

SETTLEMENT AGREEMENT

1. The parties to this Agreement are the People of the State of California through the Attorney General (“California”) and R. J. Reynolds Tobacco Company (“Reynolds”).

2. California and Reynolds are parties to the Master Settlement Agreement (“MSA”) which settled the litigation entitled *People of the State of California v. Philip Morris Inc.*, Sacramento County Superior Court No. 97AS03031, Judicial Council Coordination Proceeding No. 4041, and other claims and matters pending at the time of the settlement. Pursuant to the MSA, the Superior Court of California entered the Consent Decree and Final Judgment (“Consent Decree”) on December 9, 1998, retaining continuing jurisdiction for the purposes of implementing and enforcing the MSA and the Consent Decree.

3. On March 19, 2001, California filed a Complaint captioned *People of the State of California v. R.J. Reynolds Tobacco Company*, San Diego County Superior Court No. GIC 764118, alleging that Reynolds was violating the prohibition against targeting youth in advertising (MSA, section III(a), Consent Decree, section V.A) by placing large numbers of advertisements for its cigarette brands in magazines with substantial youth readerships during 1999, 2000, and 2001. The case was tried to the Superior Court without a jury in April-May 2002. In June 2002, the Court issued its decision in favor of California and against Reynolds on the ground that Reynolds had indirectly targeted minors, and entered Judgment (“Judgment”) permanently enjoining Reynolds, *inter alia*, to take reasonable measures designed to reduce exposure of its advertising to youth to a level significantly lower than the exposure level of target young adult smokers. Further, the Court awarded California \$20 million in monetary sanctions pursuant to section VI.A of the Consent Decree. The Court also awarded California its costs and attorneys fees in the trial court proceedings pursuant to a Stipulated Order in the amount of \$3,850,000.

4. The Court of Appeal affirmed the Judgment on the issue of liability, but found that Reynolds had targeted youth in violation of the Consent Decree and MSA on a different ground, namely that the substantially similar levels of exposure of Reynolds’ cigarette advertising to Youth and to young adult smokers demonstrated an intent to target Youth as a matter of law. The Court of Appeal also affirmed that the trial court’s injunction was not impermissibly vague and did not impose obligations on Reynolds beyond those to which it had agreed in the MSA. With respect to sanctions, the Judgment was “affirmed as to entitlement but reversed as to amount and remanded for further proceedings.” (*People ex rel Lockyer v. R.J. Reynolds Tobacco Company*, 116 CalApp.4th 1253, 1291 (2004).)

5. Subsequent to the trial Court’s issuance of the permanent injunction and Judgment in action No. GIC 764118, California contended (and Reynolds denied) that

Reynolds' placement of cigarette advertising in Youth-measured Publications in 2003 and 2004 constituted a separate and independent violation of the prohibition against youth targeting in the MSA and Consent Decree. However, California does not contend that those practices or other conduct by Reynolds violated the permanent injunction and Judgment in action No. GIC 764118.

6. The parties have discussed the disputed issues in meetings and in correspondence, and have worked cooperatively to resolve these disputes informally as contemplated by Section VII(c)(6) of the MSA and Section VI.A of the Consent Decree. California has determined that it is in the public interest to enter into this Agreement rather than continue with additional litigation. Reynolds also has decided to resolve the disputes by entering into this Agreement rather than continue with additional litigation. California has kept the NAAG Tobacco Enforcement Committee ("Committee") informed of the discussions and correspondence between the parties. If a member of the Committee expresses to California any objection to this Agreement's content or provisions, California will promptly so notify Reynolds.

7. The duration of this Agreement is from January 1, 2005 to December 31, 2010. Thereafter, the Agreement shall remain in effect subject to termination by either party upon provision of ninety (90) days advance written notice. In the event the Agreement is terminated, California and Reynolds shall have all the rights and obligations set forth in the MSA, the Judgment, and the Consent Decree with respect to Reynolds' placement of cigarette advertising in Youth-measured Publications.

8. The provisions of this Agreement shall be binding upon Reynolds and its directors, predecessors, subsidiaries, employees, officers, attorneys, representatives, agents, successors, and assigns.

9. The parties believe that this Agreement constitutes a good faith settlement of the disputes and disagreements between the parties relating to the amount of sanctions, attorneys fees, and costs to be paid to California in action No. GIC 764118 and to the application of the MSA and Consent Decree's prohibition against youth targeting with respect to Reynolds' placement of cigarette advertising in Youth-measured Publications in 2002, 2003 and 2004. This Agreement is for settlement purposes only and does not constitute an admission by Reynolds that it has violated the MSA or the Consent Decree or that the facts as alleged or asserted by California are true with respect to Reynolds' placement of cigarette advertising in Youth-measured Publications in 2002, 2003 and 2004.

10. Following execution of this Agreement by the parties, California will promptly submit this Agreement to the Committee and will request that the Committee endorse the Agreement as a fair and reasonable resolution of the disputed issues and recommend the Agreement to the other Settling States (as defined in the MSA) as a

complete, fair, and reasonable resolution of issues raised concerning Reynolds' placement of cigarette advertising in Youth-measured Publications as referred to herein.

11. Promptly following execution of this Agreement by the parties, California will submit this Agreement to the California Superior Court in action No. GIC 764118 for approval of its terms. California Superior Court approval of this Agreement is a material consideration for Reynolds entering into this Agreement, and any failure of the Court to approve the Agreement will constitute grounds for termination by Reynolds of this Agreement.

12. In the event California later settles a dispute with another entity which is a party to the MSA relating to placement of print advertising in Youth-measured Publications, which settlement contains one or more terms which are more favorable to said entity than a provision of this Agreement, Reynolds shall be entitled to the benefit of said more favorable terms and this Agreement shall be deemed revised so that Reynolds is treated as favorably with respect to said activity.

13. The parties agree to discuss in good faith any disputes or other issues that may arise with respect to this Agreement. In the event that California believes that Reynolds has acted or is acting contrary to any provision of this Agreement and the parties are unable to resolve said dispute through discussion, California shall have the same enforcement rights and remedies with respect to this Agreement as are provided in the MSA and/or the Consent Decree with respect to the prohibition against youth targeting. The California Superior Court shall retain exclusive judicial jurisdiction over all disputes that may arise with respect to this Agreement.

14. A copy of the proposed Order Approving Settlement Agreement and Dismissing Claims is attached hereto as Attachment 1. Approval of this Order by the California Superior Court is a material consideration for Reynolds' entering into this Agreement, and any failure or refusal of the Superior Court to enter such Order will constitute grounds for termination by Reynolds of this Agreement.

15. As used in this Agreement, the following terms have the following meanings:

(a) Adult Smoker: As defined by Mediamark Research Inc. (MRI), an adult who has smoked any cigarettes in the past year.

(b) Gross Impressions: The sum of all publication audiences, in total or for a specific demographic group, for all advertising insertions; the accrued readership of the publications in which the advertising appears.

(c) GRPs (Gross Rating Points): A measure of the total gross weight delivered by a plan or vehicle. One Gross Rating Point equals 1% of the demographic group's population.

(d) Population: The total number of persons in a demographic group, based on the most recent available MRI study for that demographic group.

(e) Regional Placements: Advertising that does not appear in the total circulation of a publication. Typical examples of Regional Placements are geographic selections, such as Region(s), State(s) or Metro(s), though it may refer to any edition less than the full US circulation, such as copy-splits and demographic editions. Selective Binding is a special case of Regional Placement.

(f) Index: A percentage that relates numbers to a base; used to show what is above average (101 or greater) or below average (99 or below).

(g) Selective Binding: A process that permits placement of publication content (e.g., an advertisement) only in copies that will be distributed to specific subscribers. For purposes of paragraph 16 of this Agreement, Selective Binding refers to placement of cigarette advertising in copies that will be distributed to subscribers 25 years of age or older.

(h) Youth: Persons ages 12-17. (This definition is different from the definition of "Youth" in the MSA, which is "any person or persons under 18 years of age.")

(i) Youth Index: Youth Gross Impressions (expressed as a percent of total 12+ Impressions) divided by the Youth Population (expressed as a percent of total 12+ Population), multiplied by 100. An Index of more than 100 means Youth are exposed at a higher rate than their share of the 12+ population as a whole, and an index of less than 100 means Youth are exposed at a lower rate than their share of the 12+ Population as a whole.

(j) Youth-measured Publication: Any publication whose age 12+ audience is measured by a mutually agreed upon research service. MRI, which measures the age 12+ audiences of approximately 65 publications, is the only mutually agreed upon service at this time.

(k) Gross Impressions Index for Adult Smokers 21-34: Applies the same formula as in (i) above, using Adult Smoker 21-34 smoker population information and impression delivery.

16. From January 1, 2005 to until the termination of this Agreement, Reynolds will not advertise cigarettes in a publication which, as measured by MRI or another mutually agreed upon source of readership information, has a Youth readership

greater than 15%. However, Reynolds may advertise cigarettes in Selective Bindings of publications which do not meet this criterion, provided that the publication has reliable information regarding the age of its subscribers and that Reynolds' cigarette advertising will be bound only in those copies of the publications distributed to subscribers 25 years of age or older and not in bulk-distributed copies, such as copies distributed to newsstands, airlines, hotels, public libraries, and schools.

17. From January 1, 2005 to until the termination of this Agreement, Reynolds will adhere on a company-wide basis to the following limits on Youth Gross Impressions in Youth-measured Publications, as measured in the MRI TwelvePlus media study on an annualized basis:

- (a) Between 0-10 Bil. Persons 12+ Impressions a year: Youth index shall not exceed 100.
- (b) Between 10-15 Bil. Persons 12+ Impressions a year: Youth index shall not exceed 95.
- (c) Between 15-20 Bil. Persons 12+ Impressions a year: Youth index shall not exceed 90.
- (d) In excess of 20 Bil. Persons 12+ Impressions a year: Youth index shall not exceed 85.
- (e) In addition, for each advertised brand, the Youth Index shall not exceed 100.

18. From January 1, 2005 to until the termination of this Agreement, Reynolds' media placement in Youth-measured Publications for each of its brands, on an annualized basis (1/1 to 12/31) must meet the following criteria, as measured by MRI:

- (a) The GRPs for Youth are no greater than 70% of the GRPs for Adult Smokers age 21-34; and
- (b) The Youth Index is lower than the Gross Impressions Index for Adult Smokers age 21-34.

19. The parties shall measure Reynolds' compliance with the standards set forth in paragraphs 16-18 using the most current MRI TwelvePlus research data. To determine whether a publication's Youth readership is above or below 15%, Reynolds will apply such MRI research data to any magazine insertion schedules for which space closing has not passed. To determine the Youth indices set forth in paragraph 17 and the GRP ratios in paragraph 18, Reynolds will, for example, use the 2004 MRI TwelvePlus study for calendar year 2005.

20. For the purpose of determining the contribution of Selective Binding and Regional Placement editions to the Youth Indices and GRP ratios set forth in paragraphs 17 and 18, Reynolds shall apply the percentage of the publication's circulation in which its cigarette ads appeared, as reported to Reynolds by the publication, to the audiences for those publications set forth in the MRI TwelvePlus media study.

21. Reynolds shall provide California written reports with respect to this Agreement and the Judgment in action No. GIC 764118, as set forth herein. This obligation supercedes and replaces the reporting procedures agreed to by Reynolds and California in the parties' letter agreement dated September 27, 2002.

(a) Reynolds will describe its "reasonable measures" in its media strategy to comply with paragraph 2.a of the Judgment herein on an annual basis, and will provide this description on or about January 30 of each year, starting January 30, 2005.

(b) Reynolds will provide a schedule of advertising insertions in all national consumer publications and in alternative weeklies in California (exclusive of event advertisements), by brand, on a quarterly basis. The schedule will list all such publications and the number of insertions in each such publication. The first schedule will be due on or about January 30, 2005 and will provide advertising placement data for the fourth quarter of 2004. Subsequent schedules will be due on or about January 30 (for the quarter ending December 31) and or about 15 days after the end of each other calendar quarter and will provide advertising placement data for the previous quarter. For its insertions in Selective Binding or Regional editions of Youth-measured Publications, Reynolds shall report the percentage of the copies of the publication's circulation in which its cigarette ads appeared, as reported to Reynolds by the publication.

(c) Reynolds will provide a semi-annual comparative analysis for each advertised brand and for all brands collectively, using MRI data. These analyses will be due on or about January 30 and July 15 of each year, starting January 30, 2005. Analyses will consist of full year (January 30) and six months (July 15) figures, using reach, frequency, GRPs, Youth to Adult Smoker age 21-34 target ratios, and distribution of Gross Impressions, and will include the Youth Indices, Gross Impressions Indices, and GRPs for the standards set forth in this Agreement so that California can determine compliance with said standards. Reynolds is willing to provide these schedules on a quarterly and semi-annual basis with California's understanding that the plans are annual in character and that California will measure Reynolds' compliance based on the annual plan measurement only. The annual analyses due on or about January 30 will include final analyses for the previous year and projections for the current year.

(d) The information provided pursuant to this paragraph will be subject to the terms and conditions of the Protective Order in action No. GIC 764118.

22. Within 10 business days of receipt of Notice of Entry of Order Approving Settlement Agreement and Dismissing Claims, Reynolds will pay California \$17,250,000, by check, to settle claims for sanctions and attorneys' fees and costs in this action. Upon receipt of payment, California will promptly release the Escrow Account established to secure the judgment in this matter. Said monetary amount shall be allocated as follows:

(a) The sum of \$11,417,263.65 shall be for monetary sanctions pursuant to Section VI.A of the Consent Decree.

(b) The sum of \$5,832,736.35 shall be for attorneys fees and costs incurred in action No. GIC764118 and as investigative costs for the claims resolved in this Agreement.

23. Reynolds' compliance with the terms of this Agreement shall be considered full compliance with the terms of the Judgment and compliance with Section III (a) of the MSA with respect to Reynolds' placement of advertising for its cigarette brands in Youth-measured Publications. Breach of this Agreement by Reynolds will result in the same remedies available to California for violations of the Judgment and Section III(a) of the MSA. With respect to Reynolds' obligations under this Agreement, California will have the discovery rights contained in Section VII(g) of the MSA, and whatever discovery rights might be provided by state law.

24. In consideration of the obligations set out in this Agreement, California, now and forever releases and discharges Reynolds and its past and present directors, predecessors, subsidiaries, partnerships, funds, employees, officers, shareholders, members, partners, attorneys, representatives, agents, subcontractors, trusts, trustees, heirs, family, successors, assigns and insurers, of and from any and all claims (including without limitation, claims for attorneys' fees, costs, damages or restitution), debts, liabilities, demands, obligations, costs, fees, expenses, charges, grievances, damages, actions and causes of action whatsoever, known, unknown, discovered, undiscovered, suspected or unsuspected, which California owns, holds or has owned or held, with respect to Reynolds' placement of advertising for its cigarette brands in Youth-measured Publications through December 31, 2004 and during the period in which this Agreement remains in effect. This release does not apply to any other claims that may arise under the MSA and/or Consent Decree, including claims for violation of the prohibition against youth targeting that are not based on Reynolds' placement of cigarette advertising in Youth-measured Publications.

25. California expressly waives the provisions of Section 1542 of the California Civil Code, and understands that California Civil Code Section 1542 provides:

“A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the, time of

executing the release, which if known by him must have materially affected his settlement with the debtor.”

26. This Agreement shall be governed by and construed in accordance with the laws of the State of California, without reference to conflict of laws rules.

27. The Parties understand and acknowledge that this Agreement constitutes a compromise and settlement of disputed claims. No action taken by the Parties hereto, or any of them, either previously or in connection with this Agreement, shall be deemed or construed to be (a) an admission of truth of any claims heretofore made; or (b) an acknowledgment by any party of any fault or liability whatsoever to any other party or to any third party.

28. This Agreement constitutes the entire agreement between the Parties pertaining to its subject matter and supersedes any and all prior and/or contemporaneous oral or written negotiations, agreements, representations, and undertakings. The Parties, and each of them, understand that this Agreement is made without reliance upon any inducement, statement, promise, or representation other than those contained within this Agreement. In particular, the parties have not entered into this Agreement in reliance on any representations, statements, or promises with respect to the tax consequences of the Agreement. This Agreement may not be altered, amended, modified or otherwise changed in any respect or particular whatsoever, except, by a writing duly executed by the Parties to this Agreement or their authorized representatives. The Parties acknowledge and agree that the Agreement shall not become final and binding until approved by the California Superior Court and action No. GIC 764118 is dismissed with prejudice pursuant to paragraph 14 of this Agreement.

29. This Agreement may be executed in telecopied counterparts, each of which will constitute an original but all of which taken together shall constitute one and the same document.

Dated: December 22, 2004.

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R.J. REYNOLDS TOBACCO COMPANY

THE PEOPLE OF THE STATE OF CALIFORNIA

By: _____
Name: _____
Title _____

By: _____
Name: _____
Title _____

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