activity intended to control tobacco use by children;
- . to refrain from challenging the enforceability of existing Minnesota laws or rules relating to tobacco control;
- . to discontinue all billboard and transit advertisements of Tobacco Products in the State of Minnesota;
- . to refrain from the payment for product placement within motion pictures made within the United States;
- . to permanently cease the marketing of any service or item, other than Tobacco Products and advertisements for such products, which bears the brand name or other identifying mark of any domestic Tobacco Product;
- . to disclose certain payments or provision of other benefits to lobbyists, third parties and public officials; and
- . to cause The Council for Tobacco Research-U.S.A. to cease operations.

WHEREAS, Blue Cross has specifically asserted various claims for monetary relief against the tobacco manufacturers and other defendants to recover amounts which Blue Cross has expended for the treatment of the smoking-caused illnesses of its subscribers;

WHEREAS, Blue Cross is the first such health plan to undertake such action against any of the Defendants with regard to issues of smoking and health, and until 1998, was the only such health plan to have commenced such an action;

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WHEREAS, the Defendants have denied each and every one of Plaintiffs' allegations of unlawful conduct or wrongdoing and have asserted a number of defenses to Plaintiffs' claims, which defenses have been contested by Plaintiffs; and

WHEREAS, the parties hereto wish to avoid the further expense, delay, inconvenience, burden and uncertainty of continued litigation of this matter (including appeals from any verdict), Blue Cross and the Settling Defendants have agreed to settle this litigation:

NOW, THEREFORE, BE IT KNOWN THAT, in consideration of the payments to be made by the Settling Defendants, the dismissal and release of claims by Blue Cross and such other consideration as described herein, the sufficiency of which is hereby acknowledged, the parties hereto, acting by and through their authorized agents, memorialize and agree as follows:

I. GENERAL PROVISIONS

A. Jurisdiction. Blue Cross and the Settling Defendants acknowledge

that this Court has jurisdiction over the subject matter of this action and over each of the parties to this Settlement Agreement, and that this Court shall retain jurisdiction for the purposes of implementing and enforcing this Settlement Agreement. The parties hereto agree to present any disputes under this Settlement Agreement, including without limitation any claims for breach or enforcement of this Settlement Agreement, exclusively to this Court.

B. Voluntary Agreement of the Parties. Blue Cross and the Settling

Defendants acknowledge and agree that this Settlement Agreement is voluntarily entered into by all parties hereto as the result of arm's-length negotiations during which all such parties were represented by counsel. Blue Cross and Settling Defendants understand that Congress may enact legislation dealing with some of the issues addressed in this Agreement. Settling Defendants and their assigns, affiliates, agents,

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and successors, hereby waive any right to challenge this Agreement, directly or

through third parties, on the ground that any term hereof is unconstitutional, outside the power or jurisdiction of the Court, preempted by or in conflict with any current or future federal legislation (except where non-economic terms of future federal legislation are irreconcilable).

C. Definitions.

For the purposes of this Settlement Agreement, the following terms shall have the meanings set forth below:

1. "State" or "State of Minnesota" means the State of Minnesota acting by and through its Attorney General;

2. "Blue Cross" means BCBSM, Inc., d/b/a Blue Cross and Blue Shield of Minnesota, and all of its employees, directors, officers, attorneys, parents, and divisions. BCBSM, Inc. represents that it is an independent corporation operating under license from Blue Cross and Blue Shield Association, an association of independent Blue Cross and Blue Shield Plans (the "Association"), permitting BCBSM, Inc. to use the Blue Cross and Blue Shield service marks in Minnesota, and that BCBSM, Inc. is not serving as an agent of the Association or any other Blue Cross/Blue Shield Plans in entering into this Settlement Agreement;

3. "Settling Defendants" means those Defendants in this action that are signatories hereto;

4. "Defendants" means Philip Morris Incorporated, R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation, B.A.T. Industries P.L.C., British-American Tobacco Company Limited, BAT (U.K. and Export) Limited, Lorillard Tobacco

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Company, The American Tobacco Company, The Council for Tobacco Research-U.S.A., Inc., and the Tobacco Institute, Inc. and their successors and assigns;

5. "Consumer Price Index" shall mean the Consumer Price Index for All Urban Consumers for the most recent twelve-month period, as published by the Bureau of Labor Statistics of the U.S. Department of Labor;

6. "State Settlement Agreement" means the settlement agreement entitled "Settlement Agreement and Stipulation for Entry of Consent Judgment" entered into among the State and the Settling Defendants with respect to the settlement of this action;

7. "State Escrow Agreement" means the escrow agreement so entitled and entered into among State, the Settling Defendants and an escrow agent;

8. "Court" means the District Court of the State of Minnesota, County of Ramsey, Second Judicial District;

9. "Market Share" means a Settling Defendant's respective share of sales of cigarettes by unit for consumption in the United States during the calendar year immediately preceding the year in which the payment at issue is due, regardless of when payment is made;

10. "Cigarettes" means any product which contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains (i) any roll of tobacco wrapped in paper or in any substance not containing tobacco; or (ii) tobacco, in any form, that is functional in the product, which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette; or (iii) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its

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packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in subparagraph (i) of this Paragraph.;

11. "Smokeless Tobacco" means any powder that consists of cut, ground, powdered, or leaf tobacco that contains nicotine and that is intended to be placed in the oral cavity;

12. "Tobacco Products" means Cigarettes and Smokeless Tobacco;

13. "Depository," unless otherwise specified, means the Minnesota document depository established by the Court's Order dated June 16, 1995. "Depositories" includes both the Minnesota depository and the Guildford, U.K. document depository established by the Court's Order dated September 6, 1995.

14. "Private Counsel" means Robins, Kaplan, Miller & Ciresi L.L.P.

15. "Final Settlement" means the date on which this Settlement Agreement, is executed and a Stipulation of Dismissal with prejudice is filed with the Court;

16. "Allocation Fraction" means that fraction of each of the payments made to Blue Cross which is expressed as a fraction for which, for each year, 1978-1996, the numerator is Blue Cross's damages for that year and the denominator is Blue Cross's total damages for years 1978-1996. The Allocation Fractions for years 1978-1996 are as follows:

| | |
|-----------------|--------------|
| For year, 1978: | 0.028166303; |
| For year, 1979: | 0.032609439; |
| For year, 1980: | 0.039670851; |
| For year, 1981: | 0.040893991; |
| For year, 1982: | 0.042167950; |

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| | |
|-----------------|------------------|
| For year, 1983: | 0.037203831; |
| For year, 1984: | 0.031715039; |
| For year, 1985: | 0.040184252; |
| For year, 1986: | 0.046644637; |
| For year, 1987: | 0.048474365; |
| For year, 1988: | 0.049674533; |
| For year, 1989: | 0.058874757; |
| For year, 1990: | 0.066059121; |
| For year, 1991: | 0.068837235; |
| For year, 1992: | 0.071286135; |
| For year, 1993: | 0.066550282; |
| For year, 1994: | 0.075199152; |
| For year, 1995: | 0.075114815; and |
| For year, 1996: | 0.080673311. |

D. Settlement Receipts. The payments to be made by the Settling

Defendants under this Settlement Agreement are in satisfaction of all of Blue Cross's claims for damages, including, without limitation, those for punitive damages, incurred by Blue Cross in the year of payment or earlier years, except that no part of any payment under this Settlement Agreement is made in settlement of an actual or potential liability for a fine, penalty (civil or criminal) or enhanced damages. Blue Cross represents that it does not have authority to bring: (1) claims attributable to or arising out of the payment of benefits by self-funded employer-employee benefit plans for which Blue Cross presently provides or has formerly provided administrative services, (2) claims attributable to or arising out of

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the payment of benefits under any program or plan for the Minnesota Comprehensive Health Association or under the Federal Employees Health Benefit Act or any other federal health benefit plan, or (3) claims attributable to or arising out of the payment of benefits by any employee benefit plan of any political subdivision of the State of Minnesota for which Blue Cross provides or has provided administrative services. Each payment set forth in this section shall be in partial satisfaction of each year of damages incurred and alleged by Blue Cross for the years 1978 through 1996 and each payment shall accordingly be allocated to the satisfaction of each specific year of damages incurred by Blue Cross according to the Allocation Fraction set forth above.

E. Settlement Payments to Blue Cross. Each Settling Defendant severally

shall cause to be paid to an account designated in writing by Blue Cross in accordance with and subject to Paragraph I.F. of this Settlement Agreement, the following amounts: the amount listed for it in Schedule A hereto, such amount representing its share of \$160,000,000, to be paid on or before September 5, 1998; pro rata in proportion to its Market Share, its share of \$79,200,000, to

be paid on or before January 4, 1999; pro rata in proportion to its Market

Share, its share of \$57,450,000, to be paid on or before January 3, 2000; pro

rata in proportion to its Market Share, its share of \$57,450,000, to be paid on
- ----
or before January 2, 2001; pro rata in proportion to its Market Share, its share

of \$57,450,000, to be paid on or before January 2, 2002; and pro rata in

proportion to its Market Share, its share of \$57,450,000, to be paid on or
before January 2, 2003. The payments made by the Settling Defendants pursuant to
this Paragraph shall be adjusted upward by the greater of 3% or the percentage
increase in the Consumer Price Index applied each year on the previous year,
beginning with the payment due to be made on or before January 3, 2000. The
payments due to be made by the Settling Defendants pursuant to this Paragraph E
on or before January 3, 2000, on or

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before January 2, 2001, on or before January 2, 2002, and on or before January
2, 2003, will also be decreased or increased, as the case may be, in accordance
with the formula for adjustments of payments set forth in Appendix A. The
payments due to be made by the Settling Defendants pursuant to this Paragraph E
on or before September 5, 1998, and on or before January 4, 1999, shall not be
subject to the inflation escalation and volume adjustment described in the
preceding sentences.

In the event that any of the Settling Defendants (a "Defaulting
Defendant") fails to make any payment required of it pursuant to this Paragraph
E by the applicable date set forth in this Paragraph E (a "Missed Payment"),
Blue Cross shall provide notice to each of the Settling Defendants of such
non-payment. The Defaulting Defendant shall have 15 days after receipt of such
notice to pay the Missed Payment, together with interest accrued from the
original applicable due date at the prime rate as published in the Wall Street
Journal on the latest publication date on or before the date of default plus 3%.
If the Defaulting Defendant does not make such payment within such 15-day
period, Blue Cross shall provide notice to each of the Settling Defendants of
such continued non-payment. Any or all of the Settling Defendants (other than
the Defaulting Defendant) shall thereafter have 15 days after receipt of such
notice to elect (in such Settling Defendant's or such Settling Defendants' sole
and absolute discretion) to pay the Missed Payment, together with interest
accrued from the original applicable due date the rate of prime rate as
published in the Wall Street Journal on the latest publication date on or before
the date of default plus 3%.

In the event that Blue Cross does not receive the Missed Payment,
together with such accrued interest, within such additional 15-day period, all
payments required to be made by each of the respective Settling Defendants
pursuant to this Paragraph E shall at the end of such additional 15-day period
be accelerated and shall immediately become due and owing to Blue Cross from
each Settling

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Defendant pro rata in proportion to its Market Share; provided, however, that
any such accelerated payments (a) shall all be adjusted upward by the greater of
(i) the rate of 3% per annum or (ii) the actual total percent change in the CPI,
in either instance for the period between January 1 of the year in which the
acceleration of payments pursuant to this Paragraph occurs and the date on which
such accelerated payments are due pursuant to this subsection, and (b) shall all
immediately be adjusted in accordance with the formula for adjustments of
payments set forth in Appendix A.

Nothing in this Paragraph E shall be deemed under any circumstance to
create any obligation in any of the Settling Defendants to pay any amount owed
or payable to Blue Cross from any other Settling Defendant. All obligations of
the Settling Defendants pursuant to this Paragraph E are intended to be and
shall remain several, and not joint.

F. Payment of Settlement Proceeds. Any payment made pursuant to the

Settlement Agreement shall be made to an account designated in writing by Blue
Cross.

G. Blue Cross's Dismissal of Claims. Upon execution of this Settlement

Agreement Blue Cross shall file a Stipulation of Dismissal dismissing with
prejudice all claims as to all Defendants.

H. Blue Cross's Release and Discharge. Upon Final Approval, Blue Cross

shall release and forever discharge all Defendants and their present and former parents, subsidiaries (whether or not wholly owned) and affiliates, and their divisions, organizational units, affiliates, officers, directors, employees, representatives, insurers, suppliers, agents, attorneys and distributors (and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing) ("Releasees") from any and all manner of civil claims, demands, actions, suits and causes of action, damages whenever incurred, liabilities of any nature whatsoever, including civil penalties, as well as costs, expenses and attorneys' fees, known or unknown, suspected or unsuspected, accrued or

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unaccrued, whether legal, equitable or statutory ("Claims") that Blue Cross (including any of its past, present or future parents, subsidiaries (whether or not wholly owned) and their respective representatives, employees, directors, trustees, officers, attorneys, Private Counsel, agents, representatives, divisions, organizational units (and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing, and whether or not any such person or entity participates in the settlement), whether directly, indirectly, representatively, derivatively or in any other capacity, ever had, now has or hereafter can, shall or may have as to any claims relating to the subject matter of this action (including damages not incurred as of the date of this Settlement); provided, however, that the foregoing shall not operate as a release of any person, party or entity (whether or not a signatory to this Agreement) as to any of the monetary obligations undertaken in this Agreement in connection with a breach or default of this Agreement.

Blue Cross hereby covenants and agrees that it shall not hereafter sue or seek to establish civil liability against any person or entity covered by the release provided under this Paragraph H based, in whole or in part, upon any of the Released Claims, and Blue Cross agrees that this covenant and agreement shall be a complete defense to any such civil action or proceeding. .

Notwithstanding the foregoing, if the Settling Defendants enter into any future pre-verdict settlement of any action brought by any insurer, health maintenance organization, Blue Cross plan, Blue Shield plan, employee welfare benefit plan, union trust fund providing health care benefits and/or coverage for health care benefits, or any other third-party payor (hereinafter collectively referred to as "Third-Party Payors") of health care coverage or benefits that does not release claims for damages not incurred as of the date of such settlement relating to the subject matter of such action, the scope

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of the release provided herein shall be revised so as to permit Blue Cross to assert claims for damages not incurred as of the date hereof relating to the subject matter of this action.

I. Settling Defendants' Release and Discharge. Upon Final Approval,

Settling Defendants shall release and forever discharge Blue Cross from any and all manner of civil claims, demands, actions, suits and causes of action, damages whenever incurred, liabilities of any nature whatsoever, including costs, expenses, penalties and attorneys' fees, known or unknown, suspected or unsuspected, accrued or unaccrued, whether legal, equitable or statutory, arising out of or in any way related to, in whole or in part, the subject matter of the litigation of this lawsuit, that Settling Defendants (including any of their present and former parents, subsidiaries, divisions, affiliates, officers, directors, employees, witnesses (fact or expert), representatives, insurers, agents, attorneys and distributors and the predecessors, heirs, executors, administrators, successors and assigns of each of the foregoing, and whether or not any such person participates in the settlement), whether directly, indirectly, representatively, derivatively or in any other capacity, ever had, now has or hereafter can, shall or may have.

J. Pierringer Release. Without limiting the terms or effect of

Paragraph I.H. of this Settlement Agreement, Blue Cross hereby expressly releases and discharges each Releasee from its respective fraction(s), portion(s), or percentage(s) of any of the Released Claims that shall hereafter be determined at trial or other disposition to be the fault of such Releasee. Blue Cross expressly agrees to indemnify and hold harmless all Releasees from any claims, demands, damages or causes of action for contribution or indemnification that may be made by any person or entity with respect to any Released Claim, and to satisfy such fraction, portion or percentage of any judgment, settlement or other disposition with respect to any Released Claim which is determined to be the fault of any of

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such Releasees. The parties to this Settlement Agreement specifically intend that one of the purposes and legal effects of this Settlement Agreement is to bar forever any right of contribution and/or indemnify against the Releasees, and that it thus have the effect of a "Pierringer-type" release and be construed in accordance with Pierringer v. Hoyer, 124 N.W.2d 106 (Wisc. 1963);

Frey v. Snelgrove, 269 N.W.2d 918 (Minn. 1978); and Alumax Mill Products,

Inc. v. Congress Financial Corp., 912 F.2d 996 (8th Cir. 1990).

K. Limited Most-Favored Nation Provision. In partial consideration for

the monetary payments to be made by the Settling Defendants pursuant to this Settlement Agreement, Blue Cross agrees that if the Settling Defendants enter into any future pre-verdict settlement agreement of other similar litigation brought by a Third-Party Payor on terms more favorable to such Third-Party Payor than the terms of this Settlement Agreement, the terms of this Settlement Agreement shall not be revised except as follows: to the extent, if any, such other pre-verdict settlement agreement includes terms that provide (a) for joint and several liability among the Settling Defendants with respect to monetary payments to be made pursuant to such agreement or (b) a guarantee by the parent company of any of the Settling Defendants or other assurances of payment or creditors' remedies with respect to monetary payments to be made pursuant to such agreement, then this Settlement Agreement shall, at the option of Blue Cross, be revised to include terms comparable to such terms.

II. PUBLIC ACCESS TO DOCUMENTS AND COURT FILES

In connection with the settlement of this action, Blue Cross has insisted that the Settling Defendants enter into a Consent Judgment with the State of Minnesota providing for the maintenance of the Minnesota and Guildford Depositories, thereby achieving continued public access to millions of industry documents for the public benefit.

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III. MISCELLANEOUS PROVISIONS

A. Settling Defendants and the Law Firm of Robins, Kaplan, Miller & Ciresi L.L.P. ("RKM&C") have reached separate agreement for the payment of the Blue Cross' costs and attorneys' fees. In consideration for said agreement, RKM&C has released Blue Cross from its obligation to pay costs and attorneys' fees under the retainer agreement entered into between the Blue Cross and RKM&C.

B. Representations of Parties. The respective parties hereto hereby

represent that this Settlement Agreement has been duly authorized and, upon execution, will constitute a valid and binding contractual obligation, enforceable in accordance with its terms, of each of the parties hereto. Blue Cross represents that all of its outside counsel that have represented it in connection with this action are, by and through their authorized representatives, signatories to this Settlement Agreement.

C. Obligation Several, Not Joint. All obligations of the Settling

Defendants pursuant to this Settlement Agreement are intended to be and shall remain several, and not joint.

D. Headings. The headings of the paragraphs of this Settlement

Agreement are not binding and are for reference only and do not limit, expand or otherwise affect the contents of this Settlement Agreement.

E. No Determination or Admission. This Settlement Agreement and any

proceedings taken hereunder are not intended to be and shall not in any event be construed as, or deemed to be, an admission or concession or evidence of any liability or any wrongdoing whatsoever on the part of any party hereto or any person covered by the releases provided under Paragraphs I.H. and I.I. hereof. The Settling Defendants specifically disclaim and deny any liability or wrongdoing whatsoever with respect to the allegations and claims asserted against them in this action and enter

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into this Settlement Agreement solely to avoid the further expense, inconvenience, burden and uncertainty of litigation.

F. Non-Admissibility. The settlement negotiations resulting in this

Settlement Agreement have been undertaken by the parties hereto in good faith and for settlement purposes only, and neither this Settlement Agreement nor any evidence of negotiations hereunder shall be offered or received in evidence in this action, or any other action or proceeding, for any purpose other than in an action or proceeding arising under this Settlement Agreement.

G. Amendment; Waiver. This Settlement Agreement may be amended only by

a written instrument executed by Blue Cross, and the Settling Defendants. The waiver of any rights conferred hereunder shall be effective only if made by written instrument executed by the waiving party. The waiver by any party of any breach of this Settlement Agreement shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, of this Settlement Agreement.

H. Notices. All notices or other communications to any party to this

Settlement Agreement shall be in writing (and shall include telex, telecopy or similar writing) and shall be given to the respective parties hereto at the following addresses. Any party hereto may change the name and address of the person designated to receive notice on behalf of such party by notice given as provided in this paragraph.

For Blue Cross:

Thomas F. Gilde
Associate Corporate Counsel
Blue Cross and Blue Shield of Minnesota
3535 Blue Cross Road
Eagan, MN 55122

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or

P. O. Box 64560
St. Paul, MN 55164
Fax: 612.456.6017

with a copy to:

Michael V. Ciresi
Robins, Kaplan, Miller & Ciresi L.L.P.
2800 LaSalle Plaza
800 LaSalle Avenue
Minneapolis, MN 55402-2015
Fax: 612.339.4181

For Philip Morris Incorporated:

Martin J. Barrington
Philip Morris Incorporated
120 Park Avenue
New York, NY 10017-5592
Fax: 212.907.5399

With a copy to:

Meyer G. Koplow
Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, NY 10019
Fax: 212.403.2000

For R.J. Reynolds Tobacco Company:

Charles A. Blixt
General Counsel
R.J. Reynolds Tobacco Company
401 North Main Street
Winston-Salem, NC 27102
Fax: 910.741.2998

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With a copy to:

Arthur F. Golden
Davis Polk & Wardwell
450 Lexington Avenue
New York, NY 10017
Fax: 212.450.4800

For Brown & Williamson Tobacco Corporation:

F. Anthony Burke
Brown & Williamson Tobacco Corporation
200 Brown & Williamson Tower
401 South Fourth Avenue
Louisville, KY 40202
Fax: 502.568.7297

With a copy to:

Stephen R. Patton
Kirkland & Ellis
200 East Randolph Dr.
Chicago, IL 60601
Fax: 312.861.2200

For Lorillard Tobacco Company:

Arthur J. Stevens
Lorillard Tobacco Company
714 Green Valley Road
Greensboro, NC 27408
Fax: 910.335.7707

I. Cooperation. The parties hereto agree to use their best efforts and

to cooperate with each other to cause this Settlement Agreement to become effective, to obtain all necessary approvals, consents and authorizations, if any, and to execute all documents and to take such other action as may be appropriate in connection therewith. Consistent with the foregoing, the parties hereto agree that they will not directly or indirectly assist or encourage any challenge to this Settlement Agreement by

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any other person. All parties hereto agree to support the integrity and enforcement of the terms of this Settlement Agreement.

J. Governing Law. This Settlement Agreement shall be governed by

the laws of the State of Minnesota, without regard to the conflicts of law rules of such state.

K. Construction. None of the parties hereto shall be considered to be

the drafter of this Settlement Agreement or any provision hereof for the purpose of any statute, case law or rule of interpretation or construction that would or might cause any provision to be construed against the drafter hereof.

L. Intended Beneficiaries. This action was brought by the Blue Cross,

through its Attorney General, and by Blue Cross to recover certain monies and to promote the health and welfare of the people of Minnesota. No portion of this Settlement Agreement shall provide any rights to, or be enforceable by, any person or entity that is neither a party hereto nor a person encompassed by the releases provided in Paragraphs I.H. and I.I. of this Settlement Agreement. Except as expressly provided in this Settlement Agreement, no portion of this Settlement Agreement shall bind any non-party or determine, limit or prejudice the rights of any such person or entity. None of the rights granted or obligations assumed under this Settlement Agreement by the parties hereto may be assigned or otherwise conveyed without the express prior written consent of all of the parties hereto.

M. Counterparts. This Settlement Agreement may be executed in

counterparts. Facsimile or photocopied signatures shall be considered as valid signatures as of the date hereof, although the original signature pages shall thereafter be appended to this Settlement Agreement.

IN WITNESS WHEREOF, the parties hereto, through their fully authorized representatives, have agreed to this Comprehensive Settlement Agreement and Release as of this 8th day of May, 1998.

BLUE CROSS AND BLUE SHIELD OF
MINNESOTA

By: /s/ Andrew P. Czajkowski

Andrew P. Czajkowski
Chief Executive Officer
Blue Cross and Blue Shield of Minnesota

By: /s/ Thomas F Gilde

Thomas F. Gilde
Associate Corporate Counsel

By: /s/ Michael V. Ciresi

Michael V. Ciresi
Robins, Kaplan, Miller & Ciresi L.L.P.

PHILIP MORRIS INCORPORATED

By: /s/Meyer G. Koplow

Meyer G. Koplow
Counsel

By: /s/ Martin J. Barrington

Martin J. Barrington
General Counsel

R.J. REYNOLDS TOBACCO COMPANY

By: /s/ D. Scott Wise

D. Scott Wise
Counsel

By: /s/ Charles A. Blixt

Charles A. Blixt
General Counsel

BROWN & WILLIAMSON TOBACCO CORPORATION

By: /s/ Stephen R. Patton

Stephen R. Patton
Counsel

By: /s/ F. Anthony Burke

F. Anthony Burke
Vice President and General Counsel

LORILLARD TOBACCO COMPANY

By: /s/ Arthur J. Stevens

Senior Vice President & General Counsel

SCHEDULE A

AMOUNTS PAYABLE BY SETTling DEFENDANTS ON OR
BEFORE SEPTEMBER 5, 1998 PURSUANT TO
PARAGRAPH I.E OF THE SETTLEMENT AGREEMENT

| | |
|---|---------------|
| Philip Morris Incorporated..... | \$108,800,000 |
| R.J. Reynolds Tobacco Company..... | \$ 10,880,000 |
| Brown & Williamson Tobacco Corporation..... | \$ 28,640,000 |
| Lorillard Tobacco Company..... | \$ 11,680,000 |
| Total Amount..... | \$160,000,000 |

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APPENDIX A

FORMULA FOR CALCULATING

BLUE CROSS VOLUME ADJUSTMENTS

Any payment that by the terms of the Settlement Agreement is to be adjusted pursuant to this Appendix (the "Applicable Base Payment") shall be adjusted pursuant to this Appendix in the following manner:

(A) in the event the aggregate number of units of Tobacco Products sold domestically by the Settling Defendants in the Applicable Year (as defined hereinbelow) (the "Actual Volume") is greater than the aggregate number of units of Tobacco Products sold domestically by the Settling Defendants in 1997 (the "Base Volume"), the Applicable Base Payment shall be multiplied by the ratio of the Actual Volume to the Base Volume;

(B) in the event the Actual Volume is less than the Base Volume,

(i) the Applicable Base Payment shall be multiplied by the ratio of the Actual Volume to the Base Volume, and the resulting product shall be divided by 0.98; and

(ii) if a reduction of the Applicable Base Payment results from the application of subparagraph (B)(i) of this Appendix, but the Settling Defendants' aggregate net operating profits from domestic sales of Tobacco Products for the Applicable Year (the "Actual Net Operating Profit") is greater than the Settling Defendants' aggregate net operating profits from domestic sales of Tobacco Products in 1997 (the "Base Net Operating Profit") (such Base Net Operating Profit being adjusted upward by the greater of the rate of 3% per annum or the actual total percent change in the Consumer Price Index, in either instance for the period between January 1, 1998 and the date on which the payment at issue is made), then the amount by which the Applicable Base Payment is reduced by the application of subparagraph (B)(i) shall be reduced (but not below zero) by 0.9129% of 25% of such increase in such profits. For purposes of this Appendix, "net operating profits from domestic sales of Tobacco Products" shall mean net operating profits from domestic sales of Tobacco Products as reported to the United States Securities and Exchange Commission ("SEC") for the Applicable Year or, in the case of a Settling Defendant that does not report profits to the SEC, as reported in financial statements prepared in accordance with generally accepted accounting principles and audited by a nationally recognized accounting firm. The determination of the Settling Defendants' aggregate net operating profits from domestic sales of Tobacco Products shall

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be derived using the same methodology as was employed in deriving such Settling Defendants' aggregate net operating profits from domestic sales of Tobacco Products in 1997. Any increase in an Applicable Base Payment pursuant to this subparagraph B(ii) shall be payable within 120 days after the date that the payment at issue was required to be made.

(C) "Applicable Year" means the calendar year immediately preceding the year in which the payment at issue is due, regardless of when such payment is made.

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AGREEMENT TO PAY STATE OF MINNESOTA

ATTORNEYS' FEES AND COSTS

Philip Morris Incorporated (hereinafter "PM"), R.J. Reynolds Tobacco Company (hereinafter "RJR"), Brown & Williamson Tobacco Corporation (hereinafter "B&W"), and Lorillard Tobacco Company (hereinafter "Lorillard") (collectively referred to as "The Settling Defendants"), hereby enter into this Agreement To Pay Attorneys' Fees And Costs (hereinafter the "Agreement") with Robins, Kaplan, Miller & Ciresi L.L.P. (hereinafter "RKM&C") providing for the payment of all attorneys' fees and costs incurred in the prosecution of the lawsuit captioned The State of Minnesota and Blue Cross and Blue Shield of Minnesota vs. Philip Morris Incorporated, et al., Court File C1-94-8565 (hereinafter "The Case"), by The State of Minnesota.

BACKGROUND

1. On August 17, 1994, The State of Minnesota, together with Blue Cross and Blue Shield of Minnesota (hereinafter "BCBS"), commenced The Case in Ramsey County District Court in St. Paul, Minnesota.

2. From August 1994 until January 1998, RKM&C engaged in extensive and unprecedented pretrial and discovery proceedings, which led to the establishment of a document depository in Minneapolis, Minnesota, into which was placed in excess of 28 million pages of documents. A second document depository was established in Guildford, England, into which was placed in excess of six million pages of documents. The majority of the documents in the U.S. and Guildford depositories were never previously produced by defendants in any lawsuit. Also included among the documents in the Minneapolis depository are in excess of 40,000 documents obtained by

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RKM&C over which defendants had continuously maintained the claim of attorney-client privilege. The production of the attorney-client privilege documents was the subject of numerous appeals, including an appeal to the U.S. Supreme Court.

3. RKM&C painstakingly reviewed the 34 million pages of documents and selected those it deemed the most probative and relevant, which set of documents became nationally known as the "Minnesota select" documents. The Minnesota select documents have been provided to other litigants (including state attorneys general and private parties), Congress and Governmental authorities.

4. RKM&C took or defended the depositions of more than 300 fact and expert witnesses.

5. Throughout the pretrial proceedings, more than 190 motions were prosecuted and defended by Defendants and RKM&C, resulting in 200 orders being issued by the trial court.

6. Interlocutory appeals were taken by Defendants of numerous trial court orders resulting in 12 appeals to the Minnesota Court of Appeals; four appeals to the Minnesota Supreme Court; and two appeals to the U.S. Supreme Court.

7. On January 20, 1998, trial of The Case began before the Honorable Kenneth J. Fitzpatrick. The trial proceeded for 74 trial days until May 4, 1998. Forty-one witnesses testified, and the transcript of the trial is more than 15,000 pages in length.

8. On May 8, 1998, after all parties to the trial had rested, but before submission of The Case to the jury, The Case was settled. After settlement of the State's claims, RKM&C relinquished its right to receive attorneys' fees and costs pursuant to the retainer agreement entered

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into between RKM&C and the State of Minnesota based upon the undertaking by The Settling Defendants to negotiate directly with RKM&C for payment of attorneys' fees and costs. This Agreement between The Settling Defendants and RKM&C is the

result of those negotiations and represents The Settling Defendants' undertaking to pay attorneys' fees and costs to RKM&C.

AGREEMENT

Now, therefore, the undersigned parties agree as follows:

9. For and in consideration of the payment of attorneys' fees and costs as set forth herein, RKM&C relinquishes its right to receive attorneys' fees and costs pursuant to the retainer agreement entered into between RKM&C and The State of Minnesota as part of the Special Attorney Appointment dated May 23, 1994.

10. For and in consideration of the facts set forth above; and (a) in consideration of RKM&C foregoing the offer of a comprehensive, non-severable set of terms in connection with the payment of attorneys' fees relating to this action, which terms included, without limitation, the following: the determination of attorneys' fees by an arbitration panel of three (3) members with no cap on the amount of fees to be awarded by such panel; a Five Hundred Million Dollar (\$500,000,000) annual cap on the payment in any one year of fees awarded by all such arbitration panels nationwide in tobacco and health litigation; provision that RKM&C's contractual rights, if any, for payment of attorneys' fees by The State of Minnesota or any other plaintiff would be unaffected by RKM&C's participation in such arbitration process; and a "most-favored nation" clause applicable to the payment of attorneys' fees; and (b) in consideration of RKM&C agreeing to relinquish its right to claim any fees and costs under its retainer agreement with The State of Minnesota, and in partial

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consideration for the settlement of The Case, The Settling Defendants agree to pay to RKM&C attorneys' fees in connection with its representation of The State of Minnesota in this action, over and above payments owed to The State of Minnesota by virtue of the Settlement Agreement and Release, the sum of the lodestar component described in paragraph 11.b., and the contingency component described in paragraph 12, according to the schedule set forth in paragraph 15.

11. The lodestar component shall be calculated as follows:

a. RKM&C represents to The Settling Defendants that the total amount of fees incurred as documented in its billing records for all time spent prosecuting The Case on behalf of The State of Minnesota is \$27,500,000 for purposes of the initial calculation in paragraph 11(b). This amount takes into account continuing work on The Case up to and through Final Approval of Settlement. Within ten (10) days of the execution of this Agreement, The Settling Defendants may elect to require RKM&C to submit to a mutually agreeable third party selected by The Settling Defendants an accounting of hours reasonably worked in connection with the RKM&C representation of The State of Minnesota in this action, broken out by name of attorney and including a description of the type of work done and the normal hourly billing rate of each attorney in question and costs reasonably expended and customarily charged to clients of the firm. Such accounting shall also set forth the aggregate billable amount by multiplying all hours reasonably worked in connection with RKM&C's representation of The State of Minnesota in this action times the normal hourly billing rate of the attorneys in question, which hourly rates are actually charged to other clients of RKM&C to determine whether the hours listed in such accounting were reasonably

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worked and charged in connection with RKM&C's representation of The State of Minnesota in this action. Determinations by such third party shall be binding on the parties. If the third party determines that any hours listed in such an accounting were not reasonably worked in connection with RKM&C's representation of The State of Minnesota in this action, or that hourly rates were overstated, the aggregate billable amount shall be recalculated so as to exclude such hours or recalculate the rates. If the third party determines that any costs listed in such an accounting were not reasonably expended or not customarily charged to clients of the firm, such costs will be excluded. Nothing in this section which gives The Settling Defendants the right to request a third-party review of RKM&C's time and costs records entitles The Defendants to see a copy of the time and costs records. Furthermore, the parties agree that in making the time and

costs records available for review by a third party for purposes of paying attorneys' fees and costs in partial consideration for The Settling Defendants' agreement to settle with The State of Minnesota, neither RKM&C nor The State of Minnesota is waiving any right to claim attorney-client or other privilege with regard to any RKM&C time and costs records or any other document or matter pertaining to this litigation.

b. The lodestar component shall be calculated by multiplying the aggregate billable amount (as adjusted pursuant to subsection a.), insofar as it does not exceed Thirty Million Dollars (\$30,000,000) times a multiplier derived as follows:

- i. 6; plus
- ii. 2, in that this action was filed prior to January 1, 1995, in the name of The State to recover health-care costs allegedly associated with tobacco; plus

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- iii. 2, in that this action was not predicated, in any part, upon a state statute specifically directed at tobacco companies or at a recovery of costs allegedly associated with tobacco; plus
- iv. 4, in that this action was tried to the conclusion.

12. The contingency component shall be composed of the sum of the following:

a. One percent (1%) of the first Five Billion Dollars (\$5,000,000,000) or less of nominal recovery to be paid to The State over the first twenty-five (25) years (The "Nominal Recovery");

b. .5% times the amount by which the Nominal Recovery exceeds Five Billion Dollars (\$5,000,000,000) and is less than or equal to Ten Billion Dollars (\$10,000,000,000);

c. .2% times the amount by which the Nominal Recovery exceeds Ten Billion Dollars (\$10,000,000,000) and is less than or equal to Fifteen Billion Dollars (\$15,000,000,000); and

d. .1% times the amount by which the Nominal Recovery exceeds Fifteen Billion Dollars (\$15,000,000,000).

13. The Nominal Recovery for The State herein is Six Billion One Hundred Sixty-five Million Dollars (\$6,165,000,000). Accordingly, the contingency component equals Fifty-five Million Eight Hundred Twenty-five Thousand Dollars (\$55,825,000).

14. The lodestar component equals Three Hundred Eighty-five Million Dollars (\$385,000,000).

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15. The sum of the lodestar and contingency components equals Four Hundred Forty Million Eight Hundred Twenty-five Thousand Dollars (\$440,825,000). The Defendants agree to pay this amount to RKM&C as and for attorneys' fees pursuant to the following schedule:

a. Seventy-four Million Seven Hundred Fifty Thousand Dollars (\$74,750,000) on or before September 5, 1998;

b. One Hundred Million Dollars (\$100,000,000) on or before January 31, 1999;

c. One Hundred Million Dollars (\$100,000,000) on or before April 15, 1999;

d. One Hundred Million Dollars (\$100,000,000) on or before January 31, 2000.

e. Sixty-six Million Seventy-five Thousand Dollars (\$66,075,000) on or before July 1, 2000.

16. Defendants also agree to pay Four Million Dollars (\$4,000,000) as and for costs due and owing by The State of Minnesota to RKM&C on or before May 18, 1998.

17. The amount of fees and costs due and owing pursuant to

paragraphs 15 and 16 shall be paid by Settling Defendants pro rata in proportion

to their Market Share. No Settling Defendant shall be obligated to make any payment due from any other Settling Defendant. All obligations of The Settling Defendants pursuant to this Agreement are intended to be and shall remain several, and not joint.

18. The payment of fees pursuant to paragraph 15 shall constitute the entire obligation of The Settling Defendants with respect to attorneys' fees in connection with the representation by RKM&C of The State of Minnesota in connection with this action, and the exclusive means by which RKM&C may seek payment of fees from defendants, or otherwise, in

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connection with its representation of The State of Minnesota in this action. RKM&C represents that it has served as sole outside counsel to The State of Minnesota in this action.

19. The Settling Defendants' obligation to pay attorneys' fees pursuant to paragraph 15 is contingent upon approval of the Settlement Agreement and Release between The Settling Defendants and The State of Minnesota and the State Escrow Agreement. If the Court declines to approve the Settlement Agreement between The Settling Defendants and The State of Minnesota or the State Escrow Agreement, or, pursuant to paragraph VI.B. (Court Approval) of the Settlement Agreement, either party withdraws from the Agreement before Court approval, this Agreement shall become null and void and of no effect. Once the Court has approved the Settlement Agreement between The State of Minnesota and The Settling Defendants, The Settling Defendants are obligated to make the payments set forth herein, unless there is a challenge to the Settlement Agreement between The Settling Defendants and The State of Minnesota which results in a payment required to be paid by Settling Defendants pursuant to the Settlement Agreement with The State of Minnesota being paid into escrow.

20. In the event any payments due to The State of Minnesota are required to be paid into escrow, then any unpaid attorneys' fees due under this Agreement shall also be paid into a special escrow account (the "RKM&C Escrow Account"). Any funds held in the RKM&C Escrow Account shall be immediately released to RKM&C at the same time that funds are released from The State of Minnesota Escrow Account to the State of Minnesota. Provided, however, that in the event a court should determine that the Settlement Agreement between The State of Minnesota and The Defendants is cancelled or terminated such that no further payment obligations are due under The

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State Settlement Agreement, then any outstanding funds held in the RKM&C Escrow Account shall be returned to The Defendants, and Defendants' obligations under this Agreement shall become null and void and of no effect.

MISCELLANEOUS PROVISIONS

21. In the event either party to this Agreement is required to seek enforcement of the terms of this Agreement in court, all attorneys' fees and costs incurred in enforcing the Agreement shall be paid by the party against whom enforcement is obtained.

22. Each Settling Defendant has all requisite corporate power and authority to execute, deliver and perform this Agreement and to consummate the transactions contemplated herein. This Agreement has been duly and validly executed and delivered by each Settling Defendant and constitutes its legal, valid and binding obligation.

23. This Agreement constitutes the entire agreement among the parties with regard to the subject matter of the Agreement and supersedes any previous agreements and understandings between the parties with respect to the subject matter. This Agreement may not be modified or amended except in writing and signed by all parties.

24. This Agreement may be executed in one or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

25. Except as otherwise specifically provided for in this Agreement, no party shall be liable for any costs or expenses incurred by or on behalf of any other party in connection with this Agreement and the actions contemplated hereby.

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26. This Agreement shall be construed in accordance with and governed by the laws of The State of Minnesota applicable to agreements made and to be performed in Minnesota.

27. Any disputes regarding the interpretation of this Agreement and any actions to enforce its terms shall be venued in Ramsey County District Court in the State of Minnesota.

28. The parties agree that the payment of attorneys' fees and costs provided for in this Agreement shall be made strictly according to its terms. The Settling Defendants agree not to support, directly or indirectly, in Congress or any forum, legislation, rules or other policies which would preempt, override, abrogate or diminish their obligations under this Agreement.

29. This Agreement is not intended to, and does not, vest standing in any third party with respect to the terms hereof, or create for any person other than the parties hereto a right to enforce the terms hereof.

30. For and in consideration for the payment of fees as provided herein, RKM&C hereby releases Settling Defendants from any and all claims (other than a claim to enforce this Agreement) arising out of or in any way related to the litigation or settlement of The Case.

31. Unless otherwise specified, the terms used in this Agreement are subject to the definitions contained in the Settlement Agreement.

IN WITNESS WHEREOF, the parties hereto, through their fully authorized representatives, have agreed to this Agreement as of this 8th day of May, 1998.

ROBINS, KAPLAN, MILLER & CIRESI L.L.P.

By: /s/ Michael V. Ciresi

Michael V. Ciresi

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PHILIP MORRIS INCORPORATED

By: /s/ Meyer G. Koplow

Meyer G. Koplow
Counsel

By: /s/ Martin J. Barrington

Martin J. Barrington
General Counsel

R.J. REYNOLDS TOBACCO COMPANY

By: /s/ D. Scott Wise

D. Scott Wise
Counsel

By: /s/ Charles A. Blixt

Charles A. Blixt
General Counsel

BROWN & WILLIAMSON TOBACCO CORPORATION

By: /s/ Stephen R. Patton

Stephen R. Patton
Counsel

By: /s/ F. Anthony Burke

F. Anthony Burke
Vice President and General Counsel

LORILLARD TOBACCO COMPANY

By: /s/ Arthur J. Stevens

Arthur J. Stevens
Senior Vice President & General
Counsel

AGREEMENT TO PAY

BLUE CROSS AND BLUE SHIELD OF MINNESOTA

ATTORNEYS' FEES AND COSTS

Philip Morris Incorporated (hereinafter "PM"), R.J. Reynolds Tobacco Company (hereinafter "RJR"), Brown & Williamson Tobacco Corporation (hereinafter "B&W"), and Lorillard Tobacco Company (hereinafter "Lorillard") (collectively referred to as "The Settling Defendants"), hereby enter into this Agreement To Pay Blue Cross and Blue Shield of Minnesota Attorneys' Fees And Costs (hereinafter the "Agreement") with Robins, Kaplan, Miller & Ciresi L.L.P. (hereinafter "RKM&C") providing for the payment of all attorneys' fees and costs incurred in the prosecution of the lawsuit captioned The State of Minnesota and Blue Cross and Blue Shield of Minnesota vs. Philip Morris Incorporated, et al., Court File C1-94-8565 (hereinafter "The Case"), by BCBS, Inc., d/b/a Blue Cross and Blue Shield of Minnesota (hereinafter "BCBS").

BACKGROUND

1. On August 17, 1994, The State of Minnesota, together with BCBS, commenced The Case in Ramsey County District Court in St. Paul, Minnesota.

2. From August 1994 until January 1998, RKM&C engaged in extensive and unprecedented pretrial and discovery proceedings, which led to the establishment of a document depository in Minneapolis, Minnesota, into which was placed in excess of 28 million pages of documents. A second document depository was established in Guildford, England, into which was placed in excess of six million pages of documents. The majority of the documents in the U.S. and Guildford depositories were never previously produced by defendants in any lawsuit. Also included among the documents in the Minneapolis depository are in excess of 40,000 documents obtained by RKM&C over which defendants had continuously maintained the claim of attorney-client privilege.

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The production of the attorney-client privilege documents was the subject of numerous appeals, including an appeal to the U.S. Supreme Court.

3. RKM&C painstakingly reviewed the 34 million documents and selected those it deemed the most probative and relevant, which set of documents became nationally known as the "Minnesota select" documents. The Minnesota select documents have been provided to other litigants (including state attorneys general and private parties), Congress and Governmental authorities.

4. RKM&C took or defended the depositions of more than 300 fact and expert witnesses.

5. Throughout the pretrial proceedings, more than 190 motions were prosecuted and defended by Defendants and RKM&C, resulting in 200 orders being issued by the trial court.

6. Interlocutory appeals were taken by Defendants of numerous trial court orders resulting in 12 appeals to the Minnesota Court of Appeals; four appeals to the Minnesota Supreme Court; and two appeals to the U.S. Supreme Court.

7. On January 20, 1998, trial of The Case began before the Honorable Kenneth J. Fitzpatrick. The trial proceeded for 74 trial days until May 4, 1998. Forty-one witnesses testified, and the transcript of the trial is more than 15,000 pages in length.

8. On May 8, 1998, after all parties to the trial had rested, but before the case was submitted to the jury, The Case was settled. After settlement of the BCBS's claims, RKM&C relinquished its right to receive attorneys' fees and costs pursuant to the retainer agreement entered into between RKM&C and BCBS based upon the undertaking by The Settling Defendants to negotiate directly with RKM&C for payment of attorneys' fees and costs. This Agreement between

The Settling Defendants and RKM&C is the result of those negotiations and represents The Settling Defendants' undertaking to pay attorneys' fees and costs to RKM&C

AGREEMENT

Now, therefore, the undersigned parties agree as follows:

9. For and in consideration of the payment of attorneys' fees and costs as set forth herein, RKM&C relinquishes its right to receive attorneys' fees and costs pursuant to the retainer agreement entered into between RKM&C and BCBS.

10. For and in consideration of the facts set forth above and in consideration of RKM&C agreeing to relinquish its right to claim any fees and costs under its retainer agreement with BCBS, and in partial consideration for the settlement of The Case, The Defendants agree to pay to RKM&C attorneys' fees in the amount of One Hundred Seventeen Million Two Hundred Fifty Thousand Dollars (\$117,250,000) to be paid as follows: Sixty Million Dollars (\$60,000,000) on July 1, 1998; Fifty-seven Million Two Hundred Fifty Thousand Dollars (\$57,250,000) on September 4, 1998.

11. Defendants also agree to pay Four Million Dollars (\$4,000,000) as and for costs due and owing by BCBS to RKM&C on or before May 18, 1998.

12. The amount of fees and costs due and owing pursuant to paragraphs 10 and 11 shall be paid by Settling Defendants pro rata in proportion

to their Market Share. No Settling Defendant shall be obligated to make any payment due from any other Settling Defendant. All obligations of The Settling Defendants pursuant to this Agreement are intended to be and shall remain several, and not joint.

13. The payment of fees pursuant to paragraph 10 shall constitute the entire obligation of The Settling Defendants with respect to attorneys' fees in connection with the

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representation by RKM&C of BCBS in connection with this action, and the exclusive means by which RKM&C may seek payment of fees from defendants, or otherwise, in connection with its representation of BCBS in this action. RKM&C represents that it has served as sole outside counsel to BCBS in connection with this action.

MISCELLANEOUS PROVISIONS

14. In the event either party to this Agreement is required to seek enforcement of the terms of this Agreement in court, all attorneys' fees and costs incurred in enforcing the Agreement shall be paid by the party against whom enforcement is obtained.

15. Each Defendant has all requisite corporate power and authority to execute, deliver and perform this Agreement and to consummate the transactions contemplated herein. This Agreement has been duly and validly executed and delivered by each Defendant and constitutes its legal, valid and binding obligation.

16. This Agreement constitutes the entire agreement among the parties with regard to the subject matter of the Agreement and supersedes any previous agreements and understandings between the parties with respect to the subject matter. This Agreement may not be modified or amended except in writing and signed by all parties.

17. This Agreement may be executed in one or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

18. Except as otherwise specifically provided for in this Agreement, no party shall be liable for any costs or expenses incurred by or on behalf of any other party in connection with this Agreement and the actions contemplated hereby.

19. This Agreement shall be construed in accordance with and governed by the laws of Minnesota applicable to agreements made and to be performed in Minnesota.

20. Any disputes regarding the interpretation of this Agreement and any actions to enforce its terms shall be venued in Ramsey County District Court in the State of Minnesota.

21. The parties agree that the payment of attorneys' fees and costs provided for in this Agreement shall be made strictly according to its terms. The Settling Defendants will not seek to avoid through legislation any of their obligations under this Agreement.

22. This Agreement is not intended to, and does not, vest standing in any third party with respect to the terms hereof, or create for any person other than the parties hereto a right to enforce the terms hereof.

23. For and in consideration for the payment of fees as provided herein, RKM&C hereby releases Settling Defendants from any and all claims (other than a claim to enforce this Agreement) arising out of or in any way related to the litigation or settlement of The Case.

24. Unless otherwise specified, the terms used in this Agreement are subject to the definitions contained in the Settlement Agreement.

IN WITNESS WHEREOF, the parties hereto, through their fully authorized representatives, have agreed to this Agreement To Pay Blue Cross and Blue Shield of Minnesota Attorneys' Fees and Costs as of this 8th day of May, 1998.

ROBINS, KAPLAN, MILLER & CIRESI L.L.P.

By: /s/ Michael V. Ciresi

Michael V. Ciresi

PHILIP MORRIS INCORPORATED

By: /s/ Meyer G. Koplow

Meyer G. Koplow
Counsel

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By: /s/ Martin J. Barrington

Martin J. Barrington
General Counsel

R.J. REYNOLDS TOBACCO COMPANY

By: /s/ D. Scott Wise

D. Scott Wise
Counsel

By: /s/ Charles A. Blixt

Charles A. Blixt
General Counsel

BROWN & WILLIAMSON TOBACCO CORPORATION

By: /s/ Stephen R. Patton

Stephen R. Patton
Counsel

By: /s/ F. Anthony Burke

F. Anthony Burke
Vice President and General Counsel

LORILLARD TOBACCO COMPANY

By: /s/ Arthur J. Stevens

Arthur J. Stevens
Senior Vice President & General
Counsel

STATE ESCROW AGREEMENT

This escrow agreement (the "State Escrow Agreement") is entered into as of May 8, 1998, by and among Philip Morris Incorporated, R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation and Lorillard Tobacco Company (collectively, the "Settling Defendants" and each individually a "Settling Defendant"), the State of Minnesota and [NAME OF ESCROW AGENT], as Escrow Agent (the "State Escrow Agent").

WITNESSETH:

WHEREAS, counsel for the State of Minnesota and Settling Defendants entered into a settlement agreement and release as of May 8, 1998 (the "Settlement Agreement"), which settlement agreement set forth the terms and conditions of an agreement to settle and resolve with finality all present and future claims relating to the subject matter of the litigation entitled State of Minnesota v. Philip Morris Incorporated, No. C1-94-8565, (filed August 17, 1994) (the "Action"), in the District Court of the State of Minnesota, County of Ramsey, Second Judicial District (the "Court");

WHEREAS, paragraph II.B. of the Settlement Agreement and Schedule A thereto provide that, on the dates specified therein, each Settling Defendant shall pay, severally and not jointly, its respective share of the aggregate amounts payable by the Settling Defendants pursuant to the terms of that paragraph, with each Settling Defendant's respective share to be determined according to the terms thereof;

WHEREAS, paragraph II.D. of the Settlement Agreement provides that, on December 31, 1998, and on December 31 of each year annually thereafter, each Settling Defendant shall pay, severally and not jointly, its respective share of the aggregate annual amount payable by the Settling Defendants pursuant to the terms of that paragraph, with each Settling Defendant's respective share to be determined according to the terms thereof;

WHEREAS, paragraph V.B. of the Settlement Agreement further provides that, in the event of a challenge to the Court's Final Approval of the Settlement Agreement, any payments due to be paid by Settling Defendants pursuant to paragraph II.D. of the Settlement Agreement shall be paid into a special escrow account (the "State Escrow Account"), to be held in escrow pending resolution of such challenge as set forth in paragraph V.B. and of the Settlement Agreement;

WHEREAS, paragraph V.B. of the Settlement Agreement further provides that, in the event of a challenge to the Court's Final Approval of the Settlement Agreement prior to December 31, 1998, any payments due to be paid by Settling Defendants pursuant to paragraph II.B. of the Settlement Agreement shall be paid into the State Escrow Account, to be held in escrow pending resolution of such challenge as set forth in paragraph V.B. of the Settlement Agreement;

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NOW, THEREFORE, the parties hereto agree as follows:

SECTION 1. Appointment of State Escrow Agent.

Settling Defendants and the State of Minnesota hereby appoint the State Escrow Agent to act as escrow agent on the terms and conditions set forth herein, and the State Escrow Agent hereby accepts such appointment on such terms and conditions.

SECTION 2. Deposit.

Any payment pursuant to paragraph II.D. of the Settlement Agreement that is due to be paid by Settling Defendants before resolution of any challenge to Final Approval as set forth in paragraph V.B. of the Settlement Agreement, and any payment pursuant to paragraph II.B. of the Settlement Agreement that is due to be paid by Settling Defendants before resolution of any challenge to Final Approval initiated prior to December 31, 1998 as set forth in paragraph V.B. of the Settlement Agreement shall be delivered to the State Escrow Agent and shall be deposited into the State Escrow Account (all payments deposited into the State Escrow Account, together with any interest or other income on investment with respect to such payments, being herein called the "State Escrow

Amount") and shall be governed by the terms of this State Escrow Agreement. All such deliveries of funds are subject to the right of the Settling Defendants to obtain, pursuant to section 4(a) of this State Escrow Agreement, prompt return of the entire State Escrow Amount (less appropriate deductions for administrative fees and expenses, including taxes and other related costs) in the event that the Settlement Agreement is canceled and terminated pursuant to a court order. The State Escrow Amount shall be maintained, invested and disbursed by the State Escrow Agent strictly in accordance with this State Escrow Agreement.

SECTION 3. Investment of State Escrow Amount.

The State Escrow Agent shall invest and reinvest the State Escrow Amount in either (i) direct obligations of, or obligations the principal and interest on which are unconditionally guaranteed by, the United States of America (including government-sponsored agencies) or the State of Minnesota; (ii) repurchase agreements fully collateralized by securities of the kind specified in clause (i) above; (iii) money market accounts maturing within 30 days of the acquisition thereof and issued by a bank or trust company organized under the laws of the United States of America or a State thereof (a "United States Bank") and having a combined capital surplus in excess of \$250,000,000; or (iv) demand deposits with any United States Bank or any federal savings and loan institution having a combined capital surplus in excess of \$250,000,000. Any loss on any such investment, including, without limitation, any penalty for any liquidation required to fund a disbursement, shall be borne pro rata by the parties in proportion to their ultimate entitlement to the State Escrow Amount. The State Escrow Agent's fees and all expenses, including taxes and other related costs, shall, to the extent possible, be paid out of income earned. Whenever the State Escrow Agent shall pay all or any part of the State Escrow Amount to any party as provided herein, the State Escrow Agent shall also pay

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to such party all interest and profits earned to the date of payment on such amount, less deductions for fees and all expenses, including taxes and other related fees.

SECTION 4. Release of the State Escrow Amount.

After receipt, the State Escrow Agent shall deliver the State Escrow Amount as set forth below:

a. In the event that the Settlement Agreement is canceled and terminated pursuant to paragraph V.B. of the Settlement Agreement, and upon receipt of a court order so directing, the State Escrow Agent shall disburse the entire State Escrow Amount (including any interest thereon, as provided in Section 3) to the Settling Defendants on the same pro rata basis as the Settling Defendants' contributions to the State Escrow Account.

b. Upon receipt of written notice signed by counsel for the Settling Defendants and counsel for the State of Minnesota notifying the State Escrow Agent that all challenges to Final Approval have been resolved as provided in paragraph V.B. of the Settlement Agreement and that all escrow funds may be released, the State Escrow Agent shall proceed to distribute the State Escrow Amount to an account designated in writing by the State of Minnesota.

c. For its services, the State Escrow Agent shall receive fees in accordance with the State Escrow Agent's customary fees in similar matters. All such fees shall constitute a direct charge against the State Escrow Amount, but the State Escrow Agent shall not debit the State Escrow Amount for any such charge until it shall have presented its statement to and received approval by counsel for the Settling Defendants and counsel for the State of Minnesota, which approval shall not be unreasonably withheld. Such approval shall be deemed given if the State Escrow Agent has not received written objections from either counsel for Settling Defendants or counsel for the State of Minnesota within 30 days after presentment of its statement. Such fees and all expenses charged against the State Escrow Amount shall, to the extent possible, be paid out of interest earned. In the event that counsel for the Settling Defendants or counsel for the State of Minnesota objects in writing to such fees, the State Escrow Agent shall not debit the State Escrow Amount except upon a court order approving such fees.

SECTION 5. Substitute Form W-9; Qualified Settlement Fund.

Each of the signatories to this State Escrow Agreement shall provide the State Escrow Agent with a correct taxpayer identification number on a substitute Form W-9 within 90 days of the date hereof and indicate thereon that it is not subject to backup withholding. It is anticipated that the State Escrow

SECTION 6. Termination of State Escrow Account.

This State Escrow Agreement (other than the State Escrow Agent's right to indemnification set forth in Section 7) shall terminate when the State Escrow Agent shall have released from the State Escrow Account all amounts pursuant to Section 4 hereof.

SECTION 7. State Escrow Agent.

a. The State Escrow Agent shall have no duty or obligation hereunder other than to take such specific actions as are required of it from time to time under the provisions hereof, and it shall incur no liability hereunder or in connection herewith for anything whatsoever other than as a result of its own negligence or willful misconduct. In the event the State Escrow Agent fails to receive the instructions contemplated by Section 4 hereof or receives conflicting instructions, the State Escrow Agent shall be fully protected in refraining from acting until such instructions are received or such conflict is resolved by written agreement or court order.

b. Settling Defendants, on the same pro rata basis as the funds constituting the State Escrow Amount were contributed to the State Escrow Account, agree to indemnify, hold harmless and defend the State Escrow Agent from and against any and all losses, claims, liabilities and reasonable expenses, including the reasonable fees of its counsel, which it may suffer or incur hereunder or in connection herewith prior to the date of the termination of this Escrow Agreement as provided in Section 6 hereof, except such as shall result solely and directly from its own negligence or willful misconduct. The State Escrow Agent shall not be bound in any way by any agreement or contract between Settling Defendants and the State of Minnesota (whether or not the State Escrow Agent has knowledge thereof) other than this State Escrow Agreement, and the only duties and responsibilities of the State Escrow Agent shall be to hold and invest the State Escrow Amount received hereunder and to release such State Escrow Amount in accordance with the terms of this State Escrow Agreement.

c. The State Escrow Agent may resign at any time by giving written notice thereof to the other parties hereto, but such resignation shall not become effective until a successor escrow agent, selected by the Settling Defendants and agreeable to the State of Minnesota, shall have been appointed and shall have accepted such appointment in writing. If an instrument of acceptance by a successor escrow agent shall not have been delivered to the State Escrow Agent within 30 days after the giving of such notice of resignation, the resigning State Escrow Agent may, at the expense of the Settling Defendants and the State of Minnesota (to be shared equally between the Settling Defendants and the State of Minnesota), petition the Court for the appointment of a successor escrow agent.

d. Upon resolution of any challenge to Final Approval as provided in paragraph V.B. of the Settlement Agreement, provided that Settling Defendants have performed all of their obligations required to be performed hereunder prior to such date, all duties and obligations of Settling Defendants hereunder shall cease, with the exception of any indemnification obligation of Settling Defendants incurred prior to the date of the termination of this Escrow Agreement.

SECTION 8. Miscellaneous.

a. Notices. All notices or other communications to any party or other person hereunder shall be in writing (which shall include telex, telecopy or similar writing) and shall be given to the respective parties or persons at the following addresses. Any party or person may change the name and address of the person designated to receive notice on behalf of such party or person by notice given as provided in this paragraph.

State of Minnesota:

Hubert H. Humphrey, III
Attorney General

102 State Capitol
St. Paul, MN 55155
Fax: 612.297.4193

Michael V. Ciresi
Robins, Kaplan, Miller & Ciresi L.L.P.
2800 LaSalle Plaza
800 LaSalle Avenue
Minneapolis, MN 55402-2015
Fax: 612.339.4181

Chief Deputy Attorney General
State of Minnesota
102 State Capitol
St. Paul, MN 55155
Fax: 612.297-4193

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Settling Defendants:

For Philip Morris Incorporated:

Martin J. Barrington
Philip Morris Incorporated
120 Park Avenue
New York, NY 10017-5592
Fax: 212.907.5399

With a copy to:

Meyer G. Koplow
Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, NY 10019
Fax: 212.403.2000

For R.J. Reynolds Tobacco Company:

Charles A. Blixt
General Counsel
R.J. Reynolds Tobacco Company
401 North Main Street
Winston-Salem, NC 27102
Fax: 910.741.2998

With a copy to:

Arthur F. Golden
Davis Polk & Wardwell
450 Lexington Avenue
New York, NY 10017
Fax: 212.450.4800

For Brown & Williamson Tobacco Corporation:

Michael Walter
Brown & Williamson Tobacco Corporation
200 Brown & Williamson Tower
401 South Fourth Avenue
Louisville, KY 40202
Fax: 502.568.7187

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With a copy to:

F. Anthony Burke
Brown & Williamson Tobacco Corporation
200 Brown & Williamson Tower
401 South Fourth Avenue
Louisville, KY 40202
Fax: 502.568.7297

For Lorillard Tobacco Company:

Arthur J. Stevens
Lorillard Tobacco Company
714 Green Valley Road
Greensboro, NC 27408

State Escrow Agent:

[NAME OF BANK]
[ADDRESS]
Phone: [PHONE NUMBER]
Fax: [FAX NUMBER]

Wire Transfer Instructions
ABA: [NUMBER]
Account: [NUMBER]

b. Successors and Assigns. The provisions of this State Escrow Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigns.

c. Governing Law. This State Escrow Agreement shall be construed in accordance with and governed by the laws of the State of Minnesota, without regard to the conflicts of law rules of such state.

d. Jurisdiction and Venue. The parties hereto irrevocably and unconditionally submit to the jurisdiction of the Court for purposes of any suit, action or proceeding seeking to enforce any provision of, or based on any right arising out of, this State Escrow Agreement, and the parties hereto agree not to commence any such suit, action or proceeding except in the Court. The parties hereto hereby irrevocably and unconditionally waive any objection to the laying of venue of any such suit, action or proceeding in the Court and hereby further irrevocably waive and agree not to plead or claim in the Court that any such suit, action or proceeding has been brought in an inconvenient forum.

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e. Definitions. Terms used herein that are defined in the State Settlement Agreement are, unless otherwise defined herein, used in this State Escrow Agreement as defined in the State Settlement Agreement.

f. Amendments. This State Escrow Agreement may be amended only by written instrument executed by all parties hereto. The waiver of any rights conferred hereunder shall be effective only if made by written instrument executed by the waiving party. The waiver by any party of any breach of this State Escrow Agreement shall not be deemed to be or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, of this State Escrow Agreement.

g. Counterparts; Effectiveness. This State Escrow Agreement may be signed in any number of counterparts, each of which shall be an original, with the same effect as if the signatures thereto and hereto were upon the same instrument. This State Escrow Agreement shall become effective when each party hereto shall have signed a counterpart hereof. Delivery by facsimile of a signed agreement shall be deemed delivery for purposes of acknowledging acceptance hereof; however, an original executed Agreement must promptly thereafter be delivered to each party.

h. Captions. The captions herein are included for convenience of reference only and shall be ignored in the construction and interpretation hereof.

IN WITNESS WHEREOF, the parties have executed this State Escrow Agreement as of the day and year first hereinabove written.

STATE OF MINNESOTA

By: _____

Name: Hubert H. Humphrey III
Title: Attorney General

PHILIP MORRIS INCORPORATED

By: _____

Name: Meyer G. Koplow
Title: Counsel

R.J. REYNOLDS TOBACCO COMPANY

By:

Name: D. Scott Wise
Title: Counsel

BROWN & WILLIAMSON TOBACCO CORPORATION

By:

Name: Stephen R. Patton
Title: Counsel

LORILLARD TOBACCO COMPANY

By:

Name: Arthur J. Stevens
Title: Senior Vice President &
General Counsel

[NAME OF BANK],
as Escrow Agent

By:

Name: [NAME]
Title: [TITLE]

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