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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

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

For the fiscal year ended December 31, 2006

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: 000-51173

Targacept, Inc.
(Exact Name of Registrant as Specified in its Charter)

Delaware	**56-2020050**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
200 East First Street, Suite 300 Winston-Salem, North Carolina	**27101**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant's telephone number, including area code: (336) 480-2100

Securities registered pursuant to Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Stock, $0.001 par value per share	**The NASDAQ Stock Market LLC**

Securities registered pursuant to Section 12(g) of the Exchange Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. ☐ Yes ☒ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. ☐ Yes ☒ No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Rule 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ☐ Yes ☒ No

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant as of June 30, 2006, was approximately $68,572,083, based on $6.89, the price at which the registrant's common stock was last sold on that date.

As of March 12, 2007, the registrant had 19,139,716 shares of common stock, $0.001 par value per share, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Specified portions of the registrant's proxy statement for its 2007 annual meeting of stockholders to be held on June 13, 2007, which is expected to be filed pursuant to Regulation 14A within 120 days after the end of the registrant's fiscal year ended December 31, 2006, are incorporated by reference into Part III of this report.

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Cautionary Note Regarding Forward-Looking Statements

This annual report includes forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, which we refer to as the Exchange Act. For this purpose, any statements contained in this annual report regarding the progress, timing and scope of the research and development of our product candidates or related regulatory filings or clinical trials, our development plans for the treatment combination that we refer to as TRIDMAC™, our future operations, financial position, revenues or costs, or our strategies, prospects, plans, expectations or objectives, other than statements of historical fact, are forward-looking statements made under the provisions of The Private Securities Litigation Reform Act of 1995. In some cases, words such as "may," "will," "could," "would," "should," "expect," "intend," "plan," "anticipate," "believe," "estimate," "predict," "project," "potential," "continue," "ongoing" or other comparable words identify forward-looking statements. Actual results, performance or experience may differ materially from those expressed or implied by forward-looking statements as a result of various important factors, including our critical accounting policies and risks and uncertainties relating to: our dependence on the success of our collaboration with AstraZeneca; the amount and timing of resources that AstraZeneca devotes to the development of AZD3480 (TC-1734); AstraZeneca's right in the future to terminate the preclinical research collaboration that we and AstraZeneca are currently conducting prior to the end of the planned four-year term; the position of applicable regulatory authorities with regard to a treatment combination that includes mecamylamine hydrochloride, which is a racemate, as compared to one of its constituent enantiomers such as TC-5214; the results of clinical trials and non-clinical studies and assessments with respect to our current and future product candidates in development; the conduct of such trials, studies and assessments, including the performance of third parties that we engage to execute them and difficulties or delays in the completion of patient enrollment or data analysis; the timing and success of submission, acceptance and approval of regulatory filings; our ability to obtain substantial additional funding; our ability to establish additional strategic collaborations; and our ability to obtain, maintain and enforce patent and other intellectual property protection for our product candidates and discoveries. These and other risks and uncertainties are described in more detail under the caption "Risk Factors" in Item 1A of Part I of this annual report. As a result of the risks and uncertainties, the results or events indicated by the forward-looking statements may not occur. We caution you not to place undue reliance on any forward-looking statement.

Any forward-looking statements in this annual report represent our views only as of the date of this annual report and should not be relied upon as representing our views as of any subsequent date. We anticipate that subsequent events and developments may cause our views to change. Although we may elect to update these forward-looking statements publicly at some point in the future, whether as a result of new information, future events or otherwise, we specifically disclaim any obligation to do so, except as required by applicable law. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make.

PART I

Item 1. Business.

Overview

We are a biopharmaceutical company engaged in the design, discovery and development of NNR Therapeutics™, a new class of drugs for the treatment of multiple diseases and disorders of the central nervous system. Our NNR Therapeutics selectively target neuronal nicotinic receptors, or NNRs. NNRs are found on nerve cells throughout the nervous system and serve as key regulators of nervous system activity.

We trace our scientific lineage to a research program initiated by R.J. Reynolds Tobacco Company in 1982 to study the activity and effects of nicotine, a compound that interacts non-selectively with all nicotinic receptors. Based on years of focused research in the NNR area, we believe that compounds that interact selectively with specific NNR subtypes have the potential to achieve positive medical effects by modulating their activity. We have built an extensive patent estate covering the structure or therapeutic use of small molecules designed to regulate the central nervous system by selectively affecting specific NNR subtypes.

We currently have four clinical-stage product candidates and three preclinical product candidates. Our most advanced product candidates are in development as treatments for target indications generally in three therapeutic areas: cognitive impairment, depression and anxiety, and pain.

Cognitive Impairment

AZD3480 (TC-1734). Our lead product candidate is a novel small molecule that we have historically referred to as TC-1734 and that our strategic collaborator, AstraZeneca, refers to as AZD3480. AZD3480 (TC-1734) modulates the activity of the a4ß2 NNR. We have a collaborative research and license agreement with AstraZeneca AB for the development and worldwide commercialization of AZD3480 (TC-1734) as a treatment for Alzheimer's disease, cognitive deficits in schizophrenia and potentially other conditions characterized by cognitive impairment such as attention deficit hyperactivity disorder, commonly referred to as ADHD, age associated memory impairment, commonly referred to as AAMI, and mild cognitive impairment, commonly referred to as MCI. We currently expect that AstraZeneca will initiate two Phase II clinical trials of AZD3480 (TC-1734) in mid-2007, one in mild to moderate Alzheimer's disease and one in cognitive deficits in schizophrenia, and that both trials will be completed by the end of 2008.

Our agreement with AstraZeneca relating to AZD3480 (TC-1734) became effective in January 2006. AstraZeneca paid us an initial fee of $10 million in February 2006 and an additional $20 million in January 2007 as a result of its determination to proceed with further development of AZD3480 (TC-1734) following the completion of additional clinical and non-clinical studies that it conducted during 2006. Under the agreement, we are eligible to receive other payments of up to $249 million, contingent upon the achievement of development, regulatory and first commercial sale milestones for AZD3480 (TC-1734) for Alzheimer's disease, cognitive deficits in schizophrenia and ADHD, and royalties on future product sales. If AZD3480 (TC-1734) is developed under the agreement for other indications characterized by cognitive impairment, we would also be eligible to receive payments contingent upon the achievement of development, regulatory and first commercial sale milestones for AZD3480 (TC-1734) for those indications. AstraZeneca is responsible for the commercialization of AZD3480 (TC-1734) and any compounds that arise out of the a4ß2 research collaboration described below that it elects to advance. We have the option to co-promote AZD3480 (TC-1734) and any other compounds arising out of the research collaboration that are selected for advancement in the United States to specified classes of specialist physicians.

Depression/Anxiety

TC-2216. TC-2216 is a novel small molecule that we are developing as a monotherapy for depression and anxiety disorders. TC-2216 modulates the activity of the a4ß2 NNR. We are currently conducting a Phase I

single rising dose clinical trial of this product candidate to evaluate its safety and tolerability and to assess its pharmacokinetic profile in healthy volunteers.

Mecamylamine hydrochloride and TC-5214. Mecamylamine hydrochloride is the active ingredient in Inversine®, which is our only product approved by the U.S. Food and Drug Administration, or FDA, for marketing. Inversine is approved for the management of moderately severe to severe essential hypertension, a high blood pressure disorder. However, we believe that Inversine is prescribed predominantly for the treatment of neuropsychiatric disorders, including Tourette's syndrome, autism and bipolar disorder.

In 2006, we completed a Phase II clinical trial of mecamylamine hydrochloride as an augmentation treatment to citalopram hydrobromide, a commonly prescribed treatment for depression marketed as Celexa in the United States, for major depression. We refer to this treatment combination as TRIDMAC. TC-5214 is one of the molecular components, known as enantiomers, of mecamylamine hydrochloride. We have not yet conducted a clinical trial of TC-5214 but currently expect that we will elect to advance TC-5214 into clinical development as an augmentation treatment for major depression in lieu of further development of mecamylamine hydrochloride. TC-5214 has shown anti-depressant effects in our preclinical evaluation, and we have licensed patent rights covering its composition for use as a pharmaceutical.

Pain

TC-2696. TC-2696 is a novel small molecule that we are developing currently as a treatment for acute post-operative pain. Depending on clinical trial results, available resources and other considerations, we may pursue development of TC-2696 in the future for other classes of pain in addition to or instead of acute post-operative pain. TC-2696 modulates the activity of the a4ß2 NNR. We are currently conducting a single-dose Phase II clinical trial of this product candidate to assess its pain-relieving effects in third molar extraction patients. We currently expect to complete the trial in the second half of 2007.

TC-6499. TC-6499 is a novel small molecule that we are developing currently as a treatment for one or more classes of pain. TC-6499 modulates the activity of the a4ß2 NNR. We are currently conducting manufacturing activities necessary to support the initiation of clinical development of this product candidate.

TC-5619

In addition to the product candidates described above, we are developing TC-5619, a novel small molecule that modulates the activity of the a7 NNR. We are currently conducting additional preclinical studies necessary to support a regulatory filing planned for the second quarter of 2007 to initiate clinical development of TC-5619. We have not yet selected definitively the indication for which we will pursue the development of TC-5619. We believe compounds that selectively target the a7 NNR may have application in the treatment of conditions such as schizophrenia, cognitive impairment and inflammation.

Other Research Activities

Under our agreement with AstraZeneca, we and AstraZeneca are conducting a preclinical research collaboration designed to discover and develop additional compounds that, like AZD3480 (TC-1734), act on the a4ß2 NNR. AstraZeneca is responsible for funding the research collaboration, which began in January 2006 and has a planned term of four years.

In addition to our a4ß2 research collaboration with AstraZeneca, we have a preclinical program focused on identifying and developing compounds that selectively target the a7 NNR and other preclinical programs in areas in which we believe drugs that target specific NNR subtypes can be exploited for medical benefit, such as smoking cessation (and other addictions), obesity and Parkinson's disease.

Our drug discovery activities utilize sophisticated proprietary computer-based molecular design methodologies and extensive biological data for a library of diverse compounds developed and collected over

more than 20 years. We refer to these technologies collectively as Pentad™. We used Pentad to design or optimize AZD3480 (TC-1734), TC-2696, TC-2216, TC-5619 and TC-6499.

Role of NNRs in the Nervous System

The human nervous system is a massive communications network that sends and receives information throughout the body via billions of specialized nerve cells known as neurons. Neurons continually gather information about the body's internal and external environment and send signals to the brain. These signals pass from one neuron to another across a gap between a communicating neuron and a receiving neuron known as a synapse. Electrical impulses of a communicating neuron are converted into chemicals called neurotransmitters that are released by the communicating neuron and bind to specialized proteins known as receptors located across the synapse on the receiving neuron to enable the signal to continue. The major neurotransmitters in the brain include dopamine, serotonin, norepinephrine, glutamate, gamma-aminobutyric acid, or GABA, and acetylcholine.

NNRs are a class of receptors found in the nervous system that play a critical role in modulating the release of neurotransmitters to regulate nervous system activity. When the neurotransmitter acetylcholine is released from a nearby neuron, called an interneuron, and binds to an NNR on a communicating neuron, the flow of neurotransmitters from the communicating neuron to a receiving neuron is adjusted by the NNR. This action, known as neuromodulation, results in a greater release of neurotransmitters across the synapse when the nervous system is understimulated and a lesser release of neurotransmitters across the synapse when the nervous system is overstimulated. As neuromodulators, NNRs serve as the nervous system's self-adjusting "volume knob."

The nervous system will not operate properly if the relative levels of key neurotransmitters in the brain are not maintained in a normal balance. A disruption in this balance can cause many common nervous system diseases and disorders. We believe that compounds that target NNRs to modulate their activity have the potential to restore this balance and therefore promise as treatments for these diseases and disorders.

NNRs are comprised of five protein subunits that are arranged like staves of a barrel around a central pore. Each different combination of five subunits represents an NNR subtype. There are several subtypes, each of which is identified by Greek letters. Scientific evidence has established that individual NNR subtypes have particular functions in the body that are relevant to a number of debilitating diseases and disorders.

Many published studies evaluating the effects of nicotine in humans and animals, as well as published studies showing the prevalence of diseases such as Alzheimer's disease and Parkinson's disease in non-smokers as compared to smokers, suggest the therapeutic effects of compounds such as nicotine that interact with NNRs. However, despite their beneficial effects, these compounds have historically not been desirable as therapies because they have not been sufficiently selective. This means that these compounds interact not only with NNRs, but also with nicotinic receptors in the muscles and in groups of nerve cells known as ganglia that are associated with adverse effects such as increased heart rate, high blood pressure, irregular heartbeat, nausea, vomiting and a dangerous slowing of breathing known as respiratory depression.

Based on years of focused research in the NNR area, we are developing product candidates that are designed to interact selectively with specific NNR subtypes to promote positive medical effects and limit adverse side effects.

Our Business Strategy

Our goal is to become a leader in the discovery, development and commercialization of novel drugs that selectively target NNRs in order to treat diseases and disorders where there is significant medical need and commercial potential. To achieve this goal, we are pursuing the following strategies:

- We believe that drugs designed to selectively target specific NNR subtypes can have positive medical effects with limited adverse side effects. We intend to continue to use our scientific expertise and

Pentad to identify compounds that selectively target specific NNR subtypes as potential treatments for diseases and disorders of the central nervous system.

- We have a collaborative research and license agreement with AstraZeneca for the development and worldwide commercialization of AZD3480 (TC-1734) as a treatment for Alzheimer's disease, cognitive deficits in schizophrenia and potentially other conditions characterized by cognitive impairment. Under the agreement, we and AstraZeneca are conducting a preclinical research collaboration designed to discover and develop additional compounds that, like AZD3480 (TC-1734), act on the a4ß2 NNR. We intend to selectively seek additional collaborations with leading pharmaceutical and biotechnology companies to assist us in furthering the development of our product candidates. In particular, we intend to enter into these collaborations for target indications in which our potential collaborator has particular expertise or that involve a large, primary care market that must be served by large sales and marketing organizations. In entering into these collaborations, our goal will generally be to maintain co-promotion or co-commercialization rights in the United States and, in some cases, other markets. Under our collaboration agreement with AstraZeneca, we have the option to co-promote AZD3480 (TC-1734) and any compounds arising out of the research collaboration that are selected for advancement in the United States to specified classes of specialist physicians.
- We have established ourselves as a leader in NNR research over more than 20 years. Our leadership position in this area is reflected in the numerous NNR-related articles and abstracts published by our scientists in prominent scientific journals, as well as our extensive patent estate. We intend to continue to invest significant resources to remain at the forefront of NNR research, build upon our NNR expertise and expand our intellectual property portfolio. We also plan to augment our own research by collaborating with commercial and academic institutions that seek access to our proprietary knowledge and compounds.
- We have identified numerous indications in which NNRs have been implicated and for which we believe that drugs that selectively target specific NNR subtypes can potentially provide a medical benefit. We plan to prioritize our product development opportunities in an effort to apply our product pipeline to indications in which there is a significant medical need and commercial potential.
- We intend to maximize the value of our portfolio of product candidates by seeking generally to retain marketing rights to specialists, particularly in neurology and psychiatry, in any future collaborations that we enter into.

Our Product Development Pipeline

We currently have four clinical-stage product candidates and three preclinical product candidates. In addition to these product candidates, we have preclinical programs in areas in which we believe that NNRs can be exploited for medical benefit.

Our most advanced product candidates are in development as treatments for target indications generally in three therapeutic areas: cognitive impairment, depression and anxiety, and pain. The following table summarizes our product development pipeline.

Area of Therapeutic Focus	Product Candidate	Target Indication(s)	Status of Development	Commercial Rights
Cognitive Impairment	AZD3480 (TC-1734)	Alzheimer's disease; cognitive deficits in schizophrenia	Two Phase II trials in AAMI and one Phase II trial in MCI completed; initiation of Phase II trials in mild to moderate Alzheimer's disease and cognitive deficits in schizophrenia expected in mid-2007	AstraZeneca
Depression/Anxiety	TC-2216	Depression and anxiety disorders	Phase I trial ongoing	Targacept
Depression	Mecamylamine hydrochloride	Major depression (augmentation treatment)	Phase II trial completed	Targacept
	TC-5214 (enantiomer of mecamylamine hydrochloride)	Major depression (augmentation treatment)	Preclinical	Targacept
Pain	TC-2696	Acute post-operative Pain	Phase II trial ongoing	Targacept
	TC-6499	Pain	Preclinical	Targacept
Schizophrenia, cognitive impairment or inflammation	TC-5619	To be determined	Regulatory filing for initiation of Phase I trial planned for second quarter of 2007	Targacept*

* Under our collaboration agreement, we may offer to AstraZeneca the right to develop and commercialize TC-5619 as a treatment for any or all of schizophrenia and various conditions characterized by cognitive impairment under the terms of the agreement. If we do not offer this right to AstraZeneca, we may pursue the development and commercialization of TC-5619 for other indications, such as inflammation.

We conducted our Phase II clinical trial of AZD3480 (TC-1734) in AAMI that we completed in March 2006 and we are conducting our ongoing Phase II clinical trial of TC-2696 in the United States. We conducted our Phase II clinical trial of TRIDMAC, a treatment combination comprised of mecamylamine hydrochloride as an augmentation therapy to citalopram hydrobromide, in the United States and India. All other completed or ongoing clinical trials of our product candidates have been conducted in Europe.

Information regarding our research and development expenses for the fiscal years ended December 31, 2006, 2005 and 2004 is included under "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this annual report.

Cognitive Impairment

AZD3480 (TC-1734) is being developed in collaboration with AstraZeneca as an oral treatment for Alzheimer's disease, cognitive deficits in schizophrenia and potentially other conditions characterized by cognitive impairment, such as ADHD, AAMI and MCI.

AZD3480 (TC-1734)

AZD3480 (TC-1734) is a novel small molecule that modulates the activity of the a4ß2 NNR. In March 2006, we completed a Phase II clinical trial of AZD3480 (TC-1734) in AAMI. We had previously completed two Phase II clinical trials of AZD3480 (TC-1734), one in AAMI and the other in MCI, a condition characterized by cognitive impairment that is more severe than AAMI but less severe than Alzheimer's disease. We had also previously evaluated AZD3480 (TC-1734) in four Phase I clinical trials.

While the exact causes of Alzheimer's disease, AAMI and MCI are unknown, the aging process is generally accompanied by a decline of cognitive function linked to a progressive deterioration and death of cells in the brain. This is known as neurodegeneration. If neurodegeneration reaches a more advanced stage, such as in Alzheimer's disease, a person becomes debilitated and unable to care for himself or herself. In two preclinical in vitro studies that we conducted, AZD3480 (TC-1734) protected neuronal cells from deterioration and death, a process known as neuroprotection.

In addition to Alzheimer's disease and cognitive deficits in schizophrenia, AstraZeneca has agreed under our collaboration agreement to pursue development and commercialization of AZD3480 (TC-1734) as a treatment for ADHD if AZD3480 (TC-1734) achieves the primary efficacy endpoints in a Phase II clinical trial for Alzheimer's disease or cognitive deficits in schizophrenia or if AstraZeneca initiates a Phase III clinical trial of AZD3480 (TC-1734) for Alzheimer's disease or cognitive deficits in schizophrenia.

Clinical Development of AZD3480 (TC-1734)

Phase II Clinical Trial Completed in 2006. In March 2006, we completed a placebo controlled Phase II clinical trial of AZD3480 (TC-1734) in AAMI. The trial was designed to provide additional evidence as to whether AZD3480 (TC-1734) improves cognitive performance in cognitively impaired older adults. We conducted the trial at 16 sites in the United States. We recruited 193 subjects between the ages of 50 and 80, who were classified with AAMI based on inclusion criteria reflecting both subjective and objective memory impairment, to participate in the trial. The trial was double blind, meaning that neither the subjects nor the clinical investigators knew during the trials which subjects were receiving AZD3480 (TC-1734) and which subjects were receiving placebo.

The trial design provided for three dose groups, 25mg of AZD3480 (TC-1734), 50mg of AZD3480 (TC-1734) and placebo. Each group was dosed once daily for 16 weeks. Subjects in the 50mg dose group received 25mg for the first two weeks of dosing, 37.5mg for the next two weeks of dosing and 50mg for the remaining 12 weeks of dosing. Of the 193 subjects enrolled in the trial, 59 were randomly assigned to the 25mg dose group, 68 were randomly assigned to the 50mg dose group and 66 were randomly assigned to the placebo group. Of these, 53 subjects in the 25mg dose group, 57 subjects in the 50mg dose group and 58 subjects in the placebo group completed the trial.

Each subject was assessed using a computer-based test battery developed by CDR Ltd. to test cognitive function. We tested each subject at various time points prior to the first day of the 16-week dosing period to establish baseline. We tested subjects again at eight weeks and on the last day of the 16-week dosing period. The CDR test battery includes measures of attention, speed of cognitive processes and memory that assess the ability to react to stimuli, recognize words and pictures and recall words. These measures are then used to make composite assessments on the following five factors:

- power of attention, which assesses the intensity of concentration;

- continuity of attention, which assesses the ability to sustain concentration;
- working memory, or short-term memory, which assesses the ability to retain for a short period of time information that has not been previously learned;
- episodic memory, or long-term memory, which assesses the ability to store, hold for an extended period of time and retrieve information of an episodic nature, such as an event, name, object, scene or appointment; and
- speed of memory, which assesses the time it takes to recall an item from memory.

There were three co-primary efficacy endpoints for this trial, including:

- *power of attention*—change from baseline on the power of attention factor of the CDR test battery at the end of the 16-week dosing period, as compared to placebo;
- *episodic memory*—change from baseline on the episodic memory factor of the CDR test battery at the end of the 16-week dosing period, as compared to placebo; and
- *subject global impression*—composite score on a cognitive performance scale comprised of three seven-point measures in which each subject rates himself or herself on attention, memory and speed of thinking at the end of the 16-week dosing period, as compared to placebo.

The CDR test data are presented below on both a per protocol basis and an intent to treat basis. The per protocol dataset includes all subjects who were at least 80% compliant with the dosing regimen for the trial and completed the required cognitive function assessments at the end of the dosing period. The intent to treat data set includes all subjects who received at least one dose of trial medication (AZD3480 (TC-1734) or placebo) and completed at least one cognitive function assessment.

On both a per protocol basis and an intent to treat basis, subjects receiving AZD3480 (TC-1734) in the 50mg dose group showed improvement as compared to subjects dosed with placebo on all three co-primary efficacy endpoints. These results were statistically significant. Subjects receiving AZD3480 (TC-1734) in the 25mg dose group showed improvement as compared to subjects dosed with placebo on the power of attention endpoint. This result was statistically significant.

A clinical trial result is statistically significant if it is unlikely to have occurred by chance. The statistical significance of clinical trial results is determined by a widely used statistical method that establishes the p-value of the results. Under this method, a p-value of 0.05 or less represents statistical significance. If a p-value is above 0.05, the result is not statistically significant, or NS. The p-values for the primary endpoints for the AZD3480 (TC-1734) dose groups are set forth below.

Primary Endpoint	**25mg AZD3480 (TC-1734)**		**50mg AZD3480 (TC-1734)**	
	Per Protocol	***Intent to treat***	***Per Protocol***	***Intent to treat***
CDR—Power of Attention	0.023	0.025	0.010	0.014
CDR—Episodic Memory	NS	NS	0.030	0.029
Subject Global Impression	NS	NS	0.008	0.015

AZD3480 (TC-1734) was generally well tolerated in this trial as compared to placebo. We reported two serious adverse events experienced by subjects dosed with AZD3480 (TC-1734). One of these subjects was diagnosed with lung cancer after being assigned to a dose group. The principal investigator for the trial site for this subject described the event as not related to AZD3480 (TC-1734). The other subject was diagnosed with a myocardial infarction, commonly known as a heart attack, after being dosed for approximately 12 weeks. The principal investigator for the trial site for this subject described the event as possibly related to AZD3480

(TC-1734). Because of the age range of the subject population for this trial, the types of the two serious adverse events that we observed were not unexpected.

There were no clinically significant differences among the two AZD3480 (TC-1734) dose groups and the placebo group in the incidence of adverse events. The adverse events that we observed included dizziness, headaches, diarrhea, back pain, head colds, upper respiratory tract infections, nausea and joint pain. The most frequently observed adverse event was dizziness. However, the number of subjects in the placebo group who experienced dizziness was substantially the same as the number of subjects who experienced dizziness in the group dosed with 50mg of AZD3480 (TC-1734) and greater than the number of subjects who experienced dizziness in the group dosed with 25mg of AZD3480 (TC-1734).

Previous Phase II Clinical Trials. Prior to the Phase II clinical trial of AZD3480 (TC-1734) that we completed in March 2006, we had completed two double blind, placebo controlled Phase II clinical trials of AZD3480 (TC-1734). One trial evaluated 70 persons at least 60 years of age classified with AAMI and the other trial evaluated 36 persons at least 60 years of age classified with MCI, in each case on a per protocol basis. The primary objective of each trial was to assess the safety and tolerability of AZD3480 (TC-1734) in elderly subjects compared to placebo. Secondary objectives of each trial included the assessment of the efficacy of AZD3480 (TC-1734) in improving cognitive function.

Both trials utilized a crossover design. This means that each subject initially received AZD3480 (TC-1734) or placebo for three weeks, then did not receive any trial medication for two weeks, and then received AZD3480 (TC-1734) or placebo (whichever the subject had not received initially) for three weeks. In the AAMI trial, we evaluated four doses—50mg, 100mg, 125mg and 150mg. In the MCI trial, we evaluated two doses—50mg and 100mg. Subjects were assessed for changes in cognitive function using the CDR test battery before dosing and at various time points after dosing on the first and last day of each dosing period.

In the 50mg, 100mg and 125mg arms of the AAMI trial, AZD3480 (TC-1734) was well tolerated, with no serious adverse events reported. In the 150mg dose group, three out of eight subjects treated with AZD3480 (TC-1734) experienced side effects such as headache, lightheadedness, dizziness and vomiting and dropped out of the trial.

The results of the AAMI trial were most favorable in the 50mg dose group. In that dose group, we observed statistically significant results in favor of AZD3480 (TC-1734) in four of the five CDR factors—power of attention, continuity of attention, episodic memory, and speed of memory. The results on the continuity of attention, episodic memory and speed of memory factors included only the first dosing period due to treatment-by-period interaction.

Treatment-by-period interaction refers to a situation where the initial dosing period may have had an effect on performance on one or more factors in the cognitive test battery in the second dosing period and is identified by a statistical analysis of a dose group's performance on a particular test factor in the first dosing period versus the dose group's performance on that test factor in the second dosing period. In instances in which our statistical analysis indicated that a treatment-by-period interaction might have occurred for a particular dose group and a particular test factor, we have described in this report only the first dosing period for that dose group for that test factor. The effect of including only the first dosing period in the results described in this report for a particular dose group and a particular test factor is to reduce, by 50%, both the number of evaluated subjects in that dose group for that test factor that were dosed with AZD3480 (TC-1734) and the number of subjects in that dose group for that test factor that were dosed with placebo.

The positive effects that we observed in the 50mg dose group were less pronounced in the other dose groups. However, in each of the other dose groups, we observed a statistically significant result in favor of AZD3480 (TC-1734) on at least one of the CDR test factors at at least one of the time points evaluated. In the 100mg dose group, we observed a statistically significant result on the episodic memory factor. In the 125mg

dose group, we observed a statistically significant result on the working memory factor at one of the time points evaluated, including only the first dosing period due to treatment-by-period interaction. In the 150mg dose group, we observed statistically significant results on the continuity of attention and speed of memory factors.

To generate additional data related to the tolerability of AZD3480 (TC-1734), we also tested eight elderly persons who met the inclusion criteria at a dose of 150mg, after having eaten, using the same trial design. This enabled us to assess the impact of food on the tolerability of AZD3480 (TC-1734) by comparing it in subjects dosed at 150mg who had eaten and in subjects dosed at 150mg who had not eaten. The results indicated that the 150mg dose of AZD3480 (TC-1734) was better tolerated in subjects who had eaten than in subjects who had not eaten. There were no serious adverse events in this dose group. We observed a statistically significant result in favor of AZD3480 (TC-1734) on the continuity of attention factor at one of the time points evaluated, as well as on the speed of memory factor including only the first dosing period due to treatment-by-period interaction.

As in the AAMI trial, AZD3480 (TC-1734) was well tolerated in the MCI trial, with only one serious adverse event reported. A subject who had a history of an abnormally slow heart rate lost consciousness and was hospitalized approximately one-and-one-half weeks following the end of the dosing phase of the trial. We do not believe that this adverse event was related to AZD3480 (TC-1734). In the 100mg dose group of the trial, we observed a statistically significant result in favor of AZD3480 (TC-1734) on the episodic memory factor. The results in the 50mg dose group did not favor AZD3480 (TC-1734).

Phase I Clinical Trials. Prior to our Phase II clinical trials of AZD3480 (TC-1734), we had completed four Phase I clinical trials in a total of 84 healthy volunteers in which the compound was well tolerated. The trials included a single rising dose trial, a multiple rising dose trial, a trial designed to evaluate the compound's pharmacokinetic profile and a food interaction trial. We enrolled volunteers ranging in age from 18 to 45 in the single rising dose, multiple rising dose and food interaction trials and from 64 to 73 in the pharmacokinetic trial. Pharmacokinetics refers to a compound's absorption, distribution and metabolism in, and excretion from, the body. In a single rising dose trial, each subject in a dose group receives a single dose of the drug being evaluated, with subjects in each subsequent dose group receiving a pre-determined higher dosage than subjects in the preceding dose group. In a multiple rising dose clinical trial, each subject in a dose group receives a dosage of the drug being evaluated multiple times, with subjects in each subsequent dose group receiving a pre-determined higher dosage than subjects in the preceding dose group.

Plans for Future Development in Alzheimer's Disease. We believe that the effects that we observed in our completed Phase II clinical trials of AZD3480 (TC-1734) indicate that AZD3480 (TC-1734) has potential as a treatment for Alzheimer's disease. We currently expect that AstraZeneca will initiate a double blind, placebo controlled Phase II clinical trial of AZD3480 (TC-1734) for the treatment of mild to moderate Alzheimer's disease in mid-2007. Based on our discussions with AstraZeneca, we also currently expect that:

- the trial will be conducted at sites in Western Europe, Eastern Europe and Canada;
- the trial will include approximately 500 patients with mild to moderate Alzheimer's disease;
- patients will be randomly assigned to one of three dose groups of AZD3480 (TC-1734) ranging from a dose lower than we have previously evaluated in our Phase II clinical trials of this product candidate to up to 100mg, to an active comparator, or to placebo;
- each patient will be dosed over a 12-week period;
- the co-primary outcome measures of the trial will be the Alzheimer's Disease Assessment Scale-cognitive subscale, or ADAS-Cog, the measure most often used to assess the efficacy of drugs for Alzheimer's disease, and a clinician interview-based impression of change, or CIBIC, scale;
- the CDR test battery will be included in the trial as a secondary measure; and
- the trial will be completed by the end of 2008.

The planned trial design for the Phase II clinical trial of AZD3480 (TC-1734) in mild to moderate Alzheimer's disease may change based on scientific, commercial or other factors. Changes to the trial design could relate to the number of patients, dose groups, endpoints or any other details of the planned trial. AstraZeneca has significant control over trial design, as well as the conduct and timing of development efforts with respect to AZD3480 (TC-1734).

Plans for Future Development in Cognitive Deficits in Schizophrenia. We believe that AZD3480 (TC-1734) may also have potential as a treatment for cognitive deficits in schizophrenia. We currently expect that AstraZeneca will initiate a double blind, placebo controlled Phase II clinical trial of AZD3480 (TC-1734) as a therapy for the treatment of cognitive deficits in schizophrenia in mid-2007. Based on our discussions with AstraZeneca, we also currently expect that:

- prior to initiating the Phase II trial, AstraZeneca will complete ongoing clinical trials in schizophrenic patients designed to evaluate the interaction of AZD3480 (TC-1734) with various approved treatments for schizophrenia from the drug class known as atypical anti-psychotics;
- the Phase II trial will be conducted at sites in the United States and Canada;
- the trial will include approximately 400 schizophrenic patients who are taking one of three commonly prescribed anti-psychotics and are clinically stable;
- patients will be randomly assigned to one of three dose groups of AZD3480 (TC-1734) ranging from a dose lower than we have previously evaluated in our Phase II clinical trials of this product candidate to up to 100mg, or to placebo;
- each patient will be dosed, together with continued treatment with the applicable anti-psychotic, over a 12-week period;
- the primary outcome measure will be a cognitive test battery that includes assessments of cognitive functions across nine different domains and was developed in connection with a National Institute of Mental Health initiative known as Measurement and Treatment Research to Improve Cognition in Schizophrenia, or MATRICS;
- secondary measures will include measures of life functioning, such as performance in day-to-day tasks and social skills; and
- the trial will be completed by the end of 2008.

The planned trial design for the Phase II clinical trial of AZD3480 (TC-1734) in cognitive deficits in schizophrenia may change based on the drug interaction trial that we expect AstraZeneca to conduct before initiating the Phase II trial or scientific, commercial or other factors. Changes to the trial design could relate to the number of patients, dose groups, endpoints or any other details of the planned trial. AstraZeneca has significant control over trial design, as well as the conduct and timing of development efforts with respect to AZD3480 (TC-1734).

In addition to the planned Phase II cognitive deficits in schizophrenia trial described above, we also currently expect that AstraZeneca will conduct clinical pharmacology trials in parallel.

Other AZD3480 (TC-1734) Development Studies. During 2006, AstraZeneca conducted various studies of AZD3480 (TC-1734) at its expense to generate further data with respect to AZD3480 (TC-1734), including:

- in vitro studies to assess whether AZD3480 (TC-1734), when administered at a therapeutically-relevant dose, activates a particular protein that can activate an enzyme known as CYP1A1;
- a clinical trial to characterize the cardiovascular effects of various doses of AZD3480 (TC-1734) in persons who break down and eliminate, or metabolize, AZD3480 (TC-1734) at varying rates;

- a single-dose study in dogs to further assess the cardiovascular effects of AZD3480 (TC-1734);
- a clinical trial to evaluate the interaction and combined effects of AZD3480 (TC-1734) with paroxetine, a known inhibitor of a key enzyme involved in the primary metabolic pathway of AZD3480 (TC-1734);
- in vitro and animal studies to further characterize the mechanism of action of AZD3480 (TC-1734); and
- a Phase I clinical trial in healthy volunteers of Japanese descent to support the potential future pursuit of regulatory approval of AZD3480 (TC-1734) in Japan.

Depression/Anxiety

We are developing TC-2216 as a monotherapy for either or both of depression and anxiety disorders. We are currently conducting a Phase I clinical trial of TC-2216. Our other product candidates for depression include mecamylamine hydrochloride and TC-5214. We have completed a Phase II clinical trial of mecamylamine hydrochloride as an augmentation treatment to citalopram hydrobromide, a commonly prescribed treatment for depression marketed as Celexa in the United States, for major depression. We refer to this treatment combination as TRIDMAC. TC-5214 is one of the enantiomers of mecamylamine hydrochloride.

TC-2216

TC-2216 is a novel small molecule that we are developing as an oral monotherapy for depression and anxiety disorders. TC-2216 modulates the activity of the a4ß2 NNR. We are currently conducting a Phase I single rising dose clinical trial of this product candidate. The double blind, placebo controlled trial is designed to evaluate the safety and tolerability of TC-2216 and to assess its pharmacokinetic profile in healthy volunteers.

Depression and anxiety disorders often occur together, and anti-depressants are often also used to treat anxiety disorders. In our preclinical studies, TC-2216 showed greater potency and anti-depressant effects comparable to selective serotonin reuptake inhibitors and tricyclics, which are commonly used treatments for depression. In other preclinical studies, TC-2216 showed anxiety-relieving effects.

TC-2216 is a racemate. A racemate is a mixture of two different enantiomers that are mirror images of each other and have the same chemical but potentially different biological properties. If our Phase I clinical program of TC-2216 is successful, we may elect to advance one of the enantiomers of TC-2216 in lieu of further development of TC-2216.

Mecamylamine hydrochloride and TC-5214

Mecamylamine hydrochloride is the active ingredient in Inversine, which is currently our only approved product. Inversine is approved in the United States for the management of moderately severe to severe essential hypertension. We believe that Inversine is prescribed predominantly for the treatment of neuropsychiatric disorders, including Tourette’s syndrome, autism and bipolar disorder, in children and adolescents at a lower dose than is used for hypertension. Inversine has been approved for marketing since the 1950s. We acquired marketing rights to the product in August 2002 from Layton Bioscience, Inc., which had previously acquired the rights from Merck & Co., Inc. In connection with our acquisition, we assumed Layton’s obligations under the agreement pursuant to which Layton acquired the rights from Merck. Pursuant to that agreement, we pay Merck an amount each year based on annual sales of Inversine, subject to a specified annual maximum. Our annual payment obligation to Merck expires in 2008.

In 2006, we completed a Phase II clinical trial of mecamylamine hydrochloride as an oral augmentation treatment to citalopram hydrobromide for major depression. We refer to this treatment combination as TRIDMAC.

We conducted the Phase II trial at one site in the United States and eight sites in India. The trial design included two phases. In the first phase, 450 patients with a diagnosis of major depressive disorder were given open label citalopram hydrobromide over six weeks and evaluated based on improvement on two scales —the Hamilton Depression Rating Scale (HAM-D), a commonly used 17-item scale that evaluates depressed mood and other symptoms of depression and anxiety, and the Clinical Global Impression subscale for severity of illness (CGI-SI)—to determine the extent of any response. Patients whose score on the HAM-D scale was at least equal to 14 and whose score on the CGI-SI scale was at least equal to 4 were enrolled into the second phase of the trial. The second phase was double blind and placebo controlled. We enrolled 184 patients into the second phase. In the second phase, patients received either mecamylamine hydrochloride or placebo, in each case together with continued citalopram hydrobromide therapy, for an additional eight weeks. The dose group that received mecamylamine hydrochloride together with continued citalopram hydrobromide therapy is referred to below as the TRIDMAC dose group. Patients in the TRIDMAC dose group initially received 5mg of mecamylamine daily, titrating up to 10mg over the dosing period at the clinician's discretion based on tolerability and therapeutic response.

The primary endpoints of the trial were group mean change from baseline and achievement of remission, in each case as measured by HAM-D and compared to continued citalopram therapy plus placebo. Secondary outcome measures used in the trial included rating scales to assess symptoms of depression and anxiety, disability, irritability, global improvement or severity of illness. Data from the trial were evaluated on both an intent to treat and per protocol basis. The intent to treat population included 160 patients who received at least one dose of blinded study medication and were assessed using HAM-D at least once after determination of baseline. The per protocol population included 151 patients who were at least 80% compliant with the dosing regimen called for by the protocol and were assessed using HAM-D at the end of the dosing period.

The result on the group mean change endpoint was statistically significant in favor of TRIDMAC on an intent to treat basis, with a p-value of 0.041, and showed a strong trend, but not statistical significance, on a per protocol basis (p-value of 0.059). The result on the achievement of remission endpoint favored the TRIDMAC group over the placebo group in both the intent to treat and per protocol populations, although these results did not reach statistical significance. With respect to the secondary outcome measures, the results on all five rating scales favored the TRIDMAC group over the placebo group on a per protocol basis. Each of these results was statistically significant, with a p-value of less than 0.05. On an intent to treat basis, the results on the rating scales assessing disability, irritability and severity of illness were statistically significant, with p-values less than 0.05.

TRIDMAC was generally well tolerated in the trial. There was one serious adverse event reported in each of the TRIDMAC and placebo groups. In the TRIDMAC group, a patient experienced an upper respiratory tract infection and irregular heartbeat and discontinued participation in the trial.

TC-5214 is one of the enantiomers of mecamylamine hydrochloride and has shown anti-depressant effects in our preclinical evaluation in several rodent models. We have licensed patent rights from the University of South Florida Research Foundation covering the composition of TC-5214 for use as a pharmaceutical. We have not yet conducted a clinical trial of TC-5214 but currently expect that we will elect to advance TC-5214 into clinical development as an oral augmentation treatment for major depression in lieu of further development of mecamylamine hydrochloride.

Pain

We are developing TC-2696 currently for acute post-operative pain. Depending on clinical trial results, available resources and other considerations, we may pursue development of TC-2696 in the future for other classes of pain in addition to or instead of acute post-operative pain. TC-6499 is another product candidate that we are currently developing for one or more classes of pain.

TC-2696

TC-2696 is a novel small molecule that we are developing currently as an oral treatment for acute post-operative pain. TC-2696 modulates the activity of the a4ß2 NNR. We are currently conducting a single-dose Phase II trial of this product candidate in third molar extraction patients.

In our preclinical animal studies, TC-2696 demonstrated pain-relieving effects in models of acute, chronic and inflammatory nociceptive pain and of neuropathic pain with comparable or higher potency in preclinical animal models than morphine or indomethacin, the generally accepted standards of comparison. In these studies, the compound was rapidly absorbed and demonstrated an acceptable toxicology profile.

In our preclinical in vitro studies, we found TC-2696 to act selectively at the a4ß2 NNR and to avoid interaction with nicotinic receptors in the muscles and ganglia that are associated with side effects. Published studies conducted by third parties have shown that compounds that activate a4ß2 have pain-relieving effects in animals. We believe these effects are caused in part by the activation of NNRs that are abundant in CNS pathways to block the transmission of pain signals to the brain. In contrast, opioids act through a different mechanism of action. In our preclinical animal studies, TC-2696 did not result in tolerance following repeated administration.

Clinical Development of TC-2696

Ongoing Phase II Clinical Trial. We are currently conducting a Phase II clinical trial of TC-2696 in third molar extraction patients. This double blind, placebo controlled, proof of concept trial is designed to evaluate the pain-relieving effects of TC-2696 following dental surgery. The trial is being conducted in the United States and is expected to enroll approximately 150 subjects. The trial design includes five arms—10mg, 25mg and 50mg of TC-2696, ibuprofen (400mg) as a positive control and placebo.

Phase I Clinical Trials. We have completed a Phase I single rising dose clinical trial and the dosing phase of a Phase I multiple rising dose clinical trial of TC-2696. These trials were designed to evaluate the safety and tolerability profile of TC-2696 in healthy volunteers.

Our completed single rising dose trial was conducted in France with 44 healthy volunteers divided into dose groups of 2mg, 5mg, 10mg, 20mg, 50mg, 100mg, 150mg and 200mg. In the trial, TC-2696 was well tolerated at doses of up to 150mg. At 150mg, we observed mild to moderate dizziness and lightheadedness. At 200mg, we observed nausea, vomiting and elevated blood pressure and heart rate.

Our multiple rising dose trial was also conducted in France with 25 healthy volunteers divided into three dose groups, 25mg, 50mg and 100mg. In each dose group, six subjects received TC-2696 and the remaining subjects received placebo, in each case twice per day for 11 days. We have completed the dosing phase of the trial. TC-2696 was generally well tolerated in the 25mg and 50mg dose groups. All of the volunteers in the 25mg dose group and all but two of the volunteers in the 50mg dose group completed the trial. Of the two volunteers in the 50mg dose group who did not complete the trial, one discontinued participation due to elevated heart rate and dizziness and the other discontinued participation due to anguish and malaise. We replaced one of these two discontinued volunteers. In the 100mg dose group, we ceased dosing in January 2007 after four of a total of eight volunteers discontinued participation in the trial. Each of the discontinuing volunteers experienced one or more of dizziness, nausea, vomiting, elevated heart rate and low blood pressure. All but one of these volunteers had received a single dose of TC-2696 prior to discontinuing participation in the trial. We did not see comparable effects at 100mg in our completed single rising dose trial of TC-2696. We are currently exploring potential causes for the different effects seen at 100mg in our two Phase I trials.

In both of our Phase I trials of TC-2696, we used a surrogate measure to provide an indication of the potential efficacy of this product candidate as a treatment for pain. The surrogate measure involved the use of a

metal probe, which emits increasing amounts of heat. We used the surrogate measure to assess pain threshold, which was indicated by the temperature of the metal probe at which subjects first reported feeling pain, and pain tolerance, which was indicated by subjects reporting the pain as bearable or not bearable. We also assessed pain relief, which was indicated by subjects making subjective estimations of the degree of pain felt on the day of assessment as compared to the first day of the trial.

In the 25mg and 50mg dose groups of our multiple rising dose trial, we observed a strong trend in favor of TC-2696, but not statistical significance, in pain relief on all days assessed. Subjects dosed with TC-2696 consistently reported a greater reduction in the degree of pain felt on the day of assessment versus the first day of the trial, as compared to subjects dosed with placebo. We did not observe a drug effect in our assessments of pain threshold and pain tolerance. We do not yet have the results on the surrogate measure in the 100mg dose group. In our single rising dose trial, we observed a drug effect on at least one of the pain assessments at one or more time intervals in each of the 5mg, 10mg, 50mg and 150mg dose groups.

TC-6499

TC-6499 is a novel small molecule that we are developing currently as an oral treatment for one or more classes of pain. TC-6499 modulates the activity of the a4ß2 NNR. In our preclinical animal studies, this product candidate demonstrated pain-relieving activity in multiple models of neuropathic pain, and we are currently evaluating its activity in additional preclinical models of acute and chronic pain. We are also currently evaluating TC-6499 as a potential product candidate to promote wakefulness instead of or in addition to pain. We are currently conducting manufacturing activities necessary to support the initiation of clinical development of TC-6499.

TC-5619

In addition to the product candidates described above, we are also developing TC-5619, a novel small molecule that modulates the activity of the a7 NNR. We are currently conducting additional preclinical studies necessary to support a regulatory filing planned for the second quarter of 2007 to initiate clinical development of TC-5619.

A number of published studies have indicated an association between the a7 NNR and schizophrenia. In a 2004 survey of 46 cognitive neuroscientists and neuropharmacologists conducted in connection with the MATRICS initiative, a7 was selected more often than any other target as the target of most interest in the development of treatments for cognitive deficits in schizophrenia. Other published studies have suggested an association between the a7 NNR and cognitive function. Accordingly, we believe that the compounds that act selectively on the a7 NNR, like TC-5619, or that act selectively on both the a7 and a4ß2 NNRs, may be useful in treating either or both of schizophrenia and cognitive impairment. We also believe that compounds that act on the a7 NNR may be exploited to treat inflammation. We have not yet selected definitively the indication for which we will pursue the development of TC-5619.

Under our agreement with AstraZeneca, if we seek to develop TC-5619 for Alzheimer's disease, cognitive deficits in schizophrenia, other conditions characterized by cognitive impairment or schizophrenia, we have the right to offer to AstraZeneca the right to develop and commercialize the compound under the terms of the agreement. However, if we do not offer TC-5619 for license by AstraZeneca, we are generally not permitted to develop or commercialize the compound for any of these indications. However, we would be permitted to pursue the development and commercialization of TC-5619 for other indications, such as inflammation.

Our Preclinical Research Programs

We focus our preclinical research efforts in areas in which we believe NNRs can be exploited for medical benefit and on indications for which we believe we can efficiently develop marketable product candidates. We

are conducting a preclinical research collaboration with AstraZeneca to discover and develop additional compounds that act on the a4ß2 NNR. We also have a preclinical research program focused on identifying and developing compounds that selectively target the a7 NNR and other preclinical research programs in smoking cessation (and other addictions), obesity and Parkinson's disease.

Smoking Cessation

Due primarily to nicotine's addictive effects, it is very difficult to quit smoking. Published animal studies have linked nicotine's addictive effects to the release of dopamine in regions in the brain involved in feelings of reward and pleasure. Although the specific NNR implicated in the regulation of dopamine is not fully characterized, several reported studies suggest that the a6, a4, ß2 and ß4 NNR subunits may be involved. These studies have shown that selectively modulating a6, a4 or ß4 reduced the rewarding effects of nicotine in mice. Other studies have shown that mice deficient in the ß2 NNR failed to self-administer nicotine and had reduced activity in the brain regions associated with reward and pleasure. We are evaluating a number of compounds in a variety of animal models of smoking cessation and nicotine dependence for advancement in our smoking cessation program. In addition, we are a named subcontractor on a grant awarded by the National Institute on Drug Abuse, part of the National Institutes of Health, to The California Institute of Technology to fund research on innovative NNR-based approaches to the development of therapies for smoking cessation. In addition to The California Institute of Technology, we are collaborating with University of Colorado at Boulder to conduct this research.

Obesity

A number of published studies have demonstrated that non-smokers generally weigh significantly more than smokers, and nicotine is believed to be responsible. These studies have also shown that smokers gain weight when they stop smoking. Moreover, reported studies with animals have shown that food intake and body weight gain are reduced following repeated administration of nicotine and that the effects are reversed when the nicotine administration is stopped. As part of our evaluation of our compounds for other indications, we also assess each compound for a preliminary signal of its ability to induce weight loss. We are collecting this data and plan to conduct additional preclinical evaluation of the most promising compounds for obesity.

Parkinson's disease

Parkinson's disease is associated with a deficit in dopamine in the brain resulting from neurodegeneration. As noted above, several reported studies suggest that the a6, a4, ß2 and ß4 NNR subunits may be involved in regulating dopamine release. As a result, NNRs that contain one or more of these subunits may have promise as therapeutic targets for the treatment of Parkinson's disease. Moreover, the existence of many published studies showing the greater prevalence of Parkinson's disease in non-smokers as compared to smokers further suggests the potential application of compounds that interact with NNRs as treatments for Parkinson's disease.

Our Drug Discovery Technologies—Pentad

Our drug discovery activities utilize sophisticated proprietary computer-based molecular design methodologies and extensive biological data from a library of diverse compounds developed and collected over more than 20 years. We refer to these technologies collectively as Pentad. We use Pentad to predict the likelihood that novel compounds will interact with various NNRs, the degree of the interaction and the potential of these compounds to be developed as drugs based on projected pharmacokinetic profiles.

Pentad's virtual screening facilitates more rapid identification of compounds that may be clinically viable than we believe could be achieved using traditional laboratory synthesis and screening methods. This allows us to reduce drug development time by focusing our resources on compounds that we believe to have a greater likelihood of clinical success. We used Pentad to design or optimize AZD3480 (TC-1734), TC-2696, TC-2216, TC-5619 and TC-6499.

Strategic Collaborations

AstraZeneca AB

In December 2005, we entered into a collaborative research and license agreement with AstraZeneca AB under which we granted AstraZeneca exclusive development and worldwide commercialization rights to AZD3480 (TC-1734) as a treatment for specified indications. The agreement became effective in January 2006. Under the agreement, AstraZeneca has agreed to pursue development and commercialization of AZD3480 (TC-1734) as a treatment for Alzheimer's disease and cognitive deficits in schizophrenia. AstraZeneca has also agreed to pursue development and commercialization of AZD3480 (TC-1734) as a treatment for ADHD if AZD3480 (TC-1734) achieves the primary efficacy endpoints in a Phase II clinical trial for Alzheimer's disease or cognitive deficits in schizophrenia or a Phase III clinical trial of AZD3480 (TC-1734) is otherwise initiated for Alzheimer's disease or cognitive deficits in schizophrenia. In addition, AstraZeneca can develop and commercialize AZD3480 (TC-1734) for AAMI, MCI, any other indication that is deemed a cognitive disorder under the agreement and schizophrenia. We and AstraZeneca are also conducting a preclinical research collaboration under the agreement.

*Payment Term*s. AstraZeneca paid us an initial fee of $10 million in February 2006 and an additional $20 million in January 2007 as a result of its determination to proceed with further development of AZD3480 (TC-1734) following the completion of additional clinical and non-clinical studies that it conducted during 2006 to generate further data with respect to AZD3480 (TC-1734). We are eligible to receive other payments of up to $249 million, contingent upon the achievement of development, regulatory and first commercial sale milestones for AZD3480 (TC-1734) for Alzheimer's disease, cognitive deficits in schizophrenia and ADHD, and stepped double-digit royalties on future AZD3480 (TC-1734) product sales. If AZD3480 (TC-1734) is developed under the agreement for an indication in addition to Alzheimer's disease, cognitive deficits in schizophrenia and ADHD, we would also be eligible to receive payments of up to $52 million, contingent upon the achievement of development, regulatory and first commercial sale milestones for AZD3480 (TC-1734), for each such indication. Under the terms of a sponsored research agreement and subsequent license agreement, we are required to pay the University of Kentucky Research Foundation a low single digit percentage of any of these payments, including royalties, that we receive from AstraZeneca relating to AZD3480 (TC-1734).

AstraZeneca's obligation to pay royalties to us for each compound subject to the collaboration expires on a country-by-country basis on the later of expiration of our patent rights that provide exclusivity for that compound in that country or twelve years after the first commercial sale in that country of either that compound or any related compound that meets specified criteria. If AstraZeneca obtains a patent covering the composition of a compound that is derived within a specified period from a compound that is subject to the collaboration, the term of AstraZeneca's patent would also be taken into account in determining the term of AstraZeneca's obligation to pay royalties to us for that derived compound. The U.S. patent rights to AZD3480 (TC-1734) expire between 2016 and 2018. We also have a pending U.S. patent application to a particular salt form of AZD3480 (TC-1734) that, if issued, would expire in 2025. The corresponding foreign patent rights expire between 2017 and 2019. We also have foreign patent applications that, if issued, would expire between 2017 and 2025. Royalty rates are subject to reduction under the agreement in specified circumstances, including in any country if the licensed compound is no longer subject to adequate patent protection in that country or if AstraZeneca licenses patent rights from any third party under circumstances in which the product that we license to AstraZeneca might infringe the third party's patent rights.

Research Collaboration. The agreement provides for a research collaboration, which began in January 2006 and under which we and AstraZeneca are conducting research designed to discover and develop additional compounds that, like AZD3480 (TC-1734), act on the a4ß2 NNR. AstraZeneca has the right to exclusively license a specified number of these compounds, together with metabolites of these compounds and derivatives and other compounds related to these compounds that meet specified criteria for the same indications for which AstraZeneca has development and commercialization rights for AZD3480 (TC-1734). Under the agreement, we are eligible to receive additional payments of up to $145 million, contingent upon the achievement of

development, regulatory and first commercial sale milestones for each compound discovered and developed as part of the research collaboration, and stepped royalties on future product sales. The initial term of the research collaboration is four years and can be extended by mutual agreement. AstraZeneca can terminate the research collaboration effective three years after the research term began upon at least six months notice.

Research Fees. While AstraZeneca conducted the additional studies of AZD3480 (TC-1734) during 2006, AstraZeneca paid us research fees based on 50% of an agreed reimbursement rate for research services rendered in the collaboration. Following its determination to proceed with further development of AZD3480 (TC-1734), AstraZeneca paid us additional research fees equal to the remaining 50% and has agreed under the agreement prospectively to pay us additional research fees based on 100% of the agreed upon reimbursement rate for research services rendered in the collaboration, subject to specified limits.

Development and Commercialization Costs. AstraZeneca is responsible for the clinical development and commercialization of AZD3480 (TC-1734) and any compounds that arise out of the research collaboration that it elects to advance and has agreed to assume substantially all development costs, except for costs that we incurred to complete the Phase II clinical trial of AZD3480 (TC-1734) in AAMI that we completed in March 2006. We have the option to co-promote AZD3480 (TC-1734) and any compounds that arise out of the research collaboration that are selected for advancement in the United States to specified classes of specialist physicians. If we exercise our co-promotion option, AstraZeneca is required to provide training to our sales force and compensate us for our detailing efforts following regulatory approval.

Exclusivity Rights and Restrictions. Neither we nor AstraZeneca are permitted outside of the collaboration to develop or commercialize compounds that act on the a4ß2 NNR and meet pre-defined criteria for Alzheimer’s disease, cognitive deficits in schizophrenia, other conditions characterized by cognitive impairment, schizophrenia or any indication for which AstraZeneca has development and commercialization rights under the agreement. This restriction on AstraZeneca lapses 30 months after the end of the research term. This restriction on us will lapse if AstraZeneca commences clinical development outside of the collaboration for a compound that acts on the a4ß2 NNR and meets pre-defined criteria.

We are entitled to offer to AstraZeneca the right to develop and commercialize any compound that acts on any NNR other than a4ß2 for any indication for which AstraZeneca has development and commercialization rights under the agreement. If we do not offer this right to AstraZeneca for a compound that acts on any NNR other than the a4ß2 NNR, we are generally not permitted to develop or commercialize the compound for any indication for which AstraZeneca has development and commercialization rights under the agreement. If we offer a compound to AstraZeneca, AstraZeneca could license the compound from us, together with metabolites of the compound and derivatives and other compounds related to the compound that meet specified criteria, under terms specified in the agreement. Alternatively, AstraZeneca could negotiate a development plan with us pursuant to which we would conduct development intended to provide a pre-defined indication of efficacy. AstraZeneca could license the compound from us after we complete the additional development. For each compound licensed by AstraZeneca through this process, we are eligible to receive payments of up to $266 million, contingent upon the achievement of development, regulatory and first commercial sale milestones, as well as stepped royalties on future product sales. If AstraZeneca elects not to license the compound, we are permitted to develop and commercialize the compound for any indication, except that, if we had offered the compound to AstraZeneca for schizophrenia, we will not be able to develop or commercialize the compound for any cognitive disorder. The agreement limits the number of compounds that we are permitted to offer to AstraZeneca through this process. We are generally not permitted to develop or commercialize compounds that act on any NNR for any indication for which AstraZeneca has development and commercialization rights under the agreement except through this process.

We are also entitled to offer to AstraZeneca the right to develop and commercialize (1) any compound for which AstraZeneca has development and commercialization rights for specified indications under the agreement or (2) any other compound that meets pre-defined criteria for cognitive activity, is in the same chemical family

and acts on the same NNR or NNRs as any compound for which AstraZeneca has development and commercialization rights for specified indications under the agreement for any indication for which AstraZeneca does not have development and commercialization rights under the agreement. If we do not offer this right to AstraZeneca, we are not permitted to develop or commercialize the compound.

If AstraZeneca commences clinical development outside of the collaboration of a compound that acts on any NNR other than the a7 NNR and meets other pre-defined criteria, the restriction on our right to develop and commercialize compounds that act on any NNR, other than the a4ß2 NNR, for any indication for which AstraZeneca has development and commercialization rights under the agreement will lapse.

If, in the future, we seek a strategic collaborator to develop or commercialize compounds that act by binding to NNRs for depression, anxiety or bipolar disorder, AstraZeneca has a right of first negotiation with us. If we and AstraZeneca do not agree on terms on which we would collaborate, for the following three years we would only be permitted to enter into a collaboration for the applicable compounds and indications on more favorable terms than the terms offered by AstraZeneca.

Termination. AstraZeneca can terminate the agreement without cause upon 90 days notice given any time after the earlier of the end of the research term and four years after the research term began. Either we or AstraZeneca can terminate the agreement in the event of the bankruptcy or uncured material breach of the other party. However, if a breach by AstraZeneca is limited to any specific compound or specified key market, we can terminate the agreement only with respect to that compound or key market. If a competitor of AstraZeneca acquires control of us, AstraZeneca can terminate the agreement or specified provisions of the agreement, including our right to participate on the committee overseeing development under the agreement and our co-promotion rights.

Patents and Proprietary Rights

We actively seek to protect the proprietary technology that we consider important to our business, including chemical species, compositions and forms, their methods of use and processes for their manufacture, as well as modified forms of naturally-expressed receptors, in the United States and other key pharmaceutical markets. We also rely upon trade secrets and contracts to protect our proprietary information.

As of March 20, 2007, our patent estate included 64 patents issued in the United States, 30 patent applications pending in the United States, including one U.S. patent application that has been allowed but has not yet issued, and numerous issued patents and pending patent applications in countries other than the United States. Our issued patents and pending patent applications in the United States include composition of matter coverage on a number of different structural families of compounds. The actual protection afforded by a patent varies from country to country and depends upon many factors, including the type of patent, the scope of its coverage and the availability of legal remedies in a particular country.

We consider the following United States patents that we own or license to be most important to the protection of our most advanced product candidates.

Area of Therapeutic Focus	Product Candidate	Patent Scope	Patent Expiration
Cognitive Impairment	AZD3480 (TC-1734)	Composition of matter for AZD3480 (TC-1734)	June 2018
		Composition of matter for a family of compounds that includes AZD3480 (TC-1734)	April 2016
		Methods of use of a family of compounds that includes AZD3480 (TC-1734) for treatment and prevention of CNS disorders	February 2017
Depression/Anxiety	TC-2216	Composition of matter for a family of compounds that includes TC-2216	June 2023
Depression	Mecamylamine hydrochloride	Methods of use of mecamylamine for nicotine-responsive psychiatric disorders, including depression	September 2017
	TC-5214	Pharmaceutical composition of S-mecamylamine	December 2019
		Methods of use of S-mecamylamine for neuropsychiatric disorders, including depression	December 2019
Pain	TC-2696	Composition of matter for TC-2696	June 2018
		Composition of matter for a family of compounds that includes TC-2696	April 2016
		Method of use of a family of compounds that includes TC-2696 for eliciting an analgesic effect	August 2017
	TC-6499	Composition of Matter for TC-6499	March 2023
Schizophrenia, cognitive impairment or inflammation			
	TC-5619	Composition of Matter for a family of compounds that includes TC-5619	August 2019

In addition to these patents and patent applications, we have later-expiring patents relating to some of these product candidates that cover a particular form or composition, use as part of combination therapy or method of preparation or use. These patents could provide additional or a longer period of protection. We also have patent applications pending that seek equivalent or substantially comparable protection for our product candidates in key international markets.

The patent expiration dates referenced above do not reflect any potential patent term extension that we may receive under The United States Drug Price Competition and Patent Term Restoration Act of 1984, known as the Hatch-Waxman Act. The Hatch-Waxman Act generally permits a patent extension term of up to five years as compensation for patent term lost during the FDA regulatory review process. Patent extension cannot extend the remaining term of a patent beyond a total of 14 years. The patent term restoration period is generally one-half the time between the effective date of an investigational new drug application, or IND, and the submission date of a new drug application, or NDA, plus the time between the submission date and approval of an NDA. Only one patent applicable to an approved drug is eligible for the extension, and the extension must be applied for prior to expiration of the patent. The United States Patent and Trademark Office, in consultation with the FDA, reviews and approves applications for patent term extension.

License Agreements

We are parties to five license agreements that are important to our business.

University of South Florida Research Foundation

Pursuant to a license agreement with the University of South Florida Research Foundation, or USFRF, we hold an exclusive worldwide license to patents and patent applications owned by USFRF for use in the development and commercialization of mecamylamine hydrochloride and other specified compounds. The licensed patents and patent applications include issued patents covering the composition of the enantiomers of mecamylamine hydrochloride, including TC-5214, for use as a pharmaceutical and covering methods of use for the treatment of depression, ADHD, Tourette's syndrome and nicotine-responsive neuropsychiatric disorders. Under the agreement, we are obligated to pay to USFRF:

- an annual license fee until an NDA or its equivalent is filed to cover the use of a product subject to the license to treat a neuropsychiatric disorder;
- an annual fee to maintain our rights of first refusal to acquire rights to the licensed patents and patent applications beyond the scope of our current license;
- royalties on net sales of products subject to the license or a percentage of royalties received from a sublicensee;
- aggregate payments of up to $200,000 based on the achievement of specified regulatory milestones; and
- a percentage of other amounts that we receive from a sublicensee.

The aggregate annual license fees are creditable, up to a specified amount per year, against future royalties.

We are required to use commercially reasonable efforts to develop or to market and sell a product covered by the agreement. In particular, we are required to spend a specified minimum amount on research and development of products covered by the agreement each year until we receive marketing approval for a covered product. If USFRF believes that we are not meeting our diligence obligation, it is entitled to terminate the agreement following a cure period. If we do not agree with USFRF's determination, we can submit the matter to binding arbitration. In addition, if we have not received marketing approval of a product covered by the agreement on or before December 31, 2012, USFRF can make our license nonexclusive.

We may terminate the agreement at any time. If not earlier terminated, the agreement will terminate upon expiration of the last to expire of the licensed patent rights.

Yale University

Pursuant to an exclusive license agreement with Yale University, we hold an exclusive worldwide license to pending patent applications owned by Yale. The licensed patent applications include a pending U.S. application that, if issued in the future as a patent, could potentially cover the use of mecamylamine hydrochloride and

TC-5214, or other compounds classified as nicotinic antagonists, as an augmentation to other treatments for mood disorders. Under the agreement, we paid Yale a non-refundable license initiation fee and reimbursed Yale for its prior expenses with respect to the filing and prosecution of the licensed patent rights. In addition, we agreed to pay to Yale:

- an issuance fee that is conditional upon the issuance of a licensed patent in the United States that meets specified conditions;
- aggregate payments of up to $1,500,000 for each product subject to the license for which specified regulatory and first commercial sale milestones are achieved;
- royalties on any net sales of products subject to the license, subject, following the first launch of a product subject to the license, to specified annual minimum amounts; and
- a percentage of certain amounts received from a sublicensee of the licensed patent rights if the sublicense is not combined with a license to other patent rights of ours or with an agreement by us to collaborate to discover, research, develop or commercialize compounds or products for therapeutic use.

We are required to use reasonable commercial efforts to develop at least one product subject to the license for commercialization in the United States. We may terminate the agreement upon 30 days written notice to Yale. If not earlier terminated, the agreement will expire upon expiration of the last to expire of the licensed patent rights.

Virginia Commonwealth University Intellectual Property Foundation

Pursuant to a license agreement with Virginia Commonwealth University Intellectual Property Foundation, or VCUIPF, we hold a non-exclusive worldwide license to patents covering a method of use of a family of compounds that includes TC-2696 for eliciting an analgesic effect, as well as the right to convert the license into an exclusive license upon payment of a fee. Under the agreement, we are obligated to pay to VCUIPF:

- an annual license fee and an additional annual fee to maintain the right at any time to convert the license into an exclusive license for an additional fee;
- royalties on net sales of products subject to the license or a percentage of amounts received from a sublicensee; and
- aggregate payments of up to $900,000 based on the achievement of specified development and regulatory milestones.

We are required to use reasonable efforts to bring one or more products covered by the agreement to market. We may terminate the agreement at any time with 90 days notice. If the agreement is not earlier terminated, our obligation to pay royalties under the agreement will terminate upon expiration of the licensed patent rights.

Wake Forest University Health Sciences

Pursuant to a license agreement with Wake Forest University Health Sciences, or WFUHS, we hold an exclusive worldwide license to patents covering a method of use of a family of compounds that includes TC- 2696 for the treatment of chronic or female-specific pain. Under the agreement, we paid WFUHS a non-refundable upfront license fee and are obligated to pay to WFUHS:

- royalties on net sales of products subject to the license or, if less, a percentage of amounts received from a sublicensee;
- aggregate payments of up to $878,000 per product subject to the license based on the achievement of specified development and regulatory milestones; and
- a percentage of other amounts that we receive from a sublicensee.

We are required to use commercially reasonable efforts to pursue the development of at least one product covered by the agreement and to bring at least one such product to market. We may terminate the agreement at any time with 60 days notice. If not earlier terminated, the agreement will terminate upon expiration of the last to expire of the licensed patent rights.

University of Kentucky Research Foundation

Pursuant to a sponsored research agreement, the University of Kentucky Research Foundation, or UKRF, agreed to assign to R.J. Reynolds Tobacco Company UKRF's rights to inventions that resulted in patents related to AZD3480 (TC-1734), TC-2696 and other earlier-stage compounds in our portfolio. These patents were subsequently assigned by RJR to us in August 2000. Under the sponsored research agreement and a subsequent license agreement with UKRF, we are obligated to pay royalties to UKRF based on amounts received from any licensee of these patents, including AstraZeneca.

Trade Secrets

In addition to patents, we rely upon unpatented trade secrets and know-how and continuing technological innovation to develop and maintain our competitive position. For example, we maintain Pentad as an unpatented trade secret. We seek to protect our proprietary information, in part, using confidentiality agreements with our commercial partners, collaborators, employees and consultants and invention assignment agreements with our employees.

Sales and Marketing

We currently have limited sales and distribution capabilities and limited experience in marketing and selling pharmaceutical products. Our current strategy is to selectively seek collaborations with third parties for target indications in which our potential collaborator has particular expertise or that involve a large, primary care market that must be served by large sales and marketing organizations. In entering into these collaborations, our goal will generally be to maintain co-promotion or co-commercialization rights in the United States and, in some cases, other markets. In order to implement our strategy successfully, we must develop a specialized sales and marketing organization with sufficient technical expertise. Our product currently available in the market, Inversine, is distributed by Cord Logistics, Inc., a Cardinal Health company, pursuant to an exclusive distribution agreement. Our agreement with Cord Logistics is terminable by either party at the end of each contract year upon 90 days prior notice or at any time upon 180 days notice. We paid Cord Logistics approximately $150,000 in each of 2005 and 2006.

Manufacturing

All of our current product candidates are compounds of low molecular weight, commonly referred to as small molecules, that can be manufactured in a simple synthetic process from readily available starting materials. We expect to continue to develop product candidates that can be produced cost-effectively by third-party contract manufacturers.

We are able to manufacture the quantities of our product candidates necessary for relatively short preclinical toxicology studies ourselves. However, we do rely and expect to continue to rely on a number of contract manufacturers to produce enough of our product candidates for use in more lengthy preclinical research. We also depend on these contract manufacturers to manufacture our product candidates in accordance with current good manufacturing practices, or cGMP, for use in clinical trials. We will ultimately depend on contract manufacturers for the manufacture of our products for commercial sale, as well as for process development. Contract manufacturers are subject to extensive governmental regulation.

Third parties currently manufacture Inversine and its active ingredient for us. Also, we have entered into a development and production agreement with Siegfried Ltd. Under this agreement, Siegfried has agreed to provide us with process development services and clinical trial material at specified rates for product candidates

that we elect to introduce into the agreement. We have also agreed, following marketing approval or anticipated marketing approval of any product candidate for which Siegfried performs services under the agreement, to negotiate for a separate multi-year commercial supply agreement with Siegfried for a substantial percentage of our contracted supply needs for that product candidate, except in limited circumstances. Either we or Siegfried can terminate the agreement at any time on 12 months notice or immediately in the event of an uncured material breach by the other party.

Competition

Our industry is subject to rapid and intense technological change. We face, and will continue to face, worldwide competition from biotechnology, biopharmaceutical and pharmaceutical companies, research institutions, government agencies and academic institutions.

We also face substantial competition from therapies designed to target NNRs. Pfizer's product Chantix targets NNRs and is approved in the United States for smoking cessation. In addition, we believe that several prominent pharmaceutical companies have product candidates that target NNRs in development, including as examples Sanofi-Aventis, with a compound in Phase III for smoking cessation, and Abbott Laboratories, with one compound in Phase II for Alzheimer's disease, ADHD and schizophrenia and a second compound in Phase II for pain and potentially other indications. Other companies that we believe have active NNR-based programs include Merck & Co., AstraZeneca, Eli Lilly, Memory Pharmaceuticals, Critical Therapeutics, NeuroSearch A/S, CoMentis and EnVivo Pharmaceuticals. We expect that we will face increased competition in the future if therapies that target NNRs are further validated and if companies initiate or expand programs focused on NNRs or otherwise enter the CNS market, whether independently or by collaboration or acquisition.

In addition, there are several pharmaceutical companies in the United States and globally that currently market and sell drugs for indications that we are targeting. There is currently no approved product for cognitive deficits in schizophrenia. We believe that the primary competitive products for use in indications that we are currently targeting include:

- for mild to moderate Alzheimer's disease, acetylcholinesterase inhibitors such as Aricept from Pfizer/Eisai, Reminyl from Johnson & Johnson and Exelon from Novartis and for moderate to severe Alzheimer's disease, Namenda from Forest Laboratories, which acts by regulating the neurotransmitter glutamate;
- for acute post-operative pain, opioids such as OxyContin from Purdue Pharma;
- for depression, selective serotonin reuptake inhibitors such as Prozac from Eli Lilly, Paxil/Seroxar from GlaxoSmithKline, Zoloft from Pfizer, Celexa and Lexapro from Forest Laboratories and the dual uptake inhibitor Effexor from Wyeth;
- for anxiety disorders, benzodiazepines such as Pfizer's Xanax and Biovail's Ativan, as well as anti-depressants;
- for schizophrenia, anti-psychotics such as Seroquel from AstraZeneca, Zyprexa from Eli Lilly, Risperdal from Johnson & Johnson, Geodon from Pfizer and Abilify from Bristol-Myers Squibb; and
- for smoking cessation, Zyban from GlaxoSmithKline and Chantix from Pfizer.

Many of these products have well-known brand names, are distributed by large pharmaceutical companies with substantial resources and have achieved widespread acceptance among physicians and patients. Furthermore, pharmaceutical and biotechnology companies are currently developing additional treatments for the indications that we are targeting that may be approved for marketing and sale prior to any approval of our product candidates.

We expect to compete based upon, among other things, the efficacy of our products and favorable side effect profiles. Our ability to compete successfully will depend on our continued ability to attract and retain

skilled and experienced scientific, clinical development and executive personnel, to identify and develop viable product candidates and to exploit these products and compounds commercially before others are able to develop competitive products. In addition, our ability to compete may be affected by insurers and other third-party payors encouraging the use of generic products. This may have the effect of making branded products less attractive from a cost perspective to buyers.

Government Regulation

Drug Regulation in the United States

The research, preclinical and clinical testing, manufacture and marketing of drug products are extensively regulated by the FDA and other governmental authorities in the United States. The Federal Food, Drug and Cosmetic Act and other federal and state statutes and regulations regulate the research, development, testing, manufacture, storage, record keeping, labeling, promotion and marketing and distribution of drug products.

The steps ordinarily required before a new drug may be marketed in the United States include:

- preclinical laboratory tests, preclinical studies in animals and formulation studies;
- the submission of an IND to the FDA, or comparable documents to regulatory bodies in foreign countries in which clinical trials are to be held, which must become effective before clinical trials may begin;
- adequate and well-controlled clinical trials to establish the safety and efficacy in humans of the drug for each indication;
- the submission of an NDA to the FDA using the Common Technical Document, a format for non-clinical, clinical and quality data acceptable to regulatory authorities in the United States, European Union and Japan; and
- FDA review and approval of the NDA before any commercial sale or shipment of the drug.

Preclinical tests typically include laboratory evaluation of product chemistry, formulation and stability, as well as animal studies to evaluate toxicity and metabolism. Preclinical tests are regulated by the FDA under its good laboratory practice regulations. The results of preclinical tests are submitted to the FDA as part of an IND. The FDA requires a 30-day waiting period after the filing of an IND before clinical testing in humans may begin. If the FDA has not advised otherwise within this 30-day period, the proposed trial may begin. If the FDA has comments or questions, they must be resolved to the satisfaction of the FDA before the trial can begin. In addition, the FDA may halt proposed or ongoing clinical trials at any time, in which event the trial cannot commence or recommence without FDA authorization and then only under terms authorized by the FDA. The IND application process may be extremely costly and substantially delay development of product candidates. Moreover, positive results in preclinical tests do not ensure positive results in clinical trials.

Clinical trials involve the administration of the drug to healthy volunteers or patients under the supervision of a qualified principal investigator. Clinical trials must be conducted in compliance with federal regulations and requirements and under established protocols. These protocols detail the objectives of the clinical trial, the parameters to be used in monitoring safety, the efficacy criteria to be evaluated and the analyses to be relied on. The study protocol and informed consent information for patients in clinical trials must also be approved by an institutional review board at each institution where the clinical trials are conducted.

Clinical evaluation involves a time-consuming and costly process, ordinarily involving the following three phases:

- Phase I clinical trials are typically conducted with a small number of healthy human volunteers as subjects to determine an early safety and tolerability profile, including side effects associated with increasing doses, a maximum tolerated dose and pharmacokinetics.

- Phase II clinical trials are typically well-controlled and conducted with groups of patients afflicted with the disease or condition for which the investigational drug is being tested in order to determine, among other things, potential efficacy preliminarily and an expanded safety profile that identifies short term side effects and risks.
- Phase III clinical trials are typically large-scale, geographically diverse, adequate and well-controlled and conducted with patients afflicted with a target disease or condition after obtaining preliminary evidence suggesting efficacy. Phase III clinical trials are intended to collect additional data on efficacy and safety necessary to evaluate the overall risk-benefit profile of the drug and provide an adequate basis for labeling.

The FDA, the study sponsor and the institutional review boards reviewing the clinical trial sites closely monitor the progress of each of the three phases of clinical trials that are conducted in the United States. They may change or terminate the testing based upon the data accumulated to that point and their assessment of the relative risks and benefits to the patient.

Upon successful completion of Phase III trials, a company may submit an NDA including the results of preclinical studies and clinical trials and data relating to the product candidate's chemistry, pharmacology, manufacture, safety and efficacy to the FDA in order to obtain approval to market the product in the United States. This submission is expensive, both in terms of studies and analyses required to generate and compile the requisite data and the significant user fees required for NDA submission.

The FDA has 60 days from its receipt of an NDA to determine if it will accept the filing for a substantive review. The FDA may refuse the filing, which would result in the loss of 25% of the application user fee. If the FDA accepts the filing, it begins an in-depth review. Under current performance goals, the FDA has either six or ten months to review and act on the NDA, depending upon whether the review is classified by the FDA as priority or standard. The FDA often extends the review timeline by requesting additional information or clarification. The FDA may refer issues to an advisory committee for review, evaluation and recommendation as to whether the application should be approved, but the FDA is not bound by any recommendation of an advisory committee.

If the FDA's evaluation of the NDA and the manufacturing facilities are favorable, the FDA may issue an approval letter, or, in many cases, an approvable letter followed by an approval letter. An approvable letter usually contains a number of conditions that must be met in order to secure final approval. If the FDA decides that the conditions have been met, it will issue an approval letter. An approval letter makes a drug available for physicians to prescribe in the United States, but authorizes commercial marketing of the drug only for specific indications. After a drug has been approved for a particular indication, other trials and studies may be conducted to explore its use for treatment of new indications. The drug may not be labeled or promoted for a new indication without a supplemental NDA approval by the FDA.

The FDA may also refuse to approve an NDA, or may issue a not approvable letter. A not approvable letter outlines the deficiencies in the submission and often requires additional testing or information. Even if the applicant completes the additional testing and submits additional information, the FDA may ultimately decide that the application does not satisfy the regulatory criteria for approval.

Satisfaction of FDA pre-market approval requirements for new drugs typically takes several years. The actual time required may vary substantially based upon the type, complexity and novelty of the product or target disease. Government regulation may delay or prevent marketing of potential products for a considerable period of time and require costly procedures. Success in early stage clinical trials does not assure success in later stage clinical trials. Data obtained from clinical activities is not always conclusive and may be susceptible to varying interpretations that could delay, limit or prevent regulatory approval.

Even if a drug receives regulatory approval, the FDA may require post-marketing studies, sometimes referred to as Phase IV studies, to monitor the effects of approved drugs and may limit further marketing based

on the results of these post-marketing studies. Moreover, the FDA may impose restrictions on the drug or withdraw its approval if a company does not stay in compliance with pre- and post-market regulatory standards or if problems relating to safety or effectiveness of the drug occur after it reaches the marketplace. The FDA has broad post-market regulatory and enforcement powers, including the ability to levy fines and civil penalties, suspend or delay issuance of approvals, seize or recall products and withdraw approvals.

Once an NDA is approved, the product it covers becomes a listed drug that can, in turn, be cited by potential competitors in support of approval of an abbreviated new drug application, or ANDA. An ANDA provides for marketing of a drug product that is therapeutically equivalent to a marketed drug. This means, among other things, that it has the same active ingredients in the same strengths and dosage form as the listed drug, is labeled for the same conditions of use and has been demonstrated to be bioequivalent to the listed drug, unless specified differences are approved pursuant to a suitability petition. There is generally no requirement, other than the requirement for evidence of bioequivalence, for an ANDA applicant to conduct or submit results of preclinical tests or clinical trials to establish the safety or efficacy of its drug product. Drugs approved in this way are commonly referred to as generic equivalents to the listed drug, are listed as such by the FDA and can typically be substituted by pharmacists under prescriptions written for the original listed drug.

Federal law provides for a period of three years of exclusivity following approval of a drug that contains previously approved active ingredients but is approved in a new dosage, dosage form or route of administration, or for a new use if new clinical trials were required to support the approval. During this three-year exclusivity period, the FDA cannot grant approval of an ANDA for a generic version of the listed drug. However, the FDA can approve generic equivalents of that listed drug based on other listed drugs with the same active ingredient, such as a generic that is the same in every way but its indication for use, and thus the value of this exclusivity may be limited. Federal law also provides a period of five years of exclusivity following approval of a drug that does not contain any previously approved active ingredients. During the five-year exclusivity period, no ANDA for a generic version of the listed drug can be submitted unless the submission accompanies a challenge to a listed patent, in which case the submission may be made four years following the original product approval.

In addition, applicants submitting an ANDA for a drug that has listed patents are required to make one of four certifications regarding each listed patent, which may include certifying that one or more listed patents are invalid or not infringed. If an applicant certifies invalidity or non-infringement, it is required to provide notice of its filing to the NDA sponsor and the patent holder. If the patent holder then initiates a suit for patent infringement against the ANDA applicant within 45 days of receipt of the notice, the FDA cannot grant effective approval of the ANDA until either 30 months has passed or there has been a court decision holding that the patents in question are invalid or not infringed. The first of the ANDA applicants submitting substantially complete applications certifying that listed patents for a particular product are invalid or not infringed may qualify for an exclusivity period of 180 days, which runs from the date the generic product is first marketed. Until any effective 180-day exclusivity expires, the FDA cannot grant effective approval of subsequently submitted ANDAs.

The manufacturers of approved drugs and their manufacturing facilities are subject to continuous review and periodic inspections by the FDA and must comply with the FDA's current good manufacturing process, or cGMP, regulations. A manufacturer will be subject to possible legal or regulatory action, such as suspension of manufacturing, seizure of product or recall of a product, if it does not comply with the FDA's rules. We intend to contract with third parties to manufacture our products, and our ability to control their compliance with FDA requirements will be limited.

We must also notify the FDA of any change in an approved product beyond variations already allowed in the approval. Changes to the product, its labeling or its manufacturing could require prior FDA approval and may require further clinical investigations to support the change. Such approvals may be expensive and time-consuming, and, if not approved, the product will not be allowed to be marketed as modified.

The FDA also administers a number of complex regulations and policies regarding advertising, promotion and labeling of marketed pharmaceuticals. These regulations and policies include requirements that affect direct-to-consumer advertising, off-label promotion, industry-sponsored scientific and educational activities and promotional activities involving the internet. Failure to abide by the FDA's regulations can result in penalties, including the issuance of a warning letter mandating the correction of deviations from FDA standards or the publication of corrective advertising, as well as civil and criminal investigations and prosecutions.

From time to time, legislation is drafted and introduced in the U.S. Congress that could significantly change the statutory provisions governing the approval, manufacturing and marketing of drug products. In addition, the FDA regulations and guidance are often revised or reinterpreted in ways that may significantly affect our business and our products. It is impossible to predict whether legislative changes will be enacted, or FDA regulations, guidance or interpretations changed, or what the impact of these changes, if any, may be.

Fast Track Designation

Congress enacted the Food and Drug Administration Modernization Act of 1997, or FDAMA, in part, to ensure the timely availability of safe and effective drugs, biologics and medical devices by expediting the FDA review process for some new products. FDAMA establishes a statutory program for the approval of a so-called fast track product, defined as a new drug or biologic intended for the treatment of a serious or life-threatening condition that demonstrates the potential to address unmet medical needs for that condition. Under the fast track program, the sponsor of a new drug or biologic may request the FDA to designate the drug or biologic as a fast track product at any time during clinical development of the product. Fast track designation provides for an expedited review of a product, which is intended to accelerate FDA approval. Although we have not yet requested fast track designation for any of our product candidates, we may seek fast track designation in the future. We will never be sure that we will obtain fast track designation. We cannot predict the ultimate impact, if any, of the fast track process on the timing or likelihood of FDA approval of any of our potential products.

Drug Regulation Outside the United States

In addition to U.S. regulations, we are subject to a variety of foreign regulations governing clinical trials and potential commercial sales and distribution of our products and product candidates. Even if we obtain FDA approval for a product, we must obtain approval of a product by the regulatory authorities of foreign countries before we can commence clinical trials or marketing of the product in those countries. The approval process varies from country to country, and the time may be longer or shorter than that required for FDA approval. The requirements governing the conduct of clinical trials, product licensing, pricing and reimbursement vary greatly from country to country.

Under European Union regulatory systems, we may submit marketing authorizations either under a centralized or decentralized procedure. The centralized procedure provides for the grant of a single marketing authorization that is valid for all European Union member states. The decentralized procedure provides for mutual recognition of national approval decisions. Under this latter procedure, the holder of a national marketing authorization may submit an application to the remaining member states. Within 90 days of receiving the applications and assessment report, each member state must decide whether to recognize approval.

Third-Party Reimbursement

In the United States, European Union and elsewhere, sales of pharmaceutical products depend in part on the availability of reimbursement to the patient from third-party payors, such as government health administrative authorities, managed care providers and private insurance plans. Third-party payors are increasingly challenging the prices charged for medical products and services and examining their cost-effectiveness. For example, the

European Union generally provides options for its member states to restrict the range of medicinal products for which their national health insurance systems provide reimbursement. It is possible that none of our product candidates that receive marketing approval will be considered cost-effective or that reimbursement to patients will not be sufficient to allow us to maintain price levels that enable us to realize a satisfactory return on our investment in product development.

Price Controls

In the United States there have been, and we expect that there will continue to be, a number of federal and state proposals to implement governmental pricing control on pharmaceutical products. In some foreign countries, the proposed pricing for a drug must be approved before it may be lawfully marketed. The requirements governing drug pricing vary widely from country to country. For example, the European Union generally provides options for its member states to control the prices of medicinal products for human use. A member state may approve a specific price for the medicinal product or it may instead adopt a system of direct or indirect controls on the profitability of the company placing the medicinal product on the market. We do not know whether any country that has price controls will allow favorable pricing arrangements for any of our product candidates.

Employees

As of March 20, 2007, we had 88 full-time employees, 38 of whom are Ph.D.s, M.D.s or both, and one part-time employee. Our management believes that relations with our employees are good. None of our employees is represented under a collective bargaining agreement.

Our Corporate Information

We were incorporated in Delaware in 1997 as a wholly owned subsidiary of R.J. Reynolds Tobacco Company. In August 2000, we became an independent company when we issued and sold stock to venture capital investors. Our principal executive offices are located at 200 East First Street, Suite 300, Winston-Salem, North Carolina 27101 and our telephone number is (336) 480-2100.

Our internet address is www.targacept.com. The information contained on, or that can be accessed through, our website is not incorporated by reference into this annual report. We have included our website address as a factual reference and do not intend it as an active link to our website. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports, are available to you free of charge through the Investor Relations page of our website as soon as reasonably practicable after such materials have been electronically filed with, or furnished to, the Securities and Exchange Commission, or the SEC.

Our trademarks include Targacept®, Inversine®, Pentad™, NNR Therapeutics™ and TRIDMAC™. Other service marks, trademarks and trade names appearing in this annual report are the property of their respective owners.

Item 1A. Risk Factors.

Risks Related to Our Financial Results and Need for Additional Financing

We have a substantial accumulated deficit and anticipate that we will incur substantial losses for the foreseeable future. We may never sustain profitability.

We were incorporated in 1997 and operated as a wholly owned subsidiary of R.J. Reynolds Tobacco Company until August 2000. We have a limited operating history. As of December 31, 2006, we had an

accumulated deficit of $136.2 million. We had net income of $2.1 million for the year ended December 31, 2006, but net loss of $29.0 million for the year ended December 31, 2005 and $24.0 million for the year ended December 31, 2004. Our losses have historically resulted principally from costs incurred in connection with our research and development activities, including clinical trials, and from general and administrative expenses associated with our operations. We expect to incur substantial losses for the foreseeable future. We expect our research and development expenses to increase substantially over the next several years as we expand our clinical trial activity, as our product candidates advance through the development cycle, as product candidates that arise out of our preclinical research collaboration with AstraZeneca progress and as we invest in additional product opportunities and research programs and expand our research and development infrastructure. As a result, we will need to generate significant revenues to pay these expenses.

Inversine is our only current source of product revenue. We acquired the rights to Inversine in August 2002. Sales of Inversine generated net revenue of only $585,000 for the year ended December 31, 2006, $681,000 for the year ended December 31, 2005 and $767,000 for the year ended December 31, 2004. Inversine is approved in the United States for the management of moderately severe to severe essential hypertension, a high blood pressure disorder. However, we believe that the substantial majority of Inversine sales are derived from prescriptions written by a very limited number of physicians for the treatment of neuropsychiatric disorders, such as Tourette's syndrome, autism and bipolar disorder, in children and adolescents. If any of these physicians were to change their prescribing habits, Inversine sales would suffer. We do not expect that sales of Inversine will increase substantially in the future.

If we are unable to develop and commercialize any of our product candidates, if development is delayed or if sales revenue from any product candidate that receives marketing approval is insufficient, we may not be profitable. Even if we are profitable for any particular period, we may not be able to sustain or increase our profitability on a quarterly or annual basis.

We will require substantial additional financing and our failure to obtain additional funding when needed could force us to delay, reduce or eliminate our product development programs or commercialization efforts.

We will require substantial future capital in order to continue to conduct the research and development and clinical and regulatory activities necessary to bring our product candidates to market and to establish marketing and sales capabilities. Our future capital requirements will depend on many factors, including:

- whether we elect to advance TC-5214 into clinical development as an augmentation treatment for major depression or instead to conduct Phase III clinical development of mecamylamine hydrochloride as an augmentation treatment to citalopram hydrobromide, a treatment combination that we refer to as TRIDMAC;
- the scope, progress, results and cost of preclinical development and laboratory testing and clinical trials;
- the timing, receipt and amount of milestone and other payments from AstraZeneca and potential future collaborators;
- the costs, timing and outcomes of regulatory reviews;
- the number and characteristics of product candidates that we pursue;
- the costs of preparing, filing and prosecuting patent applications and maintaining, enforcing and defending intellectual property-related claims;
- the costs of establishing sales and marketing functions and of establishing arrangements for manufacturing;
- the rate of technological advancements for the indications that we target;

- our ability to establish strategic collaborations and licensing or other arrangements on terms favorable to us;
- the costs to satisfy our obligations under existing and potential future collaborations;
- the timing, receipt and amount of sales or royalties, if any, from our potential products; and
- the extent and scope of our general and administrative expenses.

In addition, we may seek additional capital due to market conditions or strategic considerations even if we believe we have sufficient funds for our current or future operating plans. To the extent that we raise additional capital through the sale of equity or convertible debt securities, the ownership interests of our stockholders will be diluted and the terms may include liquidation or other preferences that adversely affect the rights of our stockholders. Debt financing, if available, may involve agreements that include covenants limiting or restricting our ability to take specific actions such as incurring additional debt, making capital expenditures or declaring dividends. If we raise additional funds through collaboration and licensing arrangements with third parties, we may have to relinquish valuable rights to our technologies or product candidates or grant licenses on terms that are not favorable to us.

Our current operating plan provides for us to continue, either alone or with a collaborator, to advance our product candidates through the development process. We do not expect our existing capital resources to be sufficient to enable us to fund the completion of the development of any of our product candidates. We currently expect that our existing capital resources will enable us to fund our operations at least through 2008. However, our operating plan may change as a result of many factors, including those described above, and we may need additional funds sooner than planned to meet operational needs and capital requirements for product development and commercialization. Additional funds may not be available when we need them on terms that are acceptable to us, or at all. If adequate funds are not available on a timely basis, we may:

- terminate or delay clinical trials for one or more of our product candidates;
- delay our establishment of sales and marketing capabilities or other activities that may be necessary to commercialize our product candidates; or
- curtail significant drug development programs that are designed to identify new product candidates.

Risks Related to the Development and Regulatory Approval of Our Product Candidates

Our success depends substantially on our most advanced product candidates, which are still under development. If we are unable to bring any or all of these product candidates to market, or experience significant delays in doing so, our ability to generate product or royalty revenue and our likelihood of success will be harmed.

AstraZeneca has agreed to develop AZD3480 (TC-1734) initially for Alzheimer's disease and cognitive deficits in schizophrenia. However, AZD3480 (TC-1734) has not yet been evaluated in any clinical trial in patients suffering from Alzheimer's disease or cognitive deficits in schizophrenia. In March 2006, we independently completed a Phase II clinical trial of AZD3480 (TC-1734) in age associated memory impairment, commonly referred to as AAMI, that was designed to further assess the effects of AZD3480 (TC-1734) on cognition in a cognitively impaired older adult population. Our ability to generate product or royalty revenue in the future will depend heavily on the successful development and commercialization of AZD3480 (TC-1734).

Inversine is our only approved product and generates limited revenues. Mecamylamine hydrochloride is the active ingredient in Inversine. We have completed a Phase II clinical trial of TRIDMAC, which is a treatment combination comprised of mecamylamine hydrochloride as an augmentation treatment to citalopram hydrobromide, for major depression.

We are currently conducting a Phase II trial of TC-2696 in third molar extraction patients. We are also currently conducting a Phase I single rising dose clinical trial of TC-2216, our product candidate for depression and anxiety disorders. Our other product candidates are in various stages of preclinical development.

Any of our product candidates could be unsuccessful if it:

- does not demonstrate acceptable safety and efficacy in preclinical studies or clinical trials or otherwise does not meet applicable regulatory standards for approval;
- does not offer therapeutic or other improvements over existing or future drugs used to treat the same conditions;
- is not capable of being produced in commercial quantities at acceptable costs; or
- is not accepted in the medical community and by third-party payors.

We do not expect any of our current product candidates to be commercially available for at least the next several years, if at all. If we are unable to make our product candidates commercially available, we will not generate substantial product revenue and we will not be successful.

If AstraZeneca does not have success in planned clinical trials of AZD3480 (TC-1734) for Alzheimer's disease or cognitive deficits in schizophrenia, we and AstraZeneca will not in the future obtain the regulatory approvals required to market AZD3480 (TC-1734) for Alzheimer's disease or cognitive deficits in schizophrenia notwithstanding favorable results in clinical trials of AZD3480 (TC-1734) in other indications.

Successful results in clinical trials of AZD3480 (TC-1734) in a condition characterized by one degree of cognitive impairment may not be predictive of successful results in clinical trials of AZD3480 (TC-1734) in a condition characterized by more severe cognitive impairment or in cognitive impairment resulting from a different condition. We have completed two Phase II clinical trials of AZD3480 (TC-1734) in AAMI and a third Phase II clinical trial of AZD3480 (TC-1734) in mild cognitive impairment, commonly referred to as MCI. In those trials, AZD3480 (TC-1734) demonstrated positive effects on some measures of cognition. AstraZeneca has agreed to develop AZD3480 (TC-1734) initially for Alzheimer's disease and cognitive deficits in schizophrenia. The findings in any of our completed Phase II trials of AZD3480 (TC-1734) in AAMI or MCI may not be predictive of the effect of AZD3480 (TC-1734) in Alzheimer's disease or cognitive deficits in schizophrenia. Neither we nor AstraZeneca has conducted any clinical trial of AZD3480 (TC-1734) in Alzheimer's disease or cognitive deficits in schizophrenia.

Metabolism of a drug refers to a process in which a drug is broken down and then eliminated from the body. The means by which the body metabolizes a drug is referred to as the metabolic pathway. Due to genetic differences, individuals can metabolize drugs through the same metabolic pathway at different rates. Drugs that are metabolized through a particular metabolic pathway may remain in the body at higher concentrations and for longer periods of time in people who are poor or slow metabolizers than in people who are intermediate or extensive or rapid metabolizers through that metabolic pathway. As a result, a drug that is determined to be safe when metabolized efficiently by an extensive metabolizer may not be safe when metabolized inefficiently by a poor metabolizer.

AZD3480 (TC-1734) is metabolized at a different rate by extensive metabolizers through its primary metabolic pathway than it is by intermediate or poor metabolizers. We expect that, in determining the doses at which it evaluates AZD3480 (TC-1734) in its planned clinical trials in Alzheimer's disease and cognitive deficits in schizophrenia, AstraZeneca will limit the highest dose evaluated in some of the trial subjects based on their metabolism. Because neither we nor AstraZeneca has conducted any clinical trial of AZD3480 (TC-1734) in Alzheimer's disease or cognitive deficits in schizophrenia, neither we nor AstraZeneca has determined the dose range in which positive medical effects, if any, are achieved with AZD3480 (TC-1734) in persons with

Alzheimer's disease or schizophrenia. If the doses at which AZD3480 (TC-1734) is evaluated are limited such that they are not within the dose range in which positive medical effects could be achieved with AZD3480 (TC-1734) in persons with Alzheimer's disease or schizophrenia, the planned clinical trials in these indications will not be successful. Moreover, it is possible that, even if the trials are successful and we or AstraZeneca receive in the future the regulatory approvals required to market and sell AZD3480 (TC-1734), the regulatory authorities could limit the patient population for which AZD3480 (TC-1734) is approved to those who are extensive or intermediate metabolizers through the primary metabolic pathway of AZD3480 (TC-1734). If regulatory authorities limit the patient population for which AZD3480 (TC-1734) is approved in this manner, it would have an adverse effect on the commercial potential of AZD3480 (TC-1734).

The CDR test battery that we have used in our clinical trials of AZD3480 (TC-1734) is different from the Alzheimer's Disease Assessment Scale-cognitive subscale, or ADAS-Cog, the test battery that is most often used to assess the efficacy of drugs for Alzheimer's disease. ADAS-Cog is designed to measure improvement in persons who are severely impaired and is generally less sensitive than the CDR test battery in measuring improvement in persons who are less impaired. We currently expect that AstraZeneca will use ADAS-Cog, and not the CDR test battery, as the primary endpoint in its planned Phase II clinical trial of AZD3480 (TC-1734) in Alzheimer's disease. The findings in our completed trials as to the effect of AZD3480 (TC-1734) on various aspects of cognition as measured by the CDR test battery may not be predictive of the effect of AZD3480 (TC-1734) on cognition as measured by ADAS-Cog. If clinical trials of AZD3480 (TC-1734) in Alzheimer's disease are not successful, we and AstraZeneca will not obtain the regulatory approvals required to market AZD3480 (TC-1734) for Alzheimer's disease.

If the combination of AZD3480 (TC-1734) administered together with other drugs that are commonly prescribed for schizophrenia is not considered to be safe, the commercial potential of AZD3480 (TC-1734) would be adversely affected.

A drug that is generally safe when taken alone may not be safe or may not be as safe when taken together with other drugs. We currently expect that, before initiating the planned Phase II clinical trial of AZD3480 (TC-1734) in cognitive deficits in schizophrenia, AstraZeneca will complete ongoing clinical trials in schizophrenic patients designed to evaluate the interaction of AZD3480 (TC-1734) with various approved treatments for schizophrenia from the drug class known as atypical anti-psychotics. If the interaction of AZD3480 (TC-1734) and any or all of the atypical anti-psychotics is determined to be unsafe or not tolerated, the commercial potential of AZD3480 (TC-1734) as a treatment for cognitive deficits in schizophrenia could be limited. Moreover, AstraZeneca could decide not to advance AZD3480 (TC-1734) as a treatment for cognitive deficits in schizophrenia, which would limit the overall commercial potential of AZD3480 (TC-1734).

If we do not obtain the regulatory approvals required to market and sell our product candidates, our ability to generate product revenue will be materially impaired and our business will not be successful.

The preclinical laboratory testing, development, manufacturing and clinical trials of product candidates that we develop, whether independently or in collaboration with a third party, as well as their distribution, sale and marketing, are regulated by the FDA and other federal, state and local governmental authorities in the United States and by similar agencies in other countries. We must receive regulatory approval of each product candidate before we can market and sell it. We have only limited experience in pursuing regulatory approvals. Securing FDA approval requires the submission of extensive preclinical and clinical data and information about the chemistry and manufacture of, and control procedures for, each potential product. In addition, the supporting information submitted to the FDA must establish the safety and efficacy of the product candidate for each indicated use. The drug development and marketing approval process takes many years, requires the expenditure of substantial resources, is subject to delays and can vary substantially based upon the type, complexity and novelty of the product candidates involved. In addition to the time and expense involved, the process is uncertain and we may never receive the required regulatory approvals. In addition, the FDA, the U.S. Congress and foreign regulatory authorities may from time to time change approval policies or adopt new laws or regulations, either of

which could prevent or delay our receipt of required approvals. Even if we receive regulatory approval to market a particular product candidate, the approval will be subject to limitations on the indicated uses for which it may be marketed and may not permit labeling claims that are necessary or desirable for its promotion.

According to the FDA, a Phase I clinical trial program typically takes several months to complete, a Phase II clinical trial program typically takes several months to two years to complete and a Phase III clinical trial program typically takes one to four years to complete. Industry sources report that the preparation and submission of an NDA, which is required for regulatory approval in the United States, generally takes six months to one year to complete after completion of a pivotal clinical trial. The Pharmaceutical Research and Manufacturers of America reports that only one out of five product candidates that enter clinical trials will ultimately be approved by the FDA for commercial sale.

The FDA may delay, limit or deny approval of any of our product candidates for many reasons. For example:

- clinical trial results may indicate that the product candidate is not safe or effective;
- the FDA may interpret our clinical trial results to indicate that the product candidate is not safe or effective, even if we interpret the results differently; or
- the FDA may deem the processes and facilities that we, our collaborative partners or our third-party manufacturers propose to use in connection with the manufacture of the product candidate to be unacceptable.

In addition, mecamylamine hydrochloride, our product candidate as an augmentation treatment for major depression, is the active ingredient in Inversine, which was approved by the FDA more than 50 years ago. The scope of preclinical safety information for mecamylamine previously submitted to the FDA in connection with its approval of Inversine is not as extensive as is required today. If we elect to conduct additional development of mecamylamine and ultimately pursue regulatory approval, the FDA or foreign regulatory authorities are likely to require us to conduct additional preclinical safety studies prior to considering or granting approval. These studies may include routine carcinogenicity studies, which are lengthy studies designed to evaluate any potential to cause cancer. If we conduct carcinogenicity or other lengthy studies before filing applications for regulatory approval, our receipt of regulatory approval may be delayed and, if the results of the additional preclinical safety studies are not favorable, may not occur at all.

Because drugs that target NNRs are a new class of drugs, the FDA and other applicable regulatory authorities may require more preclinical or clinical data for our product candidates or more time to evaluate that data than we currently anticipate. If we obtain the requisite regulatory approval for a particular product candidate, the approval may not extend to all indications for which we have sought approval, which could limit the use of the product and adversely impact our potential revenues.

Even if the FDA approves a product candidate for marketing and sale in the United States, applicable regulatory authorities in other countries may not approve the product candidate or may subject their approval to conditions such as additional product testing or otherwise cause delays. The regulatory approval process varies among countries, but generally includes all of the risks associated with obtaining FDA approval. In addition, many countries require a separate review process prior to marketing to determine whether their respective national health insurance schemes will pay for newly approved products, as well as the price that may be charged for a product. This process will cause delays in the marketing of any of our product candidates that receives marketing approval and could adversely impact our revenues and results of operations.

If clinical trials for our product candidates are not successful, we will not obtain the regulatory approvals required to market and sell them.

To obtain the requisite regulatory approvals to market and sell any of our product candidates, we must demonstrate, through extensive preclinical studies and clinical trials, that the product candidate is safe and effective in humans. The number of clinical trials required to obtain approval varies depending on the particular product candidate, the disease or condition for which it is in development and the regulations applicable to it. Preclinical studies and clinical trials are lengthy and expensive, difficult to design and implement and subject to a historically high rate of failure. The development of each of our product candidates involves significant risks at each stage of testing. A failure of one or more of our clinical trials could occur at any stage of testing. If we experience failures in our ongoing or future clinical trials, or if we are not able to design our clinical trials with clear criteria to determine the efficacy of our product candidates, our product candidates may never be approved for sale or become commercially available.

We may not be able to obtain authority or approval from the FDA, other applicable regulatory authorities or the institutional review boards at our intended investigational sites to commence or complete our clinical trials. Before a clinical trial may commence in the United States, we must submit an IND containing preclinical studies, chemistry, manufacturing, control and other information and a study protocol to the FDA. If the FDA does not object within 30 days after submission of the IND, then the trial may commence. If commenced, we, the FDA, other applicable regulatory authorities or institutional review boards may delay, suspend or terminate clinical trials of a product candidate at any time if, among other reasons, we or they believe the subjects or patients participating in the clinical trials are being exposed to unacceptable health risks or for other reasons.

If we do not prove in clinical trials that our product candidates are safe and effective, we will not obtain marketing approvals from the FDA and other applicable regulatory authorities. In particular, one or more of our product candidates may not exhibit the expected medical benefits in humans, may cause harmful side effects or may have other unexpected characteristics that preclude regulatory approval for any or all indications of use or limit commercial use if approved. For example, in the 100mg dose group of our Phase I multiple rising dose trial of TC-2696, our product candidate for pain, we ceased dosing in January 2007 after four of a total of eight volunteers discontinued participation in the trial. Each of the discontinuing volunteers experienced one or more of dizziness, nausea, vomiting, elevated heart rate and low blood pressure. All but one of these volunteers had received a single dose of TC-2696 prior to discontinuing participation in the trial. We did not see comparable effects at 100mg in our completed single rising dose trial of TC-2696. We have not yet determined definitively the dose range in which positive medical effects, if any, are achieved with TC-2696. If following further evaluation we determine that the dose range in which positive medical effects are achieved with TC-2696 is not sufficiently below 100mg so as to provide an acceptable margin of safety, we may not receive the regulatory approvals required to market and sell TC-2696.

Our research and preclinical programs and product candidates target diseases or disorders that are not well understood. For example, there is only limited scientific understanding of the causes of Alzheimer’s disease, cognitive deficits in schizophrenia, depression and anxiety. In addition, there are no approved drugs that target NNRs to treat these diseases, and there is only limited scientific understanding of the relationships between these diseases and the neurological pathways targeted by our product candidates and research and preclinical programs. These uncertainties increase the risk that one or more of our clinical trials will not be successful.

If positive results of completed clinical trials of our product candidates are not replicated in any future clinical trials, we will not obtain the regulatory approvals required to market and sell them.

Positive findings in preclinical studies of a product candidate may not be predictive of similar results in clinical trials in humans. In addition, positive results in early clinical trials of a product candidate may not be replicated in later clinical trials. In particular, if we were to elect to conduct additional clinical development of mecamylamine hydrochloride as part of TRIDMAC, the positive findings from our Phase II trial may not replicated in any future clinical trial.

In addition, we completed a Phase II clinical trial of AZD3480 (TC-1734) in AAMI in March 2006. We previously completed two other Phase II clinical trials of AZD3480 (TC-1734), one in AAMI and one in MCI. In those trials, AZD3480 (TC-1734) demonstrated positive effects on some measures of cognition. However, our findings in those trials on cognition may not be replicated in future clinical trials of AZD3480 (TC-1734) that involve a large number of subjects and a long duration of dosing, whether such trials are conducted in Alzheimer's disease, cognitive deficits in schizophrenia or other indications. In particular, the results of the Phase II clinical trial of AZD3480 (TC-1734) in AAMI that we completed in March 2006 were most favorable in the 50mg dose group. We do not currently expect AstraZeneca to include a 50mg dose group in its planned Phase II clinical trials of AZD3480 (TC-1734) in Alzheimer's disease and cognitive deficits in schizophrenia. Also, although AZD3480 (TC-1734) demonstrated positive effects at some dose levels with respect to some measures of cognition tested in the first Phase II clinical trial in AAMI that we conducted, AZD3480 (TC-1734) did not demonstrate positive effects as to all measures at all dose levels and placebo showed superior effects to AZD3480 (TC-1734) as to some measures at some dose levels in that trial.

If favorable results of our completed clinical trial of mecamylamine hydrochloride as an augmentation treatment for major depression are not replicated in any future clinical trials of TC-5214, we will not obtain the regulatory approvals required to market and sell TC-5214.

TRIDMAC is a treatment combination comprised of mecamylamine hydrochloride as an augmentation therapy to citalopram hydrobromide. In our Phase II clinical trial of TRIDMAC in major depression, we observed a statistically significant result in favor of TRIDMAC on one of two co-primary endpoints in the trial, group mean change from baseline on the Hamilton Depression Rating Scale, on an intent to treat basis and a strong trend in favor of TRIDMAC on a per protocol basis. The result on the other co-primary endpoint, achievement of remission, favored the TRIDMAC group over the placebo group, although this result was not statistically significant.

We currently expect that we will elect to advance our product candidate TC-5214 into clinical development as an augmentation treatment for major depression in lieu of further development of mecamylamine hydrochloride. Mecamylamine hydrochloride is a racemate and TC-5214 is one of the molecular components, known as enantiomers, of mecamylamine hydrochloride. A racemate is a mixture of two different enantiomers that are mirror images of each other and have the same chemical but potentially different biological properties. Single enantiomers may cause a different biological response, have different absorption, distribution, metabolism and excretion, known as pharmacokinetic, properties or have different degrees of toxicity, in each case as compared to each other or to the racemate that is comprised of both enantiomers. Consequently, the favorable results that we observed with mecamylamine hydrochloride in our completed Phase II clinical trial may not be replicated in any future clinical trials of TC-5214.

Development of TC-5214 as a treatment for major depression in lieu of further development of mecamylamine hydrochloride could increase our overall future development costs, extend our development timelines and delay our receipt of revenues from potential product sales.

We currently expect that we will elect to advance our product candidate TC-5214 into clinical development as an augmentation treatment for major depression in lieu of further development of mecamylamine hydrochloride. In that event, we anticipate that we would need to conduct at least one Phase I clinical trial and potentially at least one Phase II clinical trial of TC-5214 before initiating a Phase III clinical trial. As a result, we also expect that our overall development costs would be increased and our development timeline could be extended, potentially by several years, in each case as compared to the development costs and timeline we would expect if we were instead to conduct additional clinical development of mecamylamine hydrochloride. The expected extended development time could also delay our receipt of any revenues from potential product sales.

If clinical trials for our product candidates are prolonged or delayed, we would be unable to commercialize our product candidates on a timely basis, which would require us to incur additional costs and delay our receipt of any revenues from potential product sales.

We cannot predict whether we will encounter problems with any of our completed, ongoing or planned clinical trials that will cause us or any regulatory authority to delay or suspend those clinical trials or delay the analysis of data derived from them. A number of events, including any of the following, could delay the completion of our ongoing and planned clinical trials and negatively impact our ability to obtain regulatory approval for, and to market and sell, a particular product candidate:

- conditions imposed on us by the FDA or any foreign regulatory authority regarding the scope or design of our clinical trials;
- delays in recruiting and enrolling subjects and patients into clinical trials;
- delays in obtaining, or our inability to obtain, required approvals from institutional review boards or other reviewing entities at clinical sites selected for participation in our clinical trials;
- insufficient supply or deficient quality of our product candidates or other materials necessary to conduct our clinical trials;
- lower than anticipated retention rate of subjects and patients in clinical trials;
- negative or inconclusive results from clinical trials, or results that are inconsistent with earlier results, that necessitate additional clinical study;
- serious and unexpected drug-related side effects experienced by subjects and patients in clinical trials; or
- failure of our third-party contractors to comply with regulatory requirements or otherwise meet their contractual obligations to us in a timely manner.

Clinical trials require sufficient patient enrollment, which is a function of many factors, including the size of the patient population, the nature of the trial protocol, the proximity of patients to clinical sites, the availability of effective treatments for the relevant disease and the eligibility criteria for the clinical trial. Delays in patient enrollment can result in increased costs and longer development times. For example, the Phase II clinical trial of AZD3480 (TC-1734) for mild to moderate Alzheimer’s disease planned to be conducted by AstraZeneca will require some of the Alzheimer’s disease patients to be assigned randomly into a dosing group that would receive placebo instead of AZD3480 (TC-1734). Those patients would not receive any medication for the duration of the trial. As a result, Alzheimer’s disease patients or their caregivers may be unwilling or unable to give informed consent to participate in the trial, which would result in delays in patient enrollment. The failure to enroll patients in a clinical trial could delay the completion of the clinical trial beyond our current expectations. In addition, the FDA could require us or AstraZeneca to conduct clinical trials with a larger number of subjects than we have projected for any of our product candidates. We or AstraZeneca may not be able to enroll a sufficient number of patients in a timely or cost-effective manner. Furthermore, enrolled patients may drop out of clinical trials, which could impair the validity or statistical significance of those clinical trials.

Prior to commencing clinical trials in the United States, we must submit an IND to the FDA and the IND must become effective. We are conducting our ongoing Phase I clinical trial of our product candidate TC-2216 outside the United States. We have not submitted an IND to enable us to conduct clinical trials of TC-2216 in the United States.

We do not know whether our clinical trials will begin as planned, will need to be restructured or will be completed on schedule, if at all. Delays in our clinical trials will result in increased development costs for our product candidates. In addition, if our clinical trials are delayed, our competitors may be able to bring products to market before we do and the commercial viability of our product candidates could be limited.

Our product candidates will remain subject to ongoing regulatory review even if they receive marketing approval. If we fail to comply with continuing regulations, we could lose these approvals and the sale of our products could be suspended.

Even if we receive regulatory approval to market a particular product candidate, the approval could be conditioned on us conducting additional costly post-approval studies or could limit the indicated uses included in our labeling. Moreover, the product may later cause adverse effects that limit or prevent its widespread use, force us to withdraw it from the market or impede or delay our ability to obtain regulatory approvals in additional countries. In addition, the manufacturer of the product and its facilities will continue to be subject to FDA review and periodic inspections to ensure adherence to applicable regulations. After receiving marketing approval, the manufacturing, labeling, packaging, adverse event reporting, storage, advertising, promotion and record keeping related to the product will remain subject to extensive regulatory requirements. We may be slow to adapt, or we may never adapt, to changes in existing regulatory requirements or adoption of new regulatory requirements.

If we fail to comply with the regulatory requirements of the FDA and other applicable U.S. and foreign regulatory authorities or previously unknown problems with our products, manufacturers or manufacturing processes are discovered, we could be subject to administrative or judicially imposed sanctions, including:

- restrictions on the products, manufacturers or manufacturing processes;
- warning letters;
- civil or criminal penalties;
- fines;
- injunctions;
- product seizures or detentions;
- import bans;
- voluntary or mandatory product recalls and publicity requirements;
- suspension or withdrawal of regulatory approvals;
- total or partial suspension of production; and
- refusal to approve pending applications for marketing approval of new drugs or supplements to approved applications.

Because we have a number of compounds and are considering a variety of target indications, we may expend our limited resources to pursue a particular product candidate or indication and fail to capitalize on product candidates or indications that may be more profitable or for which there is a greater likelihood of success.

Because we have limited financial and managerial resources, we must focus on research programs and product candidates for the specific indications that we believe are the most promising. As a result, we may forego or delay pursuit of opportunities with other product candidates or other indications that later prove to have greater commercial potential. Our resource allocation decisions may cause us to fail to capitalize on viable commercial products or profitable market opportunities. Through 2004, we spent managerial and financial resources on clinical trials for two product candidates that we have ceased developing. We may in the future spend our resources on other research programs and product candidates for specific indications that ultimately do not yield any commercially viable products. Furthermore, if we do not accurately evaluate the commercial potential or target market for a particular product candidate, we may relinquish valuable rights to that product candidate through collaboration, licensing or other royalty arrangements in cases in which it would have been advantageous for us to retain sole development and commercialization rights.

We may not be successful in our efforts to identify or discover additional product candidates.

A key element of our strategy is to develop and commercialize drugs that selectively target specific NNR subtypes. We seek to do so through our understanding of the role of specific NNRs in the nervous system, our scientific expertise and the use of Pentad.

A significant portion of the research that we are conducting involves new and unproven compounds. Research programs to identify new product candidates require substantial technical, financial and human resources. These research programs may initially show promise in identifying potential product candidates, yet fail to yield product candidates for clinical development for a number of reasons, including:

- the research methodology used may not be successful in identifying potential product candidates; or
- potential product candidates may, on further study, be shown to have harmful side effects or other characteristics that indicate that they are unlikely to be effective products.

If we are unable to develop suitable product candidates through internal research programs, we will not be able to increase our revenues in future periods, which could result in significant harm to our financial position and adversely impact our stock price. Any additional product candidates that we are able to develop through our internal research programs will require the commitment of substantial time and financial resources for further preclinical research and clinical development.

Risks Related to Our Dependence on Third Parties

The successful development and commercialization of our lead product candidate, AZD3480 (TC-1734), depends substantially on our collaboration with AstraZeneca. If AstraZeneca is unable to further develop or commercialize AZD3480 (TC-1734), or experiences significant delays in doing so, our business will be materially harmed.

In December 2005, we entered into our collaborative research and license agreement with AstraZeneca for the development and worldwide commercialization of AZD3480 (TC-1734) for the treatment of Alzheimer's disease, cognitive deficits in schizophrenia and potentially other indications characterized by cognitive impairment. Prior to entering into the agreement, we did not have a history of working together with AstraZeneca and we cannot predict the success of the collaboration. The collaboration involves a complex allocation of rights, provides for milestone payments to us based on the achievement of specified development, regulatory and first commercial sale milestones and provides us with royalty-based revenue if AZD3480 (TC-1734) or another product candidate is successfully commercialized. AstraZeneca has decision-making authority for most matters in our collaboration. In addition, AstraZeneca has the right to assume control of patent matters with respect to AZD3480 (TC-1734).

AstraZeneca is generally responsible for conducting and funding substantially all future development and regulatory approval activities for AZD3480 (TC-1734) and will have significant control over the conduct and timing of development efforts with respect to AZD3480 (TC-1734). Although we have had discussions with AstraZeneca regarding its current plans and intentions, AstraZeneca may change its development plans for AZD3480 (TC-1734). We have little control over the amount and timing of resources that AstraZeneca devotes to the development of AZD3480 (TC-1734). If AstraZeneca fails to devote sufficient financial and other resources to the development plan for AZD3480 (TC-1734), the development and potential commercialization of AZD3480 (TC-1734) would be delayed. This would result in a delay in milestone payments and, if regulatory approval to market and sell AZD3480 (TC-1734) is obtained, royalties that we could receive on commercial sales.

If we lose AstraZeneca as a collaborator in the development or commercialization of AZD3480 (TC-1734) at any time, it would materially harm our business.

We and AstraZeneca are conducting preclinical research under our collaboration agreement that is designed to identify and develop additional compounds that act on the a4ß2 NNR and enhance cognitive function. The agreement provides for a four-year research term, which began in January 2006. AstraZeneca has the right to terminate the a4ß2 research collaboration effective three years after the research term began upon at least six months notice. AstraZeneca has the right to terminate the agreement in its entirety upon 90 days notice after the earlier of the end of the research term or four years after the research term began.

If AstraZeneca terminates our agreement at any time, for any reason, it would delay our development of AZD3480 (TC-1734) and materially harm our business and could accelerate our need for additional capital. In particular, we would have to fund the clinical development and commercialization of AZD3480 (TC-1734) on our own, seek another collaborator or licensee for clinical development and commercialization or abandon the development and commercialization of AZD3480 (TC-1734).

We will depend on collaborations with third parties for the development and commercialization of some of our product candidates. If these collaborations are not successful, we may not be able to capitalize on the market potential of these product candidates.

In addition to our collaboration with AstraZeneca, we intend to selectively enter into collaboration agreements with leading pharmaceutical and biotechnology companies where our potential collaborator has particular expertise in a target indication or where the target indication represents a large, primary care market. We will have limited control over the amount and timing of resources that our collaborators dedicate to the development of our licensed product candidates. Our ability to generate revenues from our collaborators will depend on our collaborators' abilities to establish the safety and efficacy of our product candidates, to obtain regulatory approvals and to achieve market acceptance.

Strategic collaborations involving our product candidates, including our collaboration with AstraZeneca, pose the following risks to us:

- collaborators have significant discretion in determining the efforts and resources that they will apply to these collaborations;
- collaborators may not pursue further development and commercialization of our product candidates or may elect not to continue or renew research and development programs based on preclinical or clinical trial results, changes in their strategic focus or available funding, or external factors such as an acquisition that diverts resources or creates competing priorities;
- collaborators may delay clinical trials, provide insufficient funding for a clinical trial program, stop a clinical trial or abandon a product candidate, repeat or conduct new clinical trials or require a new formulation of a product candidate for clinical testing;
- collaborators could independently develop, or develop with third parties, products that compete directly or indirectly with our products or product candidates if the collaborators believe that competitive products are more likely to be successfully developed or can be commercialized under terms that are more economically attractive;
- a collaborator with marketing and distribution rights to one or more products may not commit enough resources to their marketing and distribution;
- collaborators may not properly maintain or defend our intellectual property rights or may use our proprietary information in such a way as to invite litigation that could jeopardize or invalidate our proprietary information or expose us to potential litigation;
- disputes may arise between us and the collaborators that result in the delay or termination of the research, development or commercialization of our product candidates, that result in costly litigation or

arbitration that diverts management attention and resources or that, if resolved unfavorably to us, result in adverse financial consequences for us under the terms of the applicable collaboration agreements; and

- collaborations may be terminated and, if terminated, may result in a need for additional capital to pursue further development of the applicable product candidates.

Collaboration agreements may not lead to development of product candidates in the most efficient manner or at all. For example, a collaborative research and development agreement that we entered into with Aventis Pharma SA for the development of our compounds for the treatment or prevention of Alzheimer's disease terminated effective January 2, 2005 without any compound having been advanced into clinical development as part of the collaboration.

In addition, there have been a significant number of recent business combinations among large pharmaceutical companies that have resulted in a reduced number of potential future collaborators. If a present or future collaborator of ours were to be involved in a business combination, the continued pursuit and emphasis on our product development program could be delayed, diminished or terminated.

If we do not establish additional collaborations, we may have to alter our development plans.

Our drug development programs and potential commercialization of our product candidates will require substantial additional cash to fund expenses. Our strategy includes selectively collaborating with leading pharmaceutical and biotechnology companies to assist us in furthering development and potential commercialization of some of our product candidates. We intend to do so especially for target indications in which our potential collaborator has particular expertise or that involve a large, primary care market that must be served by large sales and marketing organizations.

We have the right to offer to AstraZeneca the right to license any compound that acts on any NNR other than the a4ß2 NNR that we may in the future seek to exploit for Alzheimer's disease, cognitive deficits in schizophrenia, other conditions characterized by cognitive impairment or schizophrenia. However, if we do not offer the compound to AstraZeneca, we are generally not permitted to develop or commercialize the compound for any of these indications. As a result, our ability to seek additional collaborations for these indications is substantially limited during the term of our collaboration with AstraZeneca. We have also granted AstraZeneca a right of first negotiation for the development and commercialization of compounds that act by binding to NNRs for depression, anxiety and bipolar disorder.

We face significant competition in seeking appropriate collaborators. Collaborations are complex and time-consuming to negotiate and document. We may not be able to negotiate collaborations on acceptable terms, or at all. If that were to occur, we may have to curtail the development of a particular product candidate, reduce or delay its development program or one or more of our other development programs, delay its potential commercialization or reduce the scope of our sales or marketing activities, or increase our expenditures and undertake development or commercialization activities at our own expense. If we elect to increase our expenditures to fund development or commercialization activities on our own, we may need to obtain additional capital, which may not be available to us on acceptable terms or at all. If we do not have sufficient funds, we will not be able to bring our product candidates to market and generate product revenue.

If our contract manufacturers fail to devote sufficient resources to our concerns, or if their performance is substandard, our clinical trials and product introductions may be delayed or there may be a shortage of commercial supply.

Our product candidates require precise, high quality manufacturing. We have limited internal manufacturing capability. We have historically manufactured our product candidates only in small quantities for preclinical

testing and have contracted with third parties to manufacture, in collaboration with us, our product candidates for clinical trials and, in the case of Inversine, for commercial sale. If any of our product candidates is approved by the FDA or by foreign regulatory authorities for marketing and sale, it will need to be manufactured in substantially larger, commercial quantities. Our experience in the manufacture of drugs in commercial quantities is limited to our contractual arrangements with third parties to manufacture Inversine and its active ingredient.

We currently rely on various third-party contract manufacturers, including Siegfried Ltd., for our product candidates and we intend to continue to rely on third-party manufacturers to supply, store and distribute our product candidates for our clinical trials and to manufacture commercial supplies of any product candidate that is approved for sale. Our reliance on third-party manufacturers will expose us to risks that could delay or prevent the initiation or completion of our clinical trials, the submission of applications for regulatory approvals, the approval of our products by the FDA or the commercialization of our products or result in higher costs or lost product revenue. In particular, any contract manufacturer:

- could encounter difficulties in achieving volume production, quality control and quality assurance and suffer shortages of qualified personnel, which could result in its inability to manufacture sufficient quantities of drugs to meet our clinical timelines or to commercialize our product candidate;
- could terminate or choose not to renew its manufacturing agreement with us, based on its own business priorities, at a time that is costly or inconvenient for us;
- could fail to establish and follow FDA-mandated current good manufacturing practices, or cGMPs, required for FDA approval of our product candidates or fail to document its adherence to cGMPs, either of which could lead to significant delays in the availability of material for clinical study and delay or prevent filing or approval of marketing applications for our product candidates; and
- could breach, or fail to perform as agreed under, its manufacturing agreement with us.

We expect to rely initially on a single contract manufacturer for each of our product candidates. Currently, we have separate arrangements with third-party manufacturers, each of which is a sole supplier to us, for mecamylamine hydrochloride, the active ingredient of Inversine, and for the finished tablets of Inversine. Changing these or any manufacturer that we subsequently engage for a particular product or product candidate may be difficult, as the number of potential manufacturers is limited and we will have to compete with third parties for access to those manufacturing facilities. cGMP manufacturing processes and procedures typically must be reviewed and approved by the FDA and changing manufacturers may require re-validation of any new facility for cGMP compliance, which would likely be costly and time-consuming. We may not be able to engage replacement manufacturers on acceptable terms quickly or at all. In addition, our contract manufacturers located in foreign countries may be subject to import limitations or bans. As a result, if any of our contract manufacturers is unable, for whatever reason, to supply the contracted amounts of Inversine or any other product that we successfully bring to market, a shortage would result which would have a negative impact on our revenues.

Drug manufacturers are subject to ongoing periodic unannounced inspection by the FDA, the United States Drug Enforcement Agency and corresponding state and foreign agencies to ensure strict compliance with cGMPs, other government regulations and corresponding foreign standards. While we are obligated to audit the performance of third-party contractors, we do not have control over our third-party manufacturers' compliance with these regulations and standards. Failure by our third-party manufacturers or us to comply with applicable regulations could result in sanctions being imposed on us, including fines, injunctions, civil penalties, failure of the government to grant pre-market approval of drugs, delays, suspension or withdrawal of approvals, seizures or recalls of product, operating restrictions and criminal prosecutions.

If third parties on which we rely for clinical trials do not perform as contractually required or as we expect, we may not be able to obtain regulatory approval for or commercialize our product candidates.

We do not have the ability to independently conduct the clinical trials required to obtain regulatory approval for our product candidates. We depend on independent clinical investigators and, in some cases, contract research

organizations and other third-party service providers to conduct the clinical trials of our product candidates and expect to continue to do so. We rely heavily on these parties for successful execution of our clinical trials, but we do not control many aspects of their activities. Nonetheless, we are responsible for confirming that each of our clinical trials is conducted in accordance with its general investigational plan and protocol. Moreover, the FDA requires us to comply with regulations and standards, commonly referred to as good clinical practices, for conducting and recording and reporting the results of clinical trials to assure that data and reported results are credible and accurate and that the trial participants are adequately protected. Our reliance on third parties that we do not control does not relieve us of these responsibilities and requirements. Third parties may not complete activities on schedule or may not conduct our clinical trials in accordance with regulatory requirements or the respective trial plans and protocols. The failure of these third parties to carry out their obligations could impair the credibility or reliability of the data generated in clinical trials of our product candidates, delay or prevent the development, approval and commercialization of our product candidates or result in enforcement action against us.

Risks Related to Our Intellectual Property

If we are unable to protect our intellectual property effectively, our competitors may develop and market similar products and the value of our technology and our ability to compete would be damaged.

Our continued success depends significantly on our ability, or our present or future collaborators' ability, to obtain and maintain meaningful intellectual property protection for our product candidates, technology and know-how. We generally seek to protect our compounds and technologies by, among other methods, filing U.S. and foreign patent applications related to our proprietary technology that is important to the development of our business. We file patent applications directed to our product candidates in an effort to establish intellectual property positions regarding new chemical entities and uses in the treatment of disease.

The patent positions of companies like ours are generally uncertain and involve complex legal and factual questions. Our ability to maintain and solidify our proprietary position for our technology will depend on our success in obtaining effective patent claims and enforcing claims that are granted. We do not know whether any of our patent applications or those patent applications that we license will result in the issuance of any patents. Moreover, our issued patents and those that may issue in the future, or those licensed to us, may be challenged, invalidated, rendered unenforceable or circumvented, any of which could limit our ability to stop competitors from marketing related products. In addition, the rights granted under any issued patents may not provide us with competitive advantages against competitors with similar compounds or technologies. Furthermore, our competitors may independently develop similar technologies in a manner that does not infringe our patents or other intellectual property.

Although we own or otherwise have rights to a number of patents, these patents may not effectively exclude competitors from engaging in activities that compete with us. Furthermore, the issuance of a patent is not conclusive as to its validity or enforceability, and third parties may challenge the validity or enforceability of our patents. Because patent applications in the United States and many foreign countries are confidential for a period of time after filing, and because publications of discoveries in the scientific literature often lag behind actual discoveries, we cannot be certain that we were the first to invent the inventions claimed in our issued U.S. patents or pending patent applications, or that we were the first to file for protection of the inventions set forth in the foreign patents or patent applications. It is possible that a competitor may successfully challenge our patents or that challenges will result in the elimination or narrowing of patent claims and, therefore, reduce our patent protection.

Because of the extensive time required for development, testing and regulatory review of a new drug, it is possible that any related patent may expire before any of our product candidates can be commercialized or remain in force for only a short period following commercialization. In either case, this would reduce any

advantages of the patent. The patent laws of various foreign countries in which we intend to compete may not protect our intellectual property to the same extent as the laws of the United States. Changes in either patent laws or in interpretations of patent laws in the United States and other countries may diminish the value of our intellectual property or narrow the scope of our patent protection.

If we are unable to protect the confidentiality of our proprietary information and know-how, the commercial value of our technology and product candidates could be reduced.

In addition to patents, we rely on protection of trade secrets, know-how and confidential and proprietary information to maintain our competitive position. For example, we generally do not seek patent protection for the computer-based molecular design technologies that form part of Pentad and instead seek to maintain those technologies as trade secrets.

To maintain the confidentiality of trade secrets and proprietary information, we generally enter into confidentiality agreements with our employees, consultants, contractors and collaborative partners upon the commencement of our relationship with them. These agreements typically require that all confidential information developed by the individual or made known to the individual by us during the course of the individual's relationship with us be kept confidential and not disclosed to third parties. However, we may not obtain these agreements in all circumstances, and individuals with whom we have these agreements may not comply with their terms. Even if obtained, these agreements may not provide meaningful protection for our trade secrets or other proprietary information or an adequate remedy in the event of their unauthorized use or disclosure. The loss or exposure of our trade secrets or other proprietary information could impair our competitive position.

We also typically enter into agreements with employees that provide inventions conceived by them in the course of rendering services to us are our exclusive property and, where appropriate, we enter into similar agreements with consultants and contractors. To the extent that our employees, consultants or contractors use technology or know-how owned by others in their work for us, disputes may arise as to the rights in related inventions.

If we fail to comply with our obligations in our intellectual property licenses with third parties, we could lose license rights that are important to our business.

We are a party to various license agreements. In particular, we license patent rights covering methods of use of TC-2696. We also license patent rights covering the composition of TC-5214 for use as a pharmaceutical and methods of use of mecamylamine hydrochloride and TC-5214. We may enter into additional licenses in the future. Our existing licenses impose, and we expect future licenses will impose, various diligence, milestone payment, royalty, insurance and other obligations on us. If we fail to comply with these obligations, the licensor may have the right to terminate the license, in which event we might not be able to market any product that is covered by the licensed patents.

Our patent protection for mecamylamine hydrochloride is, and our patent protection for any other particular compound may be, limited to a specific method of use or indication. If a third party were to obtain approval of mecamylamine hydrochloride or other particular compound for use in another indication, we could be subject to competition arising from off-label use.

Although we generally seek the broadest patent protection available for our proprietary compounds, we may not be able to obtain patent protection for the actual composition of any particular compound and may be limited to protecting a new method of use for the compound or otherwise restricted in our ability to prevent others from exploiting the compound. For example, we currently rely on method of use patent coverage in the United States for mecamylamine hydrochloride. If we are unable to obtain patent protection for the actual composition of any compound that we seek to develop and commercialize and must rely on method of use patent coverage, we would

likely be unable to prevent others from manufacturing or marketing that compound for any use that is not protected by our patent rights. We are aware of one company, CoMentis, Inc. (formerly known as Athenagen, Inc.), that is developing mecamylamine hydrochloride in an eye drop formulation as a treatment for age-related macular degeneration, a condition characterized by degeneration of the retina in the eye. If a third party were to receive marketing approval for mecamylamine hydrochloride or any other compound for which we rely on method of use patent coverage for another use, physicians could nevertheless prescribe it for indications that are not described in the product's labeling or approved by the FDA or other regulatory authorities. Even if we have patent protection for the prescribed indication, as a practical matter, we would have little recourse as a result of this off-label use. In that event, our revenues from the commercialization of the compound would likely be adversely affected.

We may be involved in lawsuits to protect or enforce our patents that could be expensive and time-consuming.

We may initiate patent litigation against third parties to protect or enforce our patent rights and we may be similarly sued by third parties. We may also become subject to interference or opposition proceedings conducted in the patent and trademark offices of various countries to determine our entitlement to patents. The defense and prosecution of intellectual property suits, interference proceedings and related legal and administrative proceedings, if necessary, would be costly and divert our technical and management personnel from conducting our business. Moreover, we may not prevail in any of these suits. An adverse determination of any litigation or proceeding could put our patents at risk of being invalidated or narrowly interpreted and our patent applications at risk of not being issued and could prevent us from protecting our rights, particularly in countries where the laws may not protect such rights as fully as in the United States.

Furthermore, because of the substantial amount of discovery required in connection with intellectual property litigation, there is a risk that disclosure of some of our confidential information could be compelled and the information compromised. In addition, during the course of this kind of litigation, there could be public announcements of the results of hearings, motions or other interim proceedings or developments that, if perceived as negative by securities analysts or investors, could have a substantial adverse effect on the trading price of our common stock.

Claims by third parties that we infringe their proprietary rights may result in liability for damages or prevent or delay our development and commercialization efforts.

Our success depends in part on avoiding the infringement of other parties' patents and proprietary rights. Patents may issue from patent applications of which we are unaware, and avoiding patent infringement may be difficult. We may infringe or it may be alleged that we infringe third-party patents. If a third party were to file a patent infringement suit against us, we could be forced to stop or delay research, development, manufacturing or sales of any infringing product in the country or countries covered by the patent infringed, unless we can obtain a license from the patent holder. Any necessary license may not be available on acceptable terms or at all, particularly if the third party is developing or marketing a product competitive with the infringing product. Even if we are able to obtain a license, the rights may be nonexclusive, which would give our competitors access to the same intellectual property.

We also may be required to pay substantial damages to the patent holder in the event of an infringement. These damages could in some circumstances be triple the actual damages the patent holder incurs. If we have supplied infringing products to third parties for marketing or have licensed third parties to manufacture, use or market infringing products, we may be obligated to indemnify these third parties for any damages they may be required to pay to the patent holder and for any losses they may sustain themselves as a result.

Any successful infringement action brought against us may also adversely affect marketing of the infringing product in other markets not covered by the infringement action, as well as our marketing of other products based

on similar technology. Furthermore, we may suffer adverse consequences from a successful infringement action against us even if the action is subsequently reversed on appeal, nullified through another action or resolved by settlement with the patent holder. The damages or other remedies awarded, if any, may be significant. As a result, any infringement action against us would likely delay the regulatory approval process, harm our competitive position, be very costly and require significant time and attention of our key management and technical personnel.

Risks Related to Commercialization

Even if approved for marketing, our product candidates may not gain market acceptance and may fail to generate significant revenues.

The commercial success of any of our product candidates for which we may obtain marketing approval from the FDA or other regulatory authorities will depend upon their acceptance by the medical community and third-party payors as clinically useful, cost-effective and safe. Many of the product candidates that we are developing are based upon technologies or methods of treatment that are relatively new and unproven. As a result, it may be more difficult for us to achieve market acceptance of our products.

The degree of market acceptance of any drug depends on a number of factors, such as:

- its demonstration of efficacy and safety in clinical trials;
- its superior efficacy as compared to alternative treatment methods and its side effect profile;
- its cost-effectiveness and the availability of insurance or other third-party reimbursement;
- its convenience and ease of administration;
- the timing of its market entry relative to competitive treatments;
- the extent and success of marketing and sales efforts; and
- the product labeling or product insert required by the FDA or regulatory authorities in other countries.

In addition, perceptions about the relationship or similarity between our product candidates and nicotine could limit their market potential. Our product candidates derive their medical effects by interacting with NNRs. Nicotine, which can have significantly negative health effects, also interacts with NNRs. Accordingly, our product candidates may be perceived by some to be nicotine or to be closely related to nicotine, particularly in light of the shared derivative names, “nicotine” and neuronal “nicotinic” receptors, and the fact that our company was launched originally as a research group within, and then as a subsidiary of, R.J. Reynolds Tobacco Company. This potential perception could result in a reluctance by patients to take, or by physicians to prescribe, any of our product candidates that receives marketing approval, which would affect our revenues.

We currently have limited sales, marketing and distribution experience and no internal sales or distribution capabilities. If we are unable to enter into collaborations or other arrangements with third parties to market and sell our product candidates or to develop our own internal marketing capability, we may not be successful in commercializing our products.

We currently have limited sales, marketing and distribution experience. Our experience is limited to a contractual arrangement with a third party to distribute Inversine, which we acquired in 2002 and which generates only limited sales. We currently have no internal sales or distribution capabilities. Although we intend to focus any future internal sales and marketing resources in areas where specialists heavily influence our target markets, such as neurology and psychiatry, we also intend to seek to further augment our sales, marketing and distribution capabilities through arrangements with third parties. In particular, our strategy includes selectively entering into collaborations and other strategic alliances with respect to product candidates for disease indications

with sales and distribution characteristics requiring a large sales force. There are risks involved with establishing our own sales force and marketing and distribution capabilities, as well as in entering into arrangements with third parties to perform these services. Developing our own sales force would be expensive and time-consuming and could delay any product launch. We may not be successful in entering into arrangements with third parties on terms that are favorable to us or at all. Also, we would have little control over such third parties, and any of them may fail to devote the necessary resources and attention to sell, market or distribute our products effectively. If we do not establish sales and distribution capabilities successfully, either on our own or in collaboration with third parties, we may not successfully commercialize our products.

Unfavorable pricing regulations, third-party reimbursement practices or healthcare reform initiatives applicable to our product candidates could limit our potential product revenue.

The regulations governing drug pricing and reimbursement vary widely from country to country. Some countries require approval of the sale price of a drug before it can be marketed and, in many of these countries, the pricing review period begins only after approval is granted. In some countries, prescription pharmaceutical pricing remains subject to continuing governmental control even after initial approval is granted. Although we monitor these regulations, our product candidates are currently in the development stage and we cannot yet assess the impact of price regulations. As a result, we or our current or potential future collaborators may obtain regulatory approval for a product in a particular country, but then be subject to price regulations that delay the commercial launch of the product and may negatively impact the revenues we are able to derive from sales in that country.

Successful commercialization of our products will also depend in part on the extent to which coverage and adequate payment for our products will be available from government health administration authorities, private health insurers and other third-party payors. If we or our current or potential future collaborators succeed in bringing a product candidate to the market, it may not be considered cost-effective and reimbursement to the patient may not be available or sufficient to allow us to sell it at a satisfactory price. Because our product candidates are in the development stage, we cannot yet determine their cost-effectiveness. We may need to conduct expensive studies in order to demonstrate cost-effectiveness. Moreover, third-party payors frequently require that drug companies provide them with predetermined discounts from list prices and are increasingly challenging the prices charged for medical products. Because our product candidates are in the development stage, we do not yet know the level of reimbursement, if any, for any products that we or our current or potential future collaborators are able to successfully develop. If the reimbursement for any of our product candidates is inadequate in light of our development and other costs, our ability to achieve or sustain profitability could be affected.

We believe that the efforts of governments and third-party payors to contain or reduce the cost of healthcare will continue to affect the business and financial condition of pharmaceutical and biopharmaceutical companies. A number of legislative and regulatory proposals to change the healthcare system in the United States and other major healthcare markets have been proposed and adopted in recent years. For example, the U.S. Congress has enacted a limited prescription drug benefit for Medicare recipients as part of the Medicare Prescription Drug, Improvement and Modernization Act of 2003. While the program established by this statute may increase demand for any of our products that are successfully developed, if we or our current or potential future collaborators participate in this program, our prices will be negotiated with drug procurement organizations for Medicare beneficiaries and are likely to be lower than prices we might otherwise obtain. If successfully developed, AZD3480 (TC-1734), our product candidate for Alzheimer’s disease, cognitive deficits in schizophrenia and other conditions characterized by cognitive impairment, could be particularly affected by this law because Alzheimer’s disease is a disease that affects the elderly. Non-Medicare third-party drug procurement organizations may also base the price they are willing to pay on the rate paid by drug procurement organizations for Medicare beneficiaries. In addition, ongoing initiatives in the United States have and will continue to increase pressure on drug pricing. The announcement or adoption of any such initiative could have an adverse effect on potential revenues from any product candidate that we may successfully develop.

If our competitors develop and market drugs that are less expensive, more effective or safer than ours, if they develop and market products faster than we do, or if they have better sales and marketing capabilities than we do, any products we are able to commercialize may not generate initial or ongoing revenues.

The development and commercialization of new drugs is highly competitive. Our business is characterized by extensive research efforts and rapid developments. We expect intense competition in our target markets as new products and advanced technologies become available. Our competitors include large pharmaceutical, biotechnology and other companies and research institutions, many of which have greater financial, technical and other resources and personnel and more experience in research, clinical development, regulatory and drug commercialization than we have. Our competitors may:

- develop products that are more effective, safer, more convenient or less costly than our product candidates;
- obtain FDA or other regulatory approval for their products more rapidly than we do;
- adapt more quickly to new technologies and scientific advances;
- initiate or withstand substantial price competition more successfully than we can;
- have greater success in recruiting skilled scientific workers from the limited pool of available talent;
- obtain more effective intellectual property protection than we have;
- negotiate third-party licensing and collaboration arrangements more effectively than we do; and
- take advantage of acquisition or other opportunities more readily than we do.

Competitive products may render our product candidates obsolete or noncompetitive before we can recover our development or commercialization expenses.

We also face substantial competition from therapies designed to target NNRs. Pfizer's product Chantix targets NNRs and is approved in the United States for smoking cessation. In addition, we believe that several prominent pharmaceutical companies have product candidates that target NNRs in development, including as examples Sanofi-Aventis, with a compound in Phase III for smoking cessation, and Abbott Laboratories, with one compound in Phase II for Alzheimer's disease, ADHD and schizophrenia and another in Phase II for pain and potentially other indications. Other companies that we believe have active NNR-based programs include Merck & Co., AstraZeneca, Eli Lilly, Memory Pharmaceuticals, Critical Therapeutics, NeuroSearch A/S, CoMentis and EnVivo Pharmaceuticals. We expect that we will face increased competition in the future if therapies that target NNRs are further validated and if companies initiate or expand programs focused on NNRs or otherwise enter the CNS market, whether independently or by collaboration or acquisition.

Any products that we are able to successfully develop and commercialize in the future could be subject to competition from lower priced generic drugs. The manufacturer of a generic product could challenge our patents as invalid or not infringed and subject us to expensive litigation. We do not know if we would prevail in litigation and succeed in keeping the generic product out of the market until our patent protection expires.

If we successfully develop and obtain approval for our product candidates, we will face competition based on the safety and effectiveness of our products, the timing and scope of regulatory approvals, the availability and cost of supply, marketing and sales capabilities, reimbursement coverage, price, patent position and other factors. Our competitors may develop or commercialize more effective or more affordable products, or obtain more effective patent protection, than we do. Accordingly, our competitors may commercialize products more rapidly or effectively than we do.

If approved, our product candidates will compete for a share of the existing market with numerous approved products. There is currently no approved product for cognitive deficits in schizophrenia. We believe that the primary competitive products for use in indications that we are currently targeting include:

- for mild to moderate Alzheimer's disease, acetylcholinesterase inhibitors such as Aricept from Pfizer/Eisai, Reminyl from Johnson & Johnson and Exelon from Novartis and for moderate to severe Alzheimer's disease, Namenda from Forest Laboratories, which acts by regulating the neurotransmitter glutamate;
- for acute post-operative pain, opioids such as OxyContin from Purdue Pharma;
- for depression, selective serotonin reuptake inhibitors such as Prozac from Eli Lilly, Paxil from GlaxoSmithKline, Zoloft from Pfizer, Celexa and Lexapro from Forest Laboratories and the dual uptake inhibitor Effexor from Wyeth;
- for anxiety disorders, benzodiazepines such as Pfizer's Xanax and Biovail's Ativan, as well as anti-depressants;
- for schizophrenia, anti-psychotics such as Seroquel from AstraZeneca, Zyprexa from Eli Lilly, Risperdal from Johnson & Johnson, Geodon from Pfizer and Abilify from Bristol-Myers Squibb; and
- for smoking cessation, Zyban from GlaxoSmithKline and Chantix from Pfizer.

We may have substantial exposure to product liability claims and may not have adequate insurance to pay them.

We face an inherent business risk of exposure to product liability claims if the use of our products is alleged to have resulted in harm to others. This risk exists for product candidates in clinical trials, whether or not the product candidate is subsequently approved for commercial sale, as well as for products in commercial distribution. Any product liability claim arising in the future against us or any third party that we have agreed to indemnify, regardless of its merit or eventual adjudication, could be costly and significantly divert management's attention from conducting our business or adversely affect our reputation and the demand for our products.

We have secured product liability insurance coverage with limits of $10 million per occurrence and $10 million in the aggregate. Our current insurance coverage may not reimburse us or may not be sufficient to reimburse us for any expenses or losses we may incur. We intend to expand our coverage with respect to any products for which we obtain marketing approval. However, additional insurance may not be available to cover our potential liabilities fully or may be prohibitively expensive. In addition, some potential product liability claims may be excluded from coverage under the terms of the policy. Our inability to obtain adequate insurance coverage at an acceptable cost could prevent or impede the commercialization of our product candidates.

Our business activities involve hazardous materials, which could subject us to significant liability.

Our research and development activities involve, and any future manufacturing processes that we conduct may involve, the use of hazardous materials, including hazardous chemicals and radioactive materials. Accordingly, we are subject to federal, state and local laws and regulations governing the use, manufacture, storage, handling and disposal of these materials. We incur significant costs to comply with these laws and regulations. Moreover, despite precautionary procedures that we implement, we cannot eliminate the risk of accidental contamination or injury from these materials. In the event of an accident or environmental discharge, we may be held liable for any resulting damages. We do not carry insurance against the risk of contamination or injury from hazardous materials.

If our promotional activities fail to comply with the regulations and guidelines of the FDA and other applicable regulatory authorities, we may be subject to warnings or enforcement actions that could harm our business.

Physicians may prescribe drugs for uses that are not described in the product's labeling or for uses that differ from those tested in clinical studies and approved by the FDA or similar regulatory authorities in other countries. Regulatory authorities generally do not regulate the behavior of physicians in their choice of treatments. Regulatory authorities do, however, restrict communications on the subject of off-label use. Companies cannot actively promote approved drugs for off-label uses but, in some countries outside of the European Union, they may under specified conditions disseminate articles published in peer-reviewed journals that discuss off-label uses of approved products to physicians. To the extent allowed, we may in the future disseminate peer-reviewed articles on our products to physicians. We do not currently promote Inversine for off-label use in the treatment of any neuropsychiatric disorder. However, if we undertake any promotional activities in the future for Inversine or any other product candidate that we are able to commercialize and our activities fail to comply with these regulations or guidelines, we may be subject to warnings from, or enforcement action by, these authorities.

Risks Related to Employees and Managing Growth

If we lose our key personnel or are unable to attract and retain additional skilled personnel, we may be unable to successfully develop and commercialize our product candidates or effectively compete in our industry.

Our performance depends substantially on the performance of our senior management and key scientific, technical and managerial personnel, including our Chief Executive Officer and President, J. Donald deBethizy, and our Vice President, Clinical Development and Regulatory Affairs, Geoffrey C. Dunbar. Our executive officers, including these individuals, can terminate their employment agreements with us at any time. The loss of the services of any of our executive officers may significantly delay or prevent the achievement of product research and development and other business objectives. We maintain key man life insurance policies on Dr. deBethizy and Dr. Dunbar, among other executive officers. We also rely on consultants and advisors to assist us in formulating our research and development strategy. All of our consultants and advisors are either self-employed or employed by other organizations, and they may have other commitments, including consulting or advisory contracts with other organizations, that may affect their ability to contribute to us.

Our ability to operate successfully and manage our potential future growth will depend on our ability to identify, recruit and retain additional qualified scientific, technical, financial and managerial personnel. There is currently a shortage of skilled executives in our industry, and we face intense competition for such personnel. We may not be able to continue to attract and retain personnel with the advanced qualifications necessary for the growth of our business.

We may encounter difficulties in managing our growth, which could increase our losses.

We expect the number of our employees and the scope of our operations to grow over the next several years. Continued growth may place a significant strain on our managerial, operational and financial resources, in particular as we expand our focus beyond drug discovery and development to commercialization. To manage our anticipated growth, we must continue to implement and improve our managerial, operational and financial systems and controls and reporting processes and procedures, to expand our facilities and to continue to recruit and train additional qualified personnel. We may not be able to manage our growth effectively. Moreover, we may experience deficiencies in existing systems and controls that could expose us to an increased risk of incurring financial or accounting irregularities or fraud.

Risks Related to Our Common Stock

The market price of our common stock may be highly volatile.

We expect that the trading price of our common stock is likely to be highly volatile in response to factors that are beyond our control. The stock market in general has previously experienced extreme price and volume fluctuations. The market prices of securities of pharmaceutical and biotechnology companies have been extremely volatile and have experienced fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These broad market fluctuations could result in extreme fluctuations in the price of our common stock, which could cause a decline in the value of shares held by any stockholder.

If our operating results fluctuate significantly, our stock price may decline.

Our operating results are likely to fluctuate significantly from quarter to quarter and year to year. These fluctuations could cause our stock price to decline. Some of the factors that could cause our operating results to fluctuate include:

- our inability, or the inability of AstraZeneca or any of our potential future collaborators, to successfully complete preclinical studies and clinical trials in a timely manner or at all, resulting in a delay in receiving, or a failure to receive, the required regulatory approvals to commercialize our product candidates;
- the timing of regulatory approvals or other regulatory actions;
- general and industry-specific economic conditions that may affect the research and development expenditures of AstraZeneca or any of our potential future collaborators;
- the timing of receipt of milestone payments from AstraZeneca or any of our potential future collaborators; and
- the expiration or termination of agreements with AstraZeneca or any of our potential future collaborators or the execution of new agreements.

Due to fluctuations in our operating results, a period-to-period comparison of our results of operations may not be a good indication of our future performance. In any particular quarter or quarters, our operating results could be below the expectations of securities analysts or investors and our stock price could decline.

If our stockholders sell a substantial number of shares of our common stock in the public market, our stock price may decline.

Sales of a substantial number of shares of our common stock in the public market could cause the market price to decline. Such sales also might make it more difficult for us to sell equity securities in the future at a time and at a price that we deem appropriate. If there are more shares of our common stock offered for sale than buyers are willing to purchase, the market price of our common stock may decline to a market price at which buyers are willing to purchase the offered shares and sellers remain willing to sell the shares. The number of shares of our common stock owned by our stockholders and available for sale in the public market is limited only to the extent provided under applicable federal securities laws. In addition, we may, in the future, issue additional shares of our common stock to our employees, directors or consultants as compensation, in connection with strategic collaborations or acquisitions or to raise capital. Accordingly, sales of a substantial number of shares of our common stock in the public market could occur at any time.

Concentration of ownership among our existing executive officers, directors and principal stockholders may prevent new investors from influencing significant corporate decisions.

Our executive officers, directors and their affiliates beneficially own or control approximately 35% of the outstanding shares of our common stock, based on the shares outstanding as of March 12, 2007. Accordingly, our current executive officers, directors and their affiliates have substantial control over the outcome of corporate

actions requiring stockholder approval, including the election of directors, any merger, consolidation or sale of all or substantially all of our assets or any other significant corporate transactions, as well as our management and affairs. The concentration of ownership may also delay or prevent a change of control of us at a premium price if these stockholders oppose it, even if it would benefit our other stockholders.

Provisions of our charter, bylaws and Delaware law may make an acquisition of us or a change in our management more difficult.

Provisions of our certificate of incorporation and bylaws could discourage, delay or prevent a merger, acquisition or other change in control that stockholders may consider favorable, including transactions in which stockholders might otherwise receive a premium for their shares. These provisions also could limit the price that investors might be willing to pay in the future for shares of our common stock, thereby depressing the market price of our common stock. Stockholders who wish to participate in these transactions may not have the opportunity to do so. Furthermore, these provisions could prevent or frustrate attempts by our stockholders to replace or remove our management. These provisions:

- allow the authorized number of directors to be changed only by resolution of our board of directors;
- establish a classified board of directors, providing that not all members of the board be elected at one time;
- authorize our board of directors to issue without stockholder approval blank check preferred stock that, if issued, could operate as a “poison pill” to dilute the stock ownership of a potential hostile acquirer to prevent an acquisition that is not approved by our board of directors;
- require that stockholder actions must be effected at a duly called stockholder meeting and prohibit stockholder action by written consent;
- establish advance notice requirements for stockholder nominations to our board of directors or for stockholder proposals that can be acted on at stockholder meetings;
- limit who may call stockholder meetings; and
- require the approval of the holders of 66 2/3% of the outstanding shares of our capital stock entitled to vote in order to amend certain provisions of our certificate of incorporation and bylaws.

In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which may, unless certain criteria are met, prohibit large stockholders, in particular those owning 15% or more of our outstanding voting stock, from merging or combining with us for a prescribed period of time.

Item 1B. Unresolved Staff Comments.

Not applicable.

Item 2. Properties.

We lease approximately 54,000 square feet of laboratory and office space located in the Piedmont Triad Research Park in Winston-Salem, North Carolina and have agreed to lease an additional 3,000 square feet beginning in August 2007. We also have rights exercisable at any time during the term of the lease on or after July 31, 2007 to lease additional space in this facility. The term of our lease expires July 31, 2012, and we have a renewal option for an additional five-year term at a rental rate to be mutually determined. The current monthly payment under our lease is approximately $180,000. We believe that our leased facilities, together with our right to lease additional space, are adequate to satisfy our current needs.

Item 3. Legal Proceedings

We are not currently a party to any material pending legal proceedings or aware of any contemplated proceeding against us by any governmental authority.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2006.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Market Information

Our common stock began trading on the NASDAQ Global Market (formerly known as the NASDAQ National Market) on April 12, 2006 under the symbol "TRGT." The following table sets forth, for the periods indicated, the high and low sales prices for our common stock, as reported on the NASDAQ Global Market:

	Common Stock	
	High	*Low*
2006:		
Second Quarter	$9.00	$ 6.63
Third Quarter	$7.30	$ 5.26
Fourth Quarter	$9.80	$ 5.50

Stockholders

As of March 12, 2007, there were approximately 94 holders of record of our common stock.

Dividends

We have never declared or paid cash dividends on any of our shares of capital stock. We currently intend to retain future earnings, if any, to finance the expansion and growth of our business and do not anticipate paying any cash dividends in the foreseeable future. Any future determination to pay dividends will be at the discretion of our board of directors and will depend on our financial condition, results of operations, capital requirements and other factors that our board of directors deems relevant. In addition, the terms of any future debt or credit facility may preclude us from paying dividends.

Calculation of Aggregate Market Value of Non-Affiliate Shares

For purposes of calculating the aggregate market value of shares of our common stock held by non-affiliates as set forth on the cover page of this annual report, we have assumed that all outstanding shares are held by non-affiliates, except for shares held by our executive officers, directors and 10% or greater stockholders. This assumption is not intended to constitute an admission that all executive officers, directors and 10% or greater stockholders are, in fact, our affiliates, or that there are not other persons who may be deemed to be our affiliates.

Unregistered Sales of Securities; Issuer Purchases of Equity Securities

Not applicable.

Use of Proceeds from Sales of Registered Securities

On April 18, 2006, we sold 5,000,000 shares of our common stock in our initial public offering at a price to the public of $9.00 per share. As part of the offering, we granted the underwriters an over-allotment option to purchase up to an additional 750,000 shares of our common stock from us, which was not exercised. The offer and sale of all of the shares in the offering were registered under the Securities Act of 1933, as amended, pursuant to a registration statement on Form S-1 (File No. 333-131050), which was declared effective by the SEC on April 11, 2006.

After deducting underwriting discounts and commissions of $3.2 million and other offering expenses of approximately $1.1 million payable by us in connection with the offering, our net proceeds from the offering were approximately $40.8 million. Between April 11, 2006 and December 31, 2006, we used approximately $12.7 million of the net proceeds to fund our operating activities, including activities relating to the development of our clinical and preclinical product candidates, and other general corporate purposes. During this period, our research and development expenses comprised approximately 78% of our operating expenses. The remaining approximately $28.1 million in net proceeds have been deposited in highly rated financial institutions in the United States. We have not used any of the net proceeds of the offering to make payments, directly or indirectly, to any of our directors or officers, to any of their associates, to any person owning ten percent or more of any class of our equity securities, or to any of our affiliates.

There has been no material change in our planned use of proceeds from our initial public offering as described in our final prospectus filed with the SEC pursuant to Rule 424(b).

Item 6. Selected Financial Data.

You should read the following selected financial data together with our financial statements and the related notes included in this annual report and the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of this annual report. The selected financial data in this section are not intended to replace our financial statements.

We derived the statements of operations data for the years ended December 31, 2006, 2005 and 2004 and the balance sheet data as of December 31, 2006 and 2005 from our audited financial statements, which are included in this annual report. We derived the statements of operations data for the years ended December 31, 2003 and 2002 and the balance sheet data as of December 31, 2004, 2003 and 2002 from our audited financial statements not included in this report. Our historical results for any prior period are not necessarily indicative of the results to be expected for any future period. You should read the notes to our financial statements for an explanation of the method used to determine the number of shares used in computing basic and diluted net loss per share.

	Year ended December 31,				
	2002	2003	2004	2005	2006
	(in thousands, except share and per share data)				
Statement of Operations Data:					
Net revenue	$ 2,286	$ 2,458	$ 3,738	$ 1,180	$ 27,538
Operating expenses:					
Research and development	16,244	18,179	22,771	24,252	21,788
General and administrative	4,135	3,600	5,163	4,753	5,696
Transaction charges	—	—	—	1,635	—
Cost of product sales	244	743	198	481	457
Purchased in-process research and development	2,666	—	—	—	—
Total operating expenses	23,289	22,522	28,132	31,121	27,941
Loss from operations	(21,003)	(20,064)	(24,394)	(29,941)	(403)
Interest and dividend income	88	791	505	1,174	2,584
Interest expense	(103)	(122)	(132)	(225)	(84)
Loss on disposal of fixed assets	(54)	—	(4)	—	—
Net (loss) income	(21,072)	(19,395)	(24,025)	(28,992)	2,097
Deemed dividend-beneficial conversion feature for Series C redeemable convertible preferred stock issued December 2004	—	—	(10,312)	—	—
Preferred stock accretion	(4,173)	(8,341)	(8,744)	(11,238)	(3,333)
Net loss attributable to common stockholders	$ (25,245)	$ (27,736)	$ (43,081)	$ (40,230)	$ (1,236)
Basic and diluted net loss per share applicable to common stockholders	$ (339.63)	$ (254.33)	$ (196.53)	$ (153.54)	$ (0.09)
Shares used to compute basic and diluted net loss per share	74,332	109,053	219,213	262,013	13,595,523

	As of December 31,				
	2002	2003	2004	2005	2006
	(in thousands)				
Balance Sheet Data:					
Cash, cash equivalents and short—term investments	$ 49,361	$ 42,977	$ 53,075	$ 24,851	$ 54,190
Working capital	46,685	40,526	50,079	20,531	69,903
Total assets	54,379	47,390	58,204	28,001	81,368
Long-term debt, net of current portion	2,088	1,462	3,443	1,409	816
Redeemable convertible preferred stock	108,026	130,134	171,778	183,628	—
Accumulated deficit	(63,936)	(91,672)	(134,754)	(174,983)	(136,162)
Total stockholders' equity (deficit)	(63,335)	(90,796)	(122,966)	(162,481)	64,999

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion and analysis of our financial condition and results of operations together with our financial statements and the related notes included in this annual report. In addition to historical information, the following discussion contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results, performance or experience could differ materially from those indicated by the forward-looking statements due to important factors, risks and uncertainties, including, but not limited to, those set forth under "Cautionary Note Regarding Forward-Looking Statements" in Part I of this annual report and under "Risk Factors" in Item 1A of Part I of this annual report.

Overview

We are a biopharmaceutical company engaged in the design, discovery and development of NNR Therapeutics, a new class of drugs for the treatment of multiple diseases and disorders of the central nervous system. Our NNR Therapeutics selectively target a class of receptors known as neuronal nicotinic receptors, or NNRs. We have four clinical-stage product candidates and three preclinical product candidates.

Our lead product candidate is a novel small molecule that we have historically referred to as TC-1734 and that our strategic collaborator, AstraZeneca, refers to as AZD3480. In December 2005, we entered into a collaborative research and license agreement with AstraZeneca AB for the development and worldwide commercialization of AZD3480 (TC-1734) as a treatment for Alzheimer's disease, cognitive deficits in schizophrenia and potentially other conditions characterized by cognitive impairment such as ADHD, AAMI and MCI. We currently expect that AstraZeneca will initiate two Phase II clinical trials of AZD3480 (TC-1734) in mid-2007, one in mild to moderate Alzheimer's disease and one in cognitive deficits in schizophrenia, and that both trials will be completed by the end of 2008.

Our most advanced product candidates, in addition to AZD3480 (TC-1734), are described below.

- *TC-2216*. TC-2216 is a product candidate that we are developing as a monotherapy for depression and anxiety disorders. We are currently conducting Phase I single rising dose clinical trial of TC-2216 to evaluate its safety and tolerability and to assess its pharmacokinetic profile in healthy volunteers.
- *Mecamylamine hydrochloride and TC-5214*. In 2006, we completed a Phase II clinical trial of mecamylamine hydrochloride as an augmentation treatment to citalopram hydrobromide, a commonly prescribed treatment for depression marketed as Celexa in the United States, for major depression. We refer to this treatment combination as TRIDMAC. Mecamylamine hydrochloride is the active ingredient in Inversine, our only product approved by the U.S. Food and Drug Administration, or FDA, for marketing. TC-5214 is one of the enantiomers of mecamylamine hydrochloride. We have not yet conducted a clinical trial of TC-5214, but expect that we will elect to advance TC-5214 into clinical development as an augmentation treatment for major depression in lieu of further development of mecamylamine hydrochloride.
- *TC-2696.* TC-2696 is a product candidate that we are developing currently as a treatment for acute post-operative pain. We are conducting an ongoing Phase II clinical trial of TC-2696 to assess its pain relieving effects in third molar extraction patients.
- *TC-5619.* TC-5619 is a preclinical product candidate selective for the a7 NNR. We believe compounds that selectively target the a7 NNR may have application in the treatment of conditions such as schizophrenia, cognitive impairment and inflammation. We are currently conducting additional preclinical studies necessary to support a regulatory filing planned for the second quarter of 2007 to initiate clinical development of TC-5619.
- *TC-6499.* TC-6499 is a preclinical product candidate that we are developing currently as a treatment for one or more classes of pain. We are currently conducting manufacturing activities necessary to support the initiation of clinical development of this product candidate.

We trace our scientific lineage to a research program initiated by R.J. Reynolds Tobacco Company in 1982 to study the activity and effects of nicotine in the body and the function of nicotinic receptors. We were incorporated in 1997 as a wholly owned subsidiary of RJR. In August 2000, we became an independent company when we issued and sold stock to venture capital investors. Since our inception, we have had limited revenue from product sales and have funded our operations principally through the sale of equity securities, revenue from collaboration agreements and equipment and building lease incentive financing. We have devoted substantially all of our resources to the discovery and development of our product candidates and technologies, including the design, conduct and management of preclinical and clinical studies and related manufacturing, regulatory and clinical affairs, as well as intellectual property prosecution.

We acquired rights to Inversine in August 2002. Inversine is approved for the management of moderately severe to severe essential hypertension, a high blood pressure disorder. However, we believe that Inversine is prescribed predominantly for the treatment of neuropsychiatric disorders, such as Tourette's syndrome, autism and bipolar disorder. Sales of Inversine generated net revenue of $585,000 for the year ended December 31, 2006, $681,000 for the year ended December 31, 2005 and $767,000 for the year ended December 31, 2004.

We generated net income for the fourth quarter and year ended December 31, 2006 due primarily to the recognition of revenue derived under our agreement with AstraZeneca. Except for these periods, we have never been profitable. As of December 31, 2006, we had an accumulated deficit of $136.2 million. We expect to incur substantial losses for the foreseeable future. We expect our research and development expenses to increase substantially over the next several years as we expand our clinical trial activity, as our product candidates advance through the development cycle, as product candidates that arise out of our preclinical research collaboration with AstraZeneca progress and as we invest in additional product opportunities and research programs and expand our research and development infrastructure. Clinical trials and preclinical studies are time-consuming, expensive and may never yield a product that will generate revenue. A substantial portion of our revenue for the next several years will depend on the conduct of research and the successful achievement of milestone events in the development of AZD3480 (TC-1734) under our agreement with AstraZeneca. Our revenue may vary substantially from quarter to quarter and year to year. We believe that period-to-period comparisons of our results of operations are not meaningful and should not be relied upon as indicative of our future performance.

Critical Accounting Policies and Estimates

Our management's discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an ongoing basis, we evaluate these estimates and judgments, including those described below. We base our estimates on historical experience and on various assumptions that we believe to be reasonable under the circumstances. These estimates and assumptions form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results and experiences may differ materially from these estimates. In addition, our reported financial condition and results of operations could vary if new accounting standards are enacted that are applicable to our business.

Our significant accounting policies are described in Note 2 to our audited financial statements for the year ended December 31, 2006 included in this annual report. We believe that our accounting policies relating to revenue recognition, accrued expenses and stock-based compensation are the most critical to understanding and evaluating our reported financial results. We have identified these policies as critical because they both are important to the presentation of our financial condition and results of operations and require us to make judgments and estimates on matters that are inherently uncertain and may change in future periods. For more information regarding these policies, you should refer to Note 2 to our audited financial statements included in this annual report.

Revenue Recognition

We use revenue recognition criteria in Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements* (SAB 101), as amended by Staff Accounting Bulletin No. 104, *Revision of Topic 13* (SAB 104). We derive a substantial portion of our revenues from our collaboration agreement with AstraZeneca and expect that we will continue to derive a substantial portion of our revenues from collaboration agreements over at least the next several years.

Collaboration agreements may contain multiple elements, including upfront fees, research fees for ongoing research and development, payments associated with achieving development, regulatory and first commercial sale milestones and royalties to be paid based on specified percentages of net product sales or net profits, if any. In determining the accounting for collaboration agreements, we follow the provisions of Emerging Issues Task Force Issue 00-21, *Revenue Arrangements with Multiple Deliverables*, or EITF 00-21. EITF provides guidance on whether an arrangement involves a single unit of accounting or separate units of accounting for revenue recognition purposes and, if separate units, how to allocate amounts received in the arrangement. If a collaboration agreement involves separate units of accounting, we determine a revenue recognition policy for each unit.

We recognize research fee revenue from research services performed under our collaboration agreements as research is performed and related expenses are incurred. We defer recognition of non-refundable upfront fees and amortize them over the estimated research and development period. The estimated research and development period may be adjusted from time to time to take into account any delays or acceleration in the development of the applicable product candidate or any extension or shortening of the applicable performance period. Any such delay or acceleration in the development of a product candidate, or extension or shortening of a performance period, could result in further deferral of revenue or in the acceleration of revenue previously deferred.

We recognize revenue for non-refundable payments that are based on the achievement of development and regulatory milestones upon achievement of the milestone event if all of the following conditions are met:

- achievement of the milestone event was not reasonably assured at the inception of the arrangement;
- substantive effort is involved to achieve the milestone event; and
- the amount of the milestone payment appears reasonable in relation to the effort expended, the other milestone payments in the arrangement and the related risk associated with achievement of the milestone event.

If any of these conditions are not met, we would recognize the portion of the milestone payment that corresponds to work performed as revenue upon receipt and defer recognition of the remaining portion until the performance obligations are completed.

Under our collaboration agreement with AstraZeneca, we received an initial fee of $10.0 million in February 2006. Based on the agreement terms and consideration of fair value, we allocated $5.0 million of the initial fee to the a4ß2 research collaboration, which we expect to recognize as revenue over the planned four-year term of the research collaboration. We deferred recognition of the remaining $5.0 million of the initial fee, which we allocated to the AZD3480 (TC-1734) license grants, until AstraZeneca made its determination in December 2006 to proceed with further development of AZD3480 (TC-1734). Beginning in January 2007, we commenced recognition of the previously deferred $5.0 million of the initial fee ratably over the expected five-year development period for AZD3480 (TC-1734).

In December 2006, AstraZeneca communicated to us its determination to proceed with further development of AZD3480 (TC-1734), triggering a $20.0 million milestone payment to us. Based on the criteria of SAB 101, we recognized this amount as revenue in the fourth quarter of 2006. We received the milestone payment in January 2007.

We recorded research fees that we received from AstraZeneca during 2006 while it conducted additional clinical and non-clinical studies of AZD3480 (TC-1734) as deferred revenue. Following AstraZeneca's determination in December 2006 to proceed with further development of AZD3480 (TC-1734), we recognized all research fees that were previously recorded as deferred revenue and expect to recognize future research fee revenue as the research is performed and related expenses are incurred.

We recognize revenue for specific research and development costs that are reimbursable under our agreement with AstraZeneca, such as third-party manufacturing costs for drug material, in accordance with Emerging Issues Task Force, or EITF, Issue 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*, and EITF Issue 01-14, *Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred*. We reflect the revenue associated with these reimbursable amounts as a component of collaboration revenue and we reflect the costs associated with these reimbursable amounts as a component of research and development expenses.

Accrued Expenses

As part of the process of preparing financial statements, we are required to estimate accrued expenses. This process involves reviewing open contracts and purchase orders, communicating with our applicable personnel to identify services that have been performed on our behalf and estimating the level of service performed and the associated cost incurred for the service when we have not yet been invoiced or otherwise notified of actual cost. The majority of our service providers invoice us monthly in arrears for services performed. We make estimates of our accrued expenses as of each balance sheet date in our financial statements based on facts and circumstances known to us. We periodically confirm the accuracy of our estimates with the service providers and make adjustments if necessary. Examples of estimated accrued expenses include:

- fees paid to contract research organizations in connection with preclinical and toxicology studies and clinical trials;
- fees paid to investigative sites in connection with clinical trials;
- fees paid to contract manufacturers in connection with the production of clinical trial materials and Inversine; and
- professional service fees.

We base our expenses related to clinical trials on our estimates of the services received and efforts expended pursuant to contracts with multiple research institutions and clinical research organizations that conduct or manage clinical trials on our behalf or with contract manufacturers that produce clinical trial material. The financial terms of these agreements are subject to negotiation, vary from contract to contract and may result in uneven payment flows. Payments under some of these contracts depend on factors such as the enrollment of subjects, the completion of clinical trial milestones and the production of drug substance or drug product. In accruing service fees, we estimate the time period over which services will be performed and the level of effort to be expended in each period. If the actual timing of the performance of services or the level of effort varies from our estimate, we will adjust the accrual accordingly. If we do not identify costs that we have begun to incur or if we underestimate or overestimate the level of services performed or the costs of these services, our actual expenses could differ from our estimates.

Stock-Based Compensation

Effective January 1, 2005, we adopted Statement of Financial Accounting Standard No. 123(R), *Share-Based Payment*, or SFAS 123R. Under SFAS 123R, we recognize the grant-date fair value of stock options and other stock-based compensation issued to employees and non-employee directors over the requisite service periods, which are typically the vesting periods. We currently use the Black-Scholes-Merton formula to estimate grant-date fair value and expect to continue to use this valuation model in the future. We adopted SFAS 123R

using the modified-prospective-transition method, which required us to record compensation expense for the non-vested portion of previously issued awards that were outstanding at January 1, 2005, and any awards issued or modified after January 1, 2005. We recorded stock-based compensation expense related to stock options granted to employees and directors of $919,000 for the year ended December 31, 2006 and $690,000 for the year ended December 31, 2005. As of December 31, 2006, we had $3.5 million in total unrecognized compensation cost related to non-vested stock-based compensation arrangements, which we expect to recognize over a weighted average period of 1.6 years.

Because there was no established market for our common stock prior to our initial public offering in April 2006, the fair value of our common stock underlying stock options and other stock-based compensation granted to employees and non-employee directors has historically been determined by our board of directors based upon information available as of the grant dates. We engaged an independent valuation firm in January 2006 to perform a retrospective analysis to determine the deemed fair market value of our common stock as of March 31, 2005 for accounting purposes. This retrospective analysis relied on income-based and market-based valuation methodologies. The independent valuation firm determined the fair market value of our common stock as of March 31, 2005 to be $1.60 per share.

For all periods prior to January 1, 2005, we accounted for our employee stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25 and related interpretations, or APB 25. Under APB 25, we recognized compensation expense for stock options granted to employees and non-employee directors only if the exercise price was below the fair market value of the underlying common stock on the date of grant. We recognized this compensation expense over the vesting periods of the shares purchasable upon exercise of options. We recorded deferred stock-based compensation related to stock options granted to employees and directors of $51,000 for the year ended December 31, 2004. We amortized our deferred stock-based compensation on a straight-line basis over the related option vesting periods, which range from immediate vesting to four years.

As required by Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, or SFAS 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*, our financial statement footnotes disclose on a pro forma basis the amount of compensation expense that we would have recorded for periods prior to January 1, 2005, had we applied the fair value option methodology described in SFAS 123. Had we recorded all of our stock-based compensation using the SFAS 123 fair value methodology, our compensation expense would have been approximately $866,000 greater and our diluted net loss per share attributable to common stockholders would have been approximately $3.95 greater for the year ended December 31, 2004.

Financial Operations Overview

Revenue

Our collaboration agreement with AstraZeneca became effective in January 2006. AstraZeneca paid us an initial fee of $10.0 million in February 2006, and an additional $20.0 million in January 2007 as a result of its determination in December 2006 to proceed with further development of AZD3480 (TC-1734). We are eligible to receive other payments of up to $249.0 million, contingent upon the achievement of development, regulatory and first commercial sale milestones for AZD3480 (TC-1734) for Alzheimer’s disease, cognitive deficits in schizophrenia and ADHD, and royalties on future product sales. If AZD3480 (TC-1734) is developed under the agreement for other indications characterized by cognitive impairment, we would also be eligible to receive payments contingent upon the achievement of development, regulatory and first commercial sale milestones for AZD3480 (TC-1734) for those indications. Under the terms of a sponsored research agreement and a subsequent license agreement between us and the University of Kentucky Research Foundation, or UKRF, we are required to pay to UKRF a low single digit percentage of any of these amounts that we receive from AstraZeneca. As a result, we paid UKRF $758,000 in January 2007.

We and AstraZeneca are conducting a preclinical research collaboration that is designed to discover and develop additional compounds that, like AZD3480 (TC-1734), act on the NNR known as a4ß2. Under the terms of our agreement, AstraZeneca has agreed to pay us research fees based on an agreed reimbursement rate for research services rendered, subject to specified limits. Through December 31, 2006, we had generated $4.7 million in research fees under the agreement. Based on the current budget for the a4ß2 research collaboration, we expect to receive approximately $21.7 million in additional aggregate research fees over the remaining three years of the planned four-year research term.

Inversine is our only approved product. Sales of Inversine generated net revenue of $585,000 for the year ended December 31, 2006, $681,000 for the year ended December 31, 2005 and $767,000 for the year ended December 31, 2004. We do not have or use a sales force or promote Inversine. Accordingly, we do not anticipate any significant increase in Inversine sales. If any of the very limited number of physicians that most often prescribe Inversine were to cease to do so, our revenue generated by Inversine sales would likely be substantially less. We have no other commercial products for sale and do not anticipate that we will have any other commercial products for sale for at least the next several years.

In 2003, we were awarded a cooperative agreement from the National Institute of Standards and Technology through its Advanced Technology Program. Under the agreement, we received $1.8 million over a three-year period that concluded in the second half of 2006 to help fund the development of sophisticated new computer simulation software designed to more accurately predict biological and toxicological effects of drugs. In addition, we are a named subcontractor under a grant awarded to The California Institute of Technology by the National Institute on Drug Abuse, part of the National Institutes of Health, to fund research on innovative NNR-based approaches to the development of therapies for smoking cessation. We currently expect to receive approximately $1.1 million in the aggregate over a five-year period that began in July 2006. We recognize grant revenue as we perform the work and incur reimbursable costs. Funding for awards under federal grant programs is subject to the availability of funds as determined annually in the federal appropriations process.

Research and Development Expenses

Since our inception, we have focused our activities on our drug discovery and development programs. We expense research and development expenses as they are incurred. Research and development expenses represented approximately 78% of our total operating expenses for both the years ended December 31, 2006 and 2005 and 81% of our total operating expenses for the year ended December 31, 2004.

Research and development expenses include expenses associated with:

- the employment of personnel involved in our drug discovery and development activities;
- research and development facilities and equipment;
- costs to conduct research activities under the a4ß2 research collaboration with AstraZeneca;
- the screening, identification and optimization of product candidates;
- the development and enhancement of our proprietary databases and computer-based molecular design technologies, which we refer to collectively as Pentad;
- formulation and chemical development;
- production of clinical materials, including fees paid to contract manufacturers;
- preclinical animal studies, including the costs to engage third-party research organizations;
- clinical trials, including fees paid to contract research organizations to monitor and oversee some of our trials;
- quality assurance activities;
- compliance with FDA regulatory requirements;

- consulting, license and sponsored research fees paid to third parties;
- depreciation of capital assets used to develop our products; and
- stock options or other stock-based compensation granted to personnel in research and development functions.

We use our employee and infrastructure resources across several programs. We currently have clinical, preclinical and early research programs ongoing, and many of our costs are not specifically attributable to a single program. Instead, these costs are directed to broadly applicable research efforts. Accordingly, we do not account for internal research and development costs on a program-by-program basis. As a result, we cannot state precisely the total costs incurred for each of our clinical and preclinical programs on a program-by-program basis.

The following table shows, for the periods presented, total payments that we made to third parties for preclinical study support, clinical supplies and clinical trial services for our most advanced product candidates, AZD3480 (TC-1734), TC-2216, mecamylamine hydrochloride, TC-2696 and TC-5619.

	Year ended December 31,		
Product Candidate	**2004**	**2005**	**2006**
		(in thousands)	
AZD3480 (TC-1734)	$ 4,135	$ 6,713	$ 209
TC-2216	—	903	1,691
Mecamylamine hydrochloride	—	1,067	555
TC-2696	1,145	879	891
TC-5619	—	—	903
	$ 5,280	$ 9,562	$ 4,249

We did not make any payments to third parties in respect of the development of TC-5214 or TC-6499 during the periods presented above. However, we currently expect that we will begin to incur development expenses for one or both of TC-5214 or TC-6499 in 2007.

At the end of 2004, we discontinued the development of mecamylamine hydrochloride for attention deficit hyperactivity disorder and another of our product candidates for ulcerative colitis following the completion of Phase II clinical trials. We made total payments to third parties of $0 for the year ended December 31, 2006, $83,000 for the year ended December 31, 2005 and $4.3 million for the year ended December 31, 2004 in connection with these discontinued programs.

Our expenditures on current and future preclinical and clinical development programs are subject to numerous uncertainties in timing and cost to completion. We test compounds in numerous preclinical studies for safety, toxicology and efficacy. We then conduct clinical trials for those product candidates that we determine to be the most promising. If we do not establish a collaboration covering the development of a particular product candidate, we fund these trials ourselves. As we obtain results from clinical trials, we may elect to discontinue or delay trials for some product candidates in order to focus our resources on more promising product candidates. Completion of clinical trials by us or our collaborators may take several years or more, but the length of time generally varies substantially according to the type, complexity, novelty and intended use of a product candidate. The cost of clinical trials may vary significantly over the life of a program as a result of a variety of factors, including:

- the number of patients who participate in the trials;
- the number and locations of sites included in the trials;
- the length of time required to enroll trial participants;
- the duration of patient follow-up;

- the costs of producing supplies of the product candidates needed for clinical trials and regulatory submissions;
- the efficacy and safety profile of the product candidate; and
- the costs and timing of, and the ability to secure, regulatory approvals.

We have not received FDA or foreign regulatory marketing approval for any of our product candidates that are in development. In order to achieve marketing approval, the FDA or foreign regulatory agencies must conclude that our or our collaborators' clinical data establishes the safety and efficacy of the product candidates. Furthermore, our strategy includes entering into collaborations with third parties to participate in the development and commercialization of some of our product candidates. In situations in which third parties have decision-making authority over the preclinical development or clinical trial process for a product candidate, the estimated completion date is largely under control of that third party and not under our control. We cannot forecast with any degree of certainty which of our product candidates will be subject to future collaborations or how such arrangements would affect our development plans or capital requirements.

As a result of the uncertainties discussed above, we are unable to determine the duration and completion costs of our research and development programs or whether or when we will generate revenue from the commercialization and sale of any of our development stage product candidates. Our failure to complete our research and development programs would likely have a material adverse effect on our financial position and results of operations.

General and Administrative Expenses

General and administrative expenses consist principally of salaries and other related costs for personnel in executive, finance, accounting, business development and human resource functions. Other general and administrative expenses include expenses associated with stock options and other stock-based compensation granted to personnel in those functions, facility costs not otherwise included in research and development expenses, patent related costs, and professional fees for consulting, legal and accounting services.

Cost of Product Sales

Cost of product sales are those costs related directly to the sale of Inversine and are principally comprised of cost of goods sold, FDA product and establishment fees, distribution expenses, product royalty obligations and product liability insurance.

Interest Income

Interest income consists of interest earned on our cash, cash equivalents and short-term investments.

Interest Expense

Interest expense consists of interest incurred on our indebtedness, which has been primarily to finance equipment, office furniture and fixtures.

Income Taxes

We generated net income for the year ended December 31, 2006 due primarily to the recognition of revenue derived under our agreement with AstraZeneca. We have incurred net operating losses for each other year since inception and consequently have not paid federal, state or foreign income taxes in any period. As of December 31, 2006, we had net operating loss carryforwards of approximately $94.6 million for each of federal and state income tax purposes. We also had $2.8 million in research and development federal income tax credits

as of December 31, 2006. Utilization of the net operating loss carryforwards and credits may be subject to a substantial annual limitation due to ownership change limitations provided by Section 382 of the Internal Revenue Code of 1986, as amended, and similar state provisions. When an ownership change, as defined by Section 382, occurs, an annual limitation is imposed on a company's use of net operating loss and credit carryforwards attributable to periods before the change. For financial reporting purposes, we have recorded a valuation allowance to fully offset the deferred tax asset related to these carryforwards because realization of the benefit is uncertain.

Results of Operations

Years ended December 31, 2006 and December 31, 2005

Revenue

Revenue increased by $26.3 million to $27.5 million for the year ended December 31, 2006, from $1.2 million for 2005. The increase was primarily attributable to $26.2 million in revenue derived under our agreement with AstraZeneca that became effective in January 2006. We had no collaboration-based revenue for 2005. The revenue derived under our AstraZeneca agreement and recognized in 2006 included the following components.

- We recognized milestone-based revenue of $20.0 million as a result of the determination communicated to us by AstraZeneca in December 2006 to proceed with further development of AZD3480 (TC-1734), which triggered a $20.0 million milestone payment that we received in January 2007. Based on the current development plans for AZD3480 (TC-1734), we do not currently expect to achieve any milestone events under the agreement during 2007.
- We recognized research fee revenue of $4.7 million for services rendered by us to AstraZeneca pursuant to an agreed research plan for the preclinical research collaboration that we and AstraZeneca are conducting. Based on the objectives and budget for the preclinical research collaboration for 2007, we currently anticipate that our research fee revenue generated under the agreement will increase substantially in 2007 as compared to 2006.
- We recognized $1.1 million of the $10.0 million initial fee that we received in February 2006 from AstraZeneca. We have recorded the remaining $8.9 million of the initial fee as deferred revenue. As described above, based on the agreement terms, we allocated $5.0 million of the initial fee to the a4ß2 research collaboration, which we expect to recognize as license fee revenue over the planned four-year term of the research collaboration. We began to recognize this allocated portion of the initial fee as license fee revenue in February 2006 at the rate of $104,000 per month. We deferred recognition of any of the remaining $5.0 million of the initial fee, which we allocated to the AZD3480 (TC-1734) license grants, until AstraZeneca made its determination in December 2006 to proceed with further development of AZD3480 (TC-1734) following the completion of additional clinical and non-clinical studies that AstraZeneca conducted during 2006. We expect to recognize the previously deferred amount over the expected five-year development period for AZD3480 (TC-1734), beginning in January 2007 at a rate of $83,000 per month.
- We recognized revenue of $347,000 in connection with payments that we made to third parties for research and manufacturing services that are reimbursable under the agreement.

In future periods, we are eligible to receive additional research fees, license fees and milestone payments under our collaboration agreement with AstraZeneca. The amount of research fees, license fees and milestone fees will depend on the extent of our research activities and the timing and achievement of development, regulatory and first commercial sale milestone events.

Grant revenue increased by $288,000 to $787,000 for the year ended December 31, 2006, from $499,000 for 2005. The grant revenue for 2006 related to work performed under the cooperative agreement awarded to us in

2003 by the National Institute of Standards and Technology through its Advanced Technology Program, or ATP, to fund the development of sophisticated molecular simulation software and to work performed in connection with our subcontract under the grant awarded to The California Institute of Technology by the National Institute on Drug Abuse, or NIDA, part of the National Institutes of Health, to fund research on innovative NNR-based approaches to the development of therapies for smoking cessation. In contrast, the grant revenue for 2005 related only to work performed in connection with the ATP award. The increase for 2006 reflects $98,000 in additional research activity by us under the cooperative agreement and revenue of $190,000 for work performed in connection with the NIDA grant. The term of the ATP award expired September 30, 2006. Due to the expiration of the term of the ATP award, we expect that our grant revenue will decrease in future periods.

Net sales of Inversine decreased by $96,000 to $585,000 for the year ended December 31, 2006, from $681,000 for 2005. This decrease resulted from a reduction in the volume of sales of Inversine. We believe that the substantial majority of Inversine sales are derived from prescriptions written by a very limited number of physicians. If any of these physicians were to change their prescribing habits, it would likely cause sales of Inversine to decrease. We do not promote sales of Inversine.

Research and Development Expenses

Research and development expenses decreased by $2.5 million to $21.8 million for the year ended December 31, 2006, from $24.3 million for 2005. The reduction in research and development expenses was primarily attributable to a decrease of $6.5 million in research and development expenses relating to AZD3480 (TC-1734) for 2006 as a result of the assumption by AstraZeneca of development costs for that product candidate under our collaboration agreement, partially offset by an increase in research and development expenses relating to TC-2216 and TC-5619 of $788,000 and $903,000, respectively, for 2006 to conduct additional preclinical safety studies and formulation work. The decrease was also partially offset by increased salary and benefit expenses for research and development personnel for 2006 and increased third-party service, supply and infrastructure costs incurred in connection with our a4ß2 research collaboration with AstraZeneca that we initiated in January 2006. Our research activities during 2006 generated $4.7 million in research fee revenue from AstraZeneca.

For the year ended December 31, 2006, we estimate that approximately 1% of our total research and development expenses were payments made to third parties in connection with our development of AZD3480 (TC-1734), 4% were payments made to third parties in connection with our development of TC-2696, 8% were payments made to third parties in connection with our development of TC-2216, 2.5% were payments made to third parties in connection with our development of mecamylamine hydrochloride and 4% were payments made to third parties in connection with our development of TC-5619. We spent the remaining 80.5% of our total research and development expenses on salaries, benefits and infrastructure costs associated with our internal research and development capabilities, including clinical programs, preclinical programs and research efforts, and on payments to third parties in connection with preclinical programs.

We expect our research and development expenses to increase substantially over the next several years as we expand our clinical trial activity, as our product candidates advance through the development cycle, as product candidates that arise out of our preclinical research collaboration with AstraZeneca progress and as we invest in additional product opportunities and research programs and expand our research and development infrastructure. In particular, we currently expect that, for 2007, our research and development expenses will increase substantially as compared to 2006 as a result of the conduct of a Phase I clinical trial of TC-2216, which we initiated in December 2006, and a Phase II clinical trial of TC-2696, which we initiated in January 2007, the currently expected initiation of clinical development of TC-5619, and non-clinical and manufacturing work that we are conducting for TC-5214 and TC-6499 in anticipation of their potential future development.

General and Administrative Expenses

General and administrative expenses increased by $900,000 to $5.7 million for the year ended December 31, 2006, from $4.8 million for 2005. The increase was principally attributable to higher awards made in 2006 under our annual cash incentive bonus program. We expect that our general and administrative expenses will increase in 2007 due to increased payroll, expanded infrastructure and increased insurance, consulting, legal, accounting and investor relations costs associated with being a public company for a full year. We completed our initial public offering in April 2006.

Transaction Charge

During the year ended December 31, 2005 we recorded expense of $1.6 million in connection with a public offering that we terminated in March 2005. There were no similar expenses for the 2006 period as all costs that we incurred in connection with our initial public offering that we completed in April 2006 were recorded as prepaid expenses pending the completion of the offering and were offset against the proceeds from the offering upon completion.

Cost of Product Sales

For the year ended December 31, 2006, our cost of product sales decreased by $24,000 to $457,000 from $481,000 for 2005. All of these costs related to sales of Inversine.

The FDA assesses product and establishment fees for marketed products each year for the twelve-month period beginning October 1. Payment is required in advance, but companies can request a waiver after making payment. In assessing waiver requests, the FDA considers whether the company is pursuing innovative drug products or technology and whether the fees would present a significant barrier to the company's ability to develop, manufacture or market innovative drug products or technology. We have historically requested a waiver of the FDA fees with respect to Inversine. We pay the fees, record our payment as a prepaid item and then recognize the prepaid amount as cost of product sales ratably over the twelve-month period. If the FDA grants our waiver, we receive a refund of the fees, which has historically occurred in the year following the year in which they are paid. If that occurs, we cease recognizing the fees for the remainder of that twelve-month period and record a credit to cost of product sales equal to the amount previously recognized. Although the FDA granted our request for waivers of both the product and establishment fees that we paid in 2004 and our request for a waiver of the establishment fees that we paid in 2005, the FDA denied our request for a waiver of $42,000 in product fees that we paid in 2005. As permitted by the FDA, we have requested a reconsideration of our request for a waiver of the product fees that we paid in 2005 with respect to Inversine.

We have petitioned the FDA for a waiver of the product and establishment fees that were assessed by the FDA and paid by us in 2006 and plan to petition again in future years. Historically, the award that we received from the National Institute of Standards and Technology through its Advanced Technology Program to fund the development of sophisticated molecular simulation software has been significant in supporting our waiver requests. Our funding under the award concluded in the third quarter of 2006, and the likelihood that our pending or future waiver requests will be allowed is uncertain. If our pending waiver and reconsideration requests are not granted, our cost of product sales for 2007 would increase by approximately $189,000.

Interest and Dividend Income

Interest income increased by $1.4 million to $2.6 million for the year ended December 31, 2006, from $1.2 million for 2005. The increase was attributable to a substantially higher average cash balance during 2006 following completion of our initial public offering in April 2006 and, to a lesser extent, higher short-term interest rates.

Interest Expense

Interest expense decreased by $141,000 to $84,000 for the year ended December 31, 2006, from $225,000 for 2005. The decrease was attributable to reduced indebtedness in 2006 resulting from our payment in August 2005 of the outstanding balance on a $1.3 million convertible promissory note to The Stanley Medical Research Institute and a lower principal balance under a loan facility used to finance laboratory and other capital equipment purchases.

In June 2006, we amended our existing loan facility to provide us with an additional $2.0 million in aggregate borrowing capacity available to us on or before June 30, 2007. As of December 31, 2006, we have not yet made draws against this additional borrowing capacity, but expect to do so during the first half of 2007. Additionally, beginning in April 2007 following expiration of a five-year grace period, we will begin to recognize interest expense on a $500,000 loan from the City of Winston-Salem. We expect that these items will increase our interest expense beginning in 2007.

Years ended December 31, 2005 and December 31, 2004

Revenue

Revenue decreased by $2.6 million, or 68%, to $1.2 million for the year ended December 31, 2005, from $3.7 million for 2004. The decrease was primarily attributable to our recognition in 2004 of $1.9 million in license fee revenue that we derived under collaboration agreements with Aventis Pharma SA and Dr. Falk Pharma GmbH that have since been terminated. Because we concluded our research obligations under our collaboration agreements with both Aventis and Dr. Falk Pharma in the fourth quarter of 2004, we recognized the remaining unamortized deferred upfront license fee balance at that time and recognized no license fee revenue for 2005. The decrease in revenue for 2005 was also attributable in part to the conclusion at the end of 2004 of our research activities under our collaboration agreement with Aventis, from which we derived $338,000 in research fees in 2004 and no research fee revenue in 2005.

Grant revenue decreased to $499,000 in 2005, from $717,000 for 2004. The grant revenue in both periods resulted from work performed in connection with the ATP award. The ATP award was structured to provide a greater amount of funding in 2004 to enable us to purchase hardware and software required to carry out the cooperative agreement activities.

Net sales of Inversine decreased by $86,000 to $681,000 for the year ended December 31, 2005, from $767,000 for 2004. This decrease resulted from a reduction in the volume of sales of Inversine.

Research and Development Expenses

Research and development expenses increased by $1.5 million, or 7%, to $24.3 million for the year ended December 31, 2005, from $22.8 million for 2004. The increase was principally attributable to an increase of $2.6 million in expenses related to the clinical development, formulation and manufacturing of AZD3480 (TC-1734), an increase of $1.1 million in clinical development expenses for mecamylamine hydrochloride, an increase of $608,000 in expenses related to the preclinical development of TC-2216 and other preclinical programs and an increase of $1.7 million in salaries and infrastructure costs for 2005. The increase in research and development salaries and infrastructure costs includes $458,000 of non-cash stock-based employee compensation charges attributable to our adoption of SFAS 123R as of January 1, 2005. There were no stock-based employee compensation charges included in our research and development expenses for 2004. These increases were partially offset by a decrease in external costs resulting from our discontinuation in the fourth quarter of 2004 of clinical programs for two of our product candidates. One of these candidates, which was in development for the treatment of ADHD, resulted in a decrease in external costs of $2.3 million for 2005. The other product candidate, which was in development for the treatment of ulcerative colitis, resulted in a decrease in external costs of $1.9 million for 2005.

For the year ended December 31, 2005, we estimate that approximately 28% of our total research and development expenses were payments made to third parties in connection with our development of AZD3480 (TC-1734), 4% were payments made to third parties in connection with our development of TC-2696, 7% were payments made to third parties in connection with our development of TC-2216 and 4% were payments made to third parties in connection with our development of mecamylamine hydrochloride. We spent the remaining 57% of our total research and development expenses on salaries, benefits and infrastructure costs associated with our internal research and development capabilities, including clinical programs, preclinical programs and research efforts, and on payments to third parties in connection with preclinical programs.

General and Administrative Expenses

General and administrative expenses decreased by $400,000 to $4.8 million for the year ended December 31, 2005, from $5.2 million for 2004. This decrease was primarily attributable to lower infrastructure and personnel costs for our general and administrative activities and lower professional fees and travel costs in connection with business development pursuits in 2005, partially offset by an additional $182,000 in non-cash stock-based compensation charges in 2005 attributable to our adoption of SFAS 123R as of January 1, 2005.

Transaction Charge

During the year ended December 31, 2005 we recorded expense of $1.6 million in connection with a public offering that we terminated in March 2005. There were no similar expenses for the 2004 period.

Cost of Product Sales

Cost of product sales increased by $283,000 to $481,000 for the year ended December 31, 2005, from $198,000 for 2004. All of these costs related to sales of Inversine. The increase in cost of product sales for 2005 resulted primarily from our receipt of a refund in 2005 of the FDA fees for 2004, as compared to our receipt of a refund in 2004 of the FDA fees for both 2003 and 2002.

Interest and Dividend Income

Interest and dividend income increased by $669,000 to $1.2 million for the year ended December 31, 2005, from $505,000 for 2004. The increase was attributable to substantially higher short-term interest rates and higher average levels of cash and short-term investments during 2005 resulting from the issuance and sale of shares of our convertible preferred stock on December 6, 2004 for net proceeds of $32.9 million.

Interest Expense

Interest expense increased by $92,000 to $225,000 for the year ended December 31, 2005, from $133,000 for 2004. This increase is attributable to higher indebtedness under a credit facility used to finance capital equipment purchases, primarily laboratory equipment. The higher indebtedness resulted from our borrowing an additional $973,000 under this facility in December 2004.

Liquidity and Capital Resources

Sources of Liquidity

From August 2000 when we became an independent company until completion of our initial public offering in April 2006, we financed our operations and internal growth primarily through private placements of convertible preferred stock. We derived aggregate net proceeds of $121.8 million from these private placements. In April 2006, we completed an initial public offering of our common stock, consisting of 5.0 million shares of our common stock at a price of $9.00 per share. After deducting underwriting discounts and commissions and

other offering expenses, our net proceeds from the offering were $40.8 million. We have also received additional funding from upfront license fees and payments for research and development services under collaboration agreements, equipment and building lease incentive financing, government grants and interest income. We began generating revenue from product sales of Inversine in December 2002. To date, the net contribution from Inversine sales has not been a significant source of cash and we do not expect it to be a significant source in the future.

In December 2005, we entered into a collaboration agreement with AstraZeneca relating to AZD3480 (TC-1734). In January 2006, the agreement became effective and we began conducting research for which we are eligible to receive research fees. AstraZeneca paid us an initial fee of $10.0 million in February 2006 and an additional $20.0 million in January 2007 as a result of its determination to proceed with further development of AZD3480 (TC-1734) following the completion of additional clinical and non-clinical studies that it conducted during 2006.

In May 2002, we borrowed $2.5 million from R.J. Reynolds Tobacco Holdings, Inc. to finance equipment and other fixed assets that we had previously purchased. This borrowing was paid and satisfied in full in May 2006. In January 2004, we amended the terms of the facility to permit us to borrow up to an additional $2.0 million in 2004 in up to three separate borrowings. We borrowed $1.0 million in April 2004 and $973,000 in December 2004 under the amended facility to finance equipment. The April 2004 borrowing bears a fixed interest rate of 5.87%, is payable in 48 equal monthly installments and matures in April 2008. The December 2004 borrowing bears a fixed interest rate of 6.89%, is payable in 48 monthly installments and matures in January 2009. In June 2006, we further amended the facility to permit us to borrow an additional $2.0 million on or before June 30, 2007 in up to three separate borrowings. Each borrowing would accrue interest at a per annum rate that approximates the hypothetical four-year U.S. Treasury rate, determined as of the date of the borrowing, plus 2.5% and be payable in equal monthly installments of principal and accrued interest over 48 months beginning on the first day of the month following the borrowing. All borrowings under the facility are, and all future borrowings under the facility will be, secured by specified tangible fixed assets determined sufficient by the lender at the time of disbursement. As of December 31, 2006, the outstanding principal balance under the loan facility was $909,000.

In April 2002, we received a $500,000 loan from the City of Winston-Salem. Under the terms of this borrowing, there is no interest accrual or payment due until the fifth anniversary of the loan. Beginning in April 2007, following expiration of the five-year grace period, the outstanding principal balance of the loan will bear interest at an interest rate of 5% and the loan will be payable in 60 equal monthly installments of $9,000.

Our cash, cash equivalents and short-term investments were $54.2 million as of December 31, 2006, $24.9 million as of December 31, 2005 and $53.1 million as of December 31, 2004.

Cash Flows

Net cash used in operating activities was $9.9 million for the year ended December 31, 2006, primarily reflecting an increase of $23.2 million in research fees and accounts receivable, partially offset by net income of $2.1 million, an increase of $8.9 million in deferred revenue and an increase of $1.9 million in current liabilities. The $23.2 million increase in research fees and accounts receivable is comprised primarily of a $20.0 million development milestone and $3.2 million in research fees triggered by Astra Zeneca’s determination to proceed with further development of AZD3480 (TC-1734). The $8.9 million increase in deferred revenue is comprised of the $10.0 million initial fee received from AstraZeneca in February 2006, net of the $1.1 million portion of the initial fee that we recognized in 2006. The $1.9 million increase in current liabilities is comprised primarily of a higher accrued liability for awards under our annual cash incentive bonus program, a liability recorded for amounts due UKRF with respect to AZD3480 (TC-1734) and additional project-related payables.

Net cash used in operating activities was $26.2 million for the year ended December 31, 2005, primarily reflecting our net loss of $29.0 million partially offset by a decrease of $999,000 in prepaid expenses primarily attributable to our recognition of payments made in 2004 in connection with a public offering that we terminated in the first quarter of 2005, $803,000 in depreciation and amortization expense and $690,000 in stock-based employee compensation expense. Net cash used for operating activities was $25.0 million for the year ended December 31, 2004. Net cash used for operating activities for 2004 consisted primarily of a net loss of $24.0 million, which included acceleration of recognition of deferred license fee revenue of $1.6 million representing the unamortized portion of the upfront payments that we received when we entered into collaboration agreements with Aventis and Dr. Falk Pharma.

Net cash used in investing activities, exclusive of cash flows from the net purchase and sale of short-term investments of $12.1 million, was $1.1 million for the year ended December 31, 2006, $250,000 for the year ended December 31, 2005 and $622,000 for the year ended December 31, 2004. These amounts were primarily to purchase equipment for use in expanding our internal research and development activities.

Net cash provided by financing activities was $40.1 million for the year ended December 31, 2006 and consisted principally of our receipt of $40.8 million in net proceeds from our initial public offering completed in April 2006, partially offset by a net reduction of $784,000 in principal repayments on our equipment financing loan facility. Net cash used in financing activities was $1.7 million for the year ended December 31, 2005 and consisted principally of the repayment of a $1.3 million convertible promissory note to The Stanley Medical Research Institute and $1.1 million in principal repayments on the equipment financing loan facility, partially offset by $612,000 in proceeds from the issuance of shares of our series C convertible preferred stock in May 2005. Net cash provided by financing activities was $35.9 million for the year ended December 31, 2004 and consisted principally of $32.9 million in net proceeds from the issuance of shares of our series C convertible preferred stock in December 2004, $2.0 million received under the equipment financing loan facility and $1.3 million received from The Stanley Medical Research Institute in return for our issuance of a convertible promissory note in an equal principal amount, partially offset by $731,000 of principal repayments on the equipment financing loan facility.

Funding Requirements

As of December 31, 2006, we had an accumulated deficit of $136.2 million. We expect to incur substantial operating losses for the foreseeable future. Our future capital requirements are difficult to forecast and will depend on many factors, including:

- whether we elect to advance TC-5214 into clinical development as an augmentation treatment for major depression or instead to conduct Phase III clinical development of TRIDMAC;
- the scope, progress, results and cost of preclinical development and laboratory testing and clinical trials;
- the timing, receipt and amount of milestone and other payments from AstraZeneca and potential future collaborators;
- the costs, timing and outcome of regulatory review;
- the number and characteristics of product candidates that we pursue;
- the costs of preparing, filing and prosecuting patent applications and maintaining, enforcing and defending intellectual property-related claims;
- the costs of establishing sales and marketing functions and of establishing arrangements for manufacturing;
- the rate of technological advancements for the indications that we target;
- our ability to establish strategic collaborations and licensing or other arrangements on terms favorable to us;

- the costs to satisfy our obligations under existing and potential future collaborations;
- the timing, receipt and amount of sales or royalties, if any, from our potential products; and
- the extent and scope of our general and administrative expenses.

We anticipate that implementing our strategy will require substantial increases in our capital expenditures and other capital commitments as we expand our clinical trial activity, as our product candidates advance through the development cycle, as product candidates that arise out of our preclinical research collaboration with AstraZeneca progress and as we invest in additional product opportunities and research programs and expand our infrastructure. In particular, we anticipate that we will purchase additional equipment over the next several quarters, and that we will incur additional costs resulting from the expansion and lease of our laboratory space, which became effective January 2007. We do not expect our existing capital resources to be sufficient to enable us to fund the completion of the development of any of our product candidates. We currently expect our existing capital resources to be sufficient to fund our operations at least through 2008. However, our operating plan may change as a result of many factors, including those described above. We may need additional funds sooner than planned to meet operational needs and capital requirements for product development.

We do not expect to generate sufficient cash from our operations to sustain our business for the foreseeable future. We expect our continuing operating losses to result in increases in our cash required to fund operations over the next several quarters and years. To the extent our capital resources are insufficient to meet future capital requirements, we will need to finance future cash needs through public or private equity offerings, debt financings or corporate collaboration and licensing arrangements. Additional equity or debt financing, or corporate collaboration and licensing arrangements, may not be available on acceptable terms, if at all. If adequate funds are not available, we may be required to delay, reduce the scope of or eliminate our research and development programs, reduce our planned commercialization efforts, or obtain funds through arrangements with collaborators or others that may require us to relinquish rights to certain product candidates that we might otherwise seek to develop or commercialize independently. Additionally, any future equity funding may dilute the ownership of our stockholders.

We cannot estimate the completion dates and costs of our current internal research and development programs due to inherent uncertainties in outcomes of clinical trials and regulatory approvals of our product candidates. We cannot be certain that we will be able to successfully complete our research and development projects or successfully find collaboration or distribution partners for our product candidates. Our failure to complete our research and development projects could have a material adverse effect on our financial position or results of operations.

To date, inflation has not had a material effect on our business.

Contractual Obligations

The following table summarizes our fixed contractual obligations as of December 31, 2006:

	Payments Due by Period				
Contractual Obligations	**Total**	**Less Than 1 Year**	**1-3 Years**	**3-5 Years**	**More Than 5 Years**
Long-term debt obligations	$ 1,409,402	$ 593,330	$ 577,971	$ 212,659	$ 25,442
Operating lease obligations	857,822	—	—	—	—
Other contractual obligations	2,945,196	2,936,396	6,600	2,200	—
Total	$ 5,212,420	$ 3,529,726	$ 584,571	$ 214,859	$ 25,442

The amounts of long-term debt obligations reflected in the above table do not include $2.0 million in additional borrowing capacity available, on or before June 30, 2007, under our amended loan facility with R.J. Reynolds Tobacco Holdings, Inc.

The amounts of operating lease obligations reflected in the above table include payment obligations under our lease of its facilities in Winston-Salem, North Carolina from Wake Forest University Health Sciences. The initial term of the lease was to expire on July 31, 2007. On January 22, 2007, the lease was amended to cover additional space, effective in part January 1, 2007 and in part August 1, 2007. In connection with the lease amendment, the Company exercised its option to extend the term of the lease, as applied to all of the leased premises, through July 31, 2012. Our expected payment obligations under the amended lease are described in Note 13 to our audited financial statements for the year ended December 31, 2006 included in this annual report.

The amounts of other contractual obligations reflected in the above table include obligations to purchase drug product or drug substance contingent on delivery, to compensate clinical investigators and clinical trial sites contingent on the performance of services in connection with clinical trials and to compensate contract research organizations contingent on the performance of non-clinical research and development services. The amount of other contractual obligations for 2007 reflected in the above table also includes annual maintenance fees or other fixed payments required under our technology license agreements. Our technology license agreements are generally terminable by us on short notice. As a result, the annual maintenance fees or other fixed payments under those agreements are not included in other contractual obligations in the above table after 2007. The amounts of other contractual obligations for all periods reflected in the above table exclude contingent royalty payments that we may be required to pay under our technology license agreements and other contingent payments that we may become required to make under our technology license agreements upon achievement of specified development, regulatory or commercial milestones.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

Recent Accounting Pronouncements

In July 2006, the FASB issued Financial Accounting Standards Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosures and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not currently expect FIN 48 to have any impact on our financial reporting for at least the next several years.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact, if any, of the provisions of SFAS 157.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

The primary objective of our investment activities is to preserve our capital to fund operations. We also seek to maximize income from our investments without assuming significant risk. To achieve our objectives, we maintain a portfolio of cash equivalents and short-term investments in a variety of securities of high credit quality. As of December 31, 2006, we had cash, cash equivalents and short-term investments of $54.2 million. A

portion of our investments may be subject to interest rate risk and could fall in value if market interest rates increase. However, because our investments are short term in duration, we believe that our exposure to interest rate risk is not significant and estimate that an immediate and uniform 10% increase in market interest rates from levels as of December 31, 2006 would not have a material impact on the total fair value of our portfolio.

We contract for the conduct of some of our clinical trials and other research and development and manufacturing activities with contract research organizations, investigational sites and manufacturers in Europe and, with respect to one completed clinical trial, in India. We may be subject to exposure to fluctuations in foreign currency exchange rates in connection with these agreements. If the average Euro/U.S. dollar exchange rate were to strengthen or weaken by 10% against the exchange rate as of December 31, 2006, we estimate that the impact on our financial position, results of operations and cash flows would not be material. We do not hedge our foreign currency exposures.

We have not used derivative financial instruments for speculation or trading purposes.

Item 8. Financial Statements and Supplementary Data.

INDEX TO THE FINANCIAL STATEMENTS

TARGACEPT, INC.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
Targacept, Inc.

We have audited the accompanying balance sheets of Targacept, Inc. as of December 31, 2005 and 2006, and the related statements of operations, redeemable convertible preferred stock and stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Targacept, Inc. at December 31, 2005 and 2006, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 2 and 12 to the financial statements, effective January 1, 2005, the Company adopted the fair value method of accounting provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment*.

/s/ ERNST & YOUNG LLP

Greensboro, North Carolina
March 20, 2007

TARGACEPT, INC.

BALANCE SHEETS

	December 31, 2005	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 24,851,302	$ 41,744,363
Short-term investments	—	12,445,193
Collaboration revenue and accounts receivable	118,163	23,367,959
Inventories	41,940	173,693
Prepaid expenses	729,241	1,121,698
Total current assets	25,740,646	78,852,906
Property and equipment, net	1,747,524	2,040,355
Intangible assets, net of accumulated amortization of $129,027 and $166,791 at December 31, 2005 and December 31, 2006, respectively	512,973	475,209
Total assets	$ 28,001,143	$ 81,368,470
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable	$ 1,173,545	$ 1,982,180
Accrued expenses	2,849,747	3,889,114
Current portion of long-term debt	783,895	593,330
Current portion of deferred rent incentive	402,647	234,877
Current portion of deferred license fee revenue	—	2,250,000
Total current liabilities	5,209,834	8,949,501
Long-term debt, net of current portion	1,409,402	816,072
Deferred rent incentive, net of current portion	234,877	—
Deferred license fee revenue, net of current portion	—	6,604,167
Total liabilities	6,854,113	16,369,740
Commitments		
Redeemable convertible preferred stock:		
Series A, $0.001 par value, 5,000,000 and 0 shares authorized, issued and outstanding at December 31, 2005 and 2006, respectively	31,836,985	—
Series B, $0.001 par value, 6,567,567 and 0 shares authorized, issued and outstanding at December 31, 2005 and 2006, respectively	41,759,905	—
Series C, $0.001 par value, 81,747,965 and 0 shares authorized and 76,937,998 and 0 issued and outstanding at December 31, 2005 and 2006, respectively	110,031,263	—
Total redeemable covertible preferred stock	183,628,153	—
Stockholders' equity (deficit):		
Common stock, $0.001 par value, 16,666,666 and 100,000,000 shares authorized at December 31, 2005 and 2006, respectively; 270,427 and 19,132,233 shares issued and outstanding at December 31, 2005 and 2006, respectively	270	19,132
Capital in excess of par value	12,287,904	201,141,257
Common stock warrants	213,710	—
Accumulated deficit	(174,983,007)	(136,161,659)
Total stockholders' equity (deficit)	(162,481,123)	64,998,730
Total liabilities, redeemable convertible preferred stock and stockholders' equity (deficit)	$ 28,001,143	$ 81,368,470

See accompanying notes.

TARGACEPT, INC.

STATEMENTS OF OPERATIONS

	Year ended December 31,		
	2004	2005	2006
Revenue:			
Collaboration research and development	$ 337,500	$ —	$ 5,019,057
Milestones and license fees from collaboration	1,917,224	—	21,145,833
Product sales	766,583	681,285	585,318
Grant revenue	717,067	498,632	787,356
Net revenue	3,738,374	1,179,917	27,537,564
Operating expenses:			
Research and development (stock-based compensation of $0, $457,670 and $643,373 in 2004, 2005 and 2006, respectively)	22,770,881	24,251,463	21,787,873
General and administrative (stock-based compensation of $50,623, $232,784 and $275,147 in 2004, 2005 and 2006 respectively)	5,162,474	4,753,464	5,696,129
Transaction charges	—	1,634,973	—
Cost of product sales	198,446	480,933	457,254
Total operating expenses	28,131,801	31,120,833	27,941,256
Loss from operations	(24,393,427)	(29,940,916)	(403,692)
Other income (expense):			
Interest income	504,986	1,174,398	2,584,294
Interest expense	(132,749)	(225,005)	(84,073)
Loss on disposal of fixed asset	(4,199)	—	—
Total other income (expense)	368,038	949,393	2,500,221
Net income (loss)	(24,025,389)	(28,991,523)	2,096,529
Deemed dividend—beneficial coversion feature for Series C redeemable convertible preferred stock issued December 2004	(10,312,499)	—	—
Preferred stock accretion	(8,743,559)	(11,237,976)	(3,332,705)
Net loss attributable to common stockholders	$ (43,081,447)	$ (40,229,499)	$ (1,236,176)
Basic and diluted net loss attributable to common stockholders per share	$ (196.53)	$ (153.54)	$ (0.09)
Weighted average common shares outstanding—basic and diluted	219,213	262,013	13,595,523

See accompanying notes.

TARGACEPT, INC.

STATEMENTS OF REDEEMBABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (DEFICIT)

	Redeemable Convertible Preferred Stock			Common Stock		Capital in Excess of Par Value	Common Stock Warrants	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders' Equity(Deficit)
	Series A	Series B	Series C	Shares	Amount					
Balances at December 31, 2003	$28,496,497	$37,484,419	$ 64,153,421	144,370	$ 144	$ 691,614	$ 213,710	$ (91,672,061)	$ (29,282)	$ (90,795,875)
Stock issuance costs	—	—	(100,000)	—	—	—	—	—	—	—
Issuance of 27,272,728 shares of Series C redeemable convertible preferred stock at $1.21 per share	—	—	33,000,000	—	—	—	—	—	—	—
Deemed dividend—beneficial conversion feature for Series C redeemable convertible preferred stock issued December 2004	—	—	—	—	—	10,312,499	—	(10,312,499)	—	—
Issuance of 112,446 shares of common stock at $0.001 per share par value, related to exercise of stock options	—	—	—	112,446	113	569,564	—	—	—	569,677
Accreted redemption value for common stock warrants attached to Series A redeemable convertible preferred stock	42,744	—	—	—	—	—	—	(42,744)	—	(42,744)
Accreted redemption value for Series A, Series B and Series C redeembal convertible preferred stock	1,627,500	2,137,742	4,935,573	—	—	—	—	(8,700,815)	—	(8,700,815)
Net change in unrealized holding loss on available-for-sale securities	—	—	—	—	—	—	—	—	29,282	29,282
Net loss	—	—	—	—	—	—	—	(24,025,389)	—	(24,025,389)
Comprehensive loss										(23,996,107)
Balances at December 31, 2004	$30,166,741	$39,622,161	$101,988,994	256,816	$ 257	$11,573,677	$ 213,710	$(134,753,508)	—	$ (122,965,864)
Issuance of 496,132 shares of Series C redeemable convertible preferred stock at $1.21 per share	—	—	612,281	—	—	—	—	—	—	—
Issuance of 13,611 shares of common stock at $0.001 per share par value, related to exercise of stock options	—	—	—	13,611	13	23,773	—	—	—	23,786
Stock-based compensation	—	—	—	—	—	690,454	—	—	—	690,454
Accreted redemption value for common stock warrants attached to Series A redeemable convertible preferred stock	42,744	—	—	—	—	—	—	(42,744)	—	(42,744)
Accreted redemption value for Series A, Series B and Series C redeembal convertible preferred stock	1,627,500	2,137,744	7,429,988	—	—	—	—	(11,195,232)	—	(11,195,232)
Net loss	—	—	—	—	—	—	—	(28,991,523)	—	(28,991,523)
Comprehensive loss										(28,991,523)
Balances at December 31, 2005	$31,836,985	$41,759,905	$110,031,263	270,427	$ 270	$12,287,904	$ 213,710	$(174,983,007)	—	$ (162,481,123)

See accompanying notes.

TARGACEPT, INC.

STATEMENTS OF REDEEMBABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (DEFICIT)—(continued)

	Redeemable Convertible Preferred Stock			Common Stock		Capital in Excess of Par Value	Common Stock Warrants	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders' Equity(Deficit)
	Series A	Series B	Series C	Shares	Amount					
Balances at December 31, 2005 (carried forwaard)	$ 31,836,985	$ 41,759,905	$ 110,031,263	270,427	$ 270	$ 12,287,904	$ 213,710	$(174,983,007)	—	$ (162,481,123)
Issuance of 29,793 shares of common stock at $0.001 per share par value, related to exercise of stock options	—	—	—	29,793	30	61,608	—	—	—	61,638
Stock-based compensation	—	—	—	—	—	918,520	—	—	—	918,520
Accreted redemption value for Series A, Series B, and Series C redeemable convertible preferred stock	483,729	635,385	2,213,591	—	—	—	—	(3,332,705)	—	(3,332,705)
Net Proceeds from initial public offering	—	—	—	5,000,000	5,000	40,770,013	—	—	—	40,775,013
Conversion of redeemable convertible preferred stock	(32,320,714)	(42,395,290)	(112,244,854)	13,832,013	13,832	147,103,212	—	39,843,814	—	186,960,858
Expiration of common stock warrants	—	—	—	—	—		(213,710)	213,710	—	—
Net income	—	—	—	—	—	—	—	2,096,529	—	2,096,529
Comprehensive loss										2,096,529
Balances at December 31, 2006	—	—	—	19,132,233	$ 19,132	$201,141,257	—	$(136,161,659)	—	$ 64,998,730

See accompanying notes.

TARGACEPT, INC.

STATEMENTS OF CASH FLOWS

	Year ended December 31,		
	2004	2005	2006
Operating activities			
Net income (loss)	$ (24,025,389)	$ (28,991,523)	$ 2,096,529
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	766,335	803,185	820,920
Loss on disposal of equipment	4,199	—	—
Stock-based compensation expense	50,623	690,454	918,520
Recognition of deferred rent incentive	(402,647)	(402,647)	(402,647)
Realized loss on sale of investments	87,948	—	—
Changes in operating assets and liabilities, excluding the effects from acquired assets and liabilities:			
Collaboration revenue and accounts receivable	334,053	366,402	(23,249,796)
Inventories	15,880	60,700	(131,753)
Prepaid expenses and accrued interest receivable	(1,091,627)	998,595	(646,219)
Accounts payable and accrued expenses	1,141,221	228,318	1,848,002
Deferred license fee revenue	(1,917,224)	—	8,854,167
Net cash used in operating activities	(25,036,628)	(26,246,516)	(9,892,277)
Investment activities			
Purchase of investments	(6,191,930)	(25,500,000)	(41,191,431)
Proceeds from sale of investments	37,379,107	25,500,000	29,000,000
Purchase of property and equipment	(660,624)	(250,247)	(1,075,987)
Proceeds from sale of property and equipment	38,191	—	—
Net cash provided by (used in) investing activities	30,564,744	(250,247)	(13,267,418)
Financing activities			
Proceeds from issuance of notes payable	3,250,000	—	406,967
Principal payments on notes payable and long-term debt	(730,979)	(2,363,350)	(1,190,862)
Proceeds from issuance of redeemable convertible preferred stock, net of transaction costs	32,900,000	612,281	—
Proceeds from issuance of common stock	519,054	23,786	40,836,651
Net cash provided by (used in) financing activities	35,938,075	(1,727,283)	40,052,756
Net increase (decrease) in cash and cash equivalents	41,466,191	(28,224,046)	16,893,061
Cash and cash equivalents at beginning of period	11,609,157	53,075,348	24,851,302
Cash and cash equivalents at end of period	$ 53,075,348	$ 24,851,302	$ 41,744,363

See accompanying notes

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2006

1. The Company and Nature of Operations

Targacept, Inc., a Delaware corporation (the Company), was formed on March 7, 1997. The Company is a biopharmaceutical company engaged in the design, discovery and development of NNR Therapeutics™, a new class of drugs for the treatment of multiple diseases and disorders of the central nervous system. The Company's NNR Therapeutics selectively target neuronal nicotinic receptors, or NNRs. Its facilities are located in Winston-Salem, North Carolina.

2. Summary of Significant Accounting Policies

Cash and Cash Equivalents

The Company considers cash equivalents to be those investments which are highly liquid, readily convertible to cash and mature within three months from the date of purchase.

Investments

In accordance with the Company's investment policy, surplus cash is invested with high quality financial institutions in money market accounts, certificates of deposit and Student Loan Auction Rate Securities. The Company determines the appropriate classification of marketable securities at the time of purchase and reevaluates such designation as of each balance sheet date. All marketable securities entered into during 2005 and 2006 were classified as available-for-sale. Interest income on investments, as well as realized gains and losses, are included in "Interest income." The cost of securities sold is based on the specific identification method.

Collaboration Revenue and Accounts Receivable

Substantially all of the Company's collaboration revenue is related to the collaboration agreements discussed in Note 15. Substantially all of the Company's accounts receivable are related to such collaboration agreements and trade sales of its approved product Inversine®. All of the Company's trade accounts receivable are due from customers located within the United States. The Company makes judgments with respect to the collectability of trade accounts receivable based on historical experience and current economic trends. Actual collections could differ from those estimates.

During 2004, 2005 and 2006, the Company recognized revenue of $2,255,000, $0 and $26,165,000, respectively, or 60%, 0% and 95%, respectively, of net revenue, from the collaboration agreements discussed in Note 15.

Inventories

Inventories are stated at the lower of cost or market. Cost is determined by the weighted-average method.

Property and Equipment and Intangible Assets

Property and equipment consists primarily of lab equipment, office furniture and fixtures and leasehold improvements and is recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets ranging from 3-10 years. Lab equipment is typically depreciated over 3-5 years, office furniture and fixtures are typically depreciated over 5-10 years, and leasehold improvements are typically amortized over the lesser of the asset life or the lease term.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

2. Summary of Significant Accounting Policies—(continued)

Intangible assets consist of patents acquired from Layton Bioscience, Inc. The intangible assets are being amortized to research and development expense on a straight-line basis over the remaining useful life of the patents, or a period of 17 years from the date of acquisition.

The Company assesses the net realizable value of its long-lived assets and evaluates such assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment would be recognized when estimated undiscounted future cash flows expected to result from the use of the asset and its eventual disposition are less than its carrying amount. An impairment, if recognized, would be based on the excess of the carrying value of the impaired asset over its fair value. Through December 31, 2006, there has been no such impairment.

Patents

The Company capitalizes the costs of patents purchased from external sources as intangible assets. The Company expenses all other patent-related costs.

Research and Development Expense

Research and development costs are expensed as incurred and include related salaries of personnel involved in research and development activities, contractor fees, administrative expenses and allocations of research-related overhead costs. Administrative expenses and research-related overhead costs included in research and development consist of allocations of facility and equipment lease charges, depreciation and amortization of assets, and insurance, legal and supply costs that are directly related to research and development activities.

The Company directly reduces research and development expenses for amounts reimbursed pursuant to cost-sharing agreements. During 2004, 2005 and 2006, research and development expenses were reduced by $23,000, $0 and $207,000, respectively, for costs reimbursed primarily by Dr. Falk Pharma, GmbH in 2004 and by AstraZeneca AB in 2006 under the terms of the collaboration agreements described in Note 15.

Accrued Expenses

The Company records accruals based on estimates of the services received, efforts expended and amounts owed pursuant to contracts with numerous clinical trial centers, contract research organizations and other service providers. In the normal course of business, the Company contracts with third parties to perform various clinical trial and development activities in the ongoing development of potential products. The financial terms of these agreements are subject to negotiation and variation from contract to contract and may result in uneven payment flows. Payments under the contracts depend on factors such as the achievement of certain events, the production of drug substance or drug product, the successful recruitment of subjects, the completion of portions of the clinical trial or similar conditions. The objective of the Company’s accrual policy is to match the recording of expenses in its financial statements to the actual services received and efforts expended. As such, expense accruals are recognized based on the Company’s estimate of the degree of completion of the event or events specified in the specific contract.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

2. Summary of Significant Accounting Policies—(continued)

Transaction Charges

In the first quarter of 2005, the Company recognized $1,635,000 for expenses incurred in connection with a terminated public offering. The Company had $99,000 and $0 of charges related to its initial public offering in prepaid expenses at December 31, 2005 and 2006, respectively.

Deferred Rent Incentive

In August 2002, the Company received $2,013,000 as an incentive to lease its current office space. The incentive is being recognized monthly over the initial five-year term of the lease on a straight-line basis as a reduction to the lease expense. The Company recognized $403,000, annually, of the incentive during 2004, 2005 and 2006.

Fair Value of Financial Instruments

The carrying amounts of cash and cash equivalents, short-term investments, accounts receivable, accounts payable, accrued expenses and redeemable convertible preferred stock are considered to be representative of their respective fair values. The fair value of long-term debt was $2,162,000 and $1,402,000 at December 31, 2005 and 2006, respectively, as compared to the book value of $2,193,000 and $1,409,000 at December 31, 2005 and 2006, respectively. The difference between fair value and book value was attributable to the benefit of the interest grace period on the Company's loan from the City of Winston-Salem. The Company estimates the fair value of long-term debt using discounted cash flows based on its incremental borrowing rates for similar debt.

Credit Risk

Financial instruments that potentially subject the Company to credit risk consist principally of cash, short-term investments and collaboration revenue and accounts receivable. The Company places its cash and cash equivalents with high-credit quality financial institutions. The Company has established guidelines for investment of its excess cash designed to emphasize safety, liquidity and preservation of capital. At December 31, 2005 and 2006, the Company had deposits with high credit quality major financial institutions in excess of federally insured limits of approximately $24,800,000 and $41,500,000, respectively.

Revenue Recognition

The Company uses revenue recognition criteria in Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements* (SAB 101), as amended by Staff Accounting Bulletin No. 104, *Revision of Topic 13* (SAB 104).

In determining the accounting for collaboration agreements, the Company follows the provisions of Emerging Issues Task force, or EITF, Issue 00-21, *Revenue Arrangements with Multiple Deliverables*, or EITF 00-21, for multiple element revenue arrangements. EITF 00-21 provides guidance on whether an arrangement that involves multiple revenue-generating activities or deliverables should be divided into separate units of accounting for revenue recognition purposes and, if this division is required, how the arrangement consideration should be allocated among the separate units of accounting. If the arrangement constitutes separate units of accounting according to the EITF's separation criteria, a revenue-recognition policy must be determined for each unit. If the arrangement constitutes a single unit of accounting, the revenue-recognition policy must be determined for the entire arrangement.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

2. Summary of Significant Accounting Policies—(continued)

Research fee revenue is earned and recognized as research is performed and related expenses are incurred. Non-refundable upfront fees are deferred and recognized as revenue on a straight-line basis over the expected term of the Company's continued involvement in the research and development process.

Revenue for non-refundable payments based on the achievement of research and development milestones is recognized as revenue when the milestones are achieved if all of the following conditions are met: (1) achievement of the milestone event was not reasonably assured at the inception of the arrangement; (2) substantive effort is involved to achieve the milestone event; and (3) the amount of the milestone payment appears reasonable in relation to the effort expended, the other milestone payments in the arrangement and the related risk associated with achievement of the milestone event. If any of these conditions are not met, the Company would recognize the portion of the milestone payment that corresponds to work performed as revenue upon receipt and defer recognition of the remaining portion until the performance obligations are completed.

Revenues for specific research and development costs that are reimbursable under collaboration agreements in accordance with Emerging Issues Task Force, or EITF, Issue 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*, and EITF Issue 01-14, *Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred* are recognized. The revenue associated with these reimbursable amounts is reflected as a component of collaboration revenue and the costs associated with these reimbursable amounts is reflected as a component of research and development expenses.

Product sales revenue is recorded when goods are shipped, at which point title has passed, net of allowances for returns and discounts. Revenues from grants are recognized as the Company performs the work and incurs reimbursable costs in accordance with the objectives of the award.

Shipping and Handling Costs

During 2004, 2005 and 2006, $174,000, $175,000 and $191,000, respectively, of shipping and handling costs were included in cost of product sales.

Income Taxes

The liability method is used in accounting for income taxes as required by Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. Under this method, deferred tax assets and liabilities are recognized for operating loss and tax credit carryforwards and for the future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the results of operations in the period that includes the enactment date. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets unless it is more likely than not that such assets will be realized.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

2. Summary of Significant Accounting Policies—(continued)

Comprehensive Loss

SFAS No. 130, *Reporting Comprehensive Income*, requires components of other comprehensive loss, including unrealized gains and losses on available-for-sale securities, to be included as part of total comprehensive loss. The components of comprehensive loss are included in the statements of redeemable convertible preferred stock and stockholders' equity (deficit).

Net Loss Per Share Attributable to Common Stockholders

The Company computes net loss per share attributable to common stockholders in accordance with SFAS No. 128, *Earnings Per Share* (SFAS 128). Under the provisions of SFAS 128, basic net loss per share attributable to common stockholders (Basic EPS) is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding. Diluted net loss per share attributable to common stockholders (Diluted EPS) is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares and dilutive common share equivalents then outstanding. Common share equivalents consist of the incremental common shares issuable upon the conversion of preferred stock, shares issuable upon the exercise of stock options and shares issuable upon the exercise of warrants. For the periods presented, Diluted EPS is identical to Basic EPS because common share equivalents are excluded from the calculation, as their effect is antidilutive.

Initial Public Offering and Pro Forma Information

On April 18, 2006, the Company completed an initial public offering (IPO) of 5,000,000 shares of its common stock at a price of $9.00 per share. The Company's net proceeds from the IPO, after deducting underwriters' discounts and commissions and offering expenses payable by the Company, were $40,775,000. The Company's common stock began trading on the NASDAQ Global Market (formerly known as the NASDAQ National Market) on April 12, 2006.

All outstanding shares of the Company's Series A, Series B, and Series C convertible preferred stock (Preferred Stock) automatically converted into shares of common stock upon completion of the IPO. Series A converted at a ratio of approximately 0.133 common share per preferred share, Series B converted at a ratio of approximately 0.133 or 0.318 common share per preferred share and Series C converted at a ratio of approximately 0.144 common share per preferred share. These conversion ratios reflect a 1 for 7.5 share reverse stock split effected February 3, 2005.

Unaudited pro forma Basic EPS and Diluted EPS is computed using the weighted average number of common shares outstanding, including the pro forma effects of the automatic conversion of all outstanding shares of Preferred Stock into shares of the Company's common stock effective upon the completion of the IPO as if such conversion had occurred at the date of the original issuance.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

2. Summary of Significant Accounting Policies—(continued)

The following table sets forth the computation of Basic EPS and Diluted EPS:

	Years ended December 31,		
	2004	2005	2006
Historical			
Numerator:			
Net loss attributable to common stockholders	$ (43,081,447)	$ (40,229,499)	$ (1,236,176)
Denominator:			
Weighted-average common shares outstanding	219,213	262,013	13,595,523
Basic and diluted net loss per share attributable to common stockholders	$ (196.53)	$ (153.54)	$ (0.09)
Pro forma (unaudited)			
Numerator:			
Net income (loss) attributable to common stockholders	$ (24,025,389)	$ (28,991,523)	$ 2,096,529
Denominator:			
Shares used above	219,213	262,013	13,595,523
Pro forma adjustments to reflect assumed conversion of preferred stock and shares issued upon completion of IPO, on a weighted average basis	10,111,066	13,806,169	4,054,865
Shares used to compute pro forma basic net income (loss) per share attributable to common stockholders	10,330,279	14,068,182	17,650,388
Pro forma adjustments to reflect effects of dilutive stock options outstanding, on a weighted average basis	—	—	904,628
Shares used to compute pro forma diluted net income (loss) per share attributable to common stockholders	10,330,279	14,068,182	18,555,016
Pro forma basic and diluted net income (loss) per share attributable to common stockholders:			
Basic	$ (2.33)	$ (2.06)	$ 0.12
Diluted	$ (2.33)	$ (2.06)	$ 0.11

The Company has excluded all outstanding stock options and warrants from the pro forma calculation of net loss per share attributable to common stockholders because such securities are antidilutive for the 2004 and 2005 periods presented. For 2006, the dilutive effects of outstanding stock options have been included in the pro forma calculation. The potentially dilutive securities consist of the following on a weighted average basis:

	Year ended December 31,		
	2004	2005	2006
Outstanding stock options	1,010,716	1,466,715	1,924,628
Redeemable convertible preferred stock	10,111,066	13,806,169	4,054,865
Outstanding warrants	215,054	215,054	63,043
Total	11,336,836	15,487,938	6,042,536

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

2. Summary of Significant Accounting Policies—(continued)

Stock-Based Compensation

The Company has two stock-based incentive plans, the 2000 Equity Incentive Plan of Targacept, Inc., as amended and restated (the 2000 Plan), and the Targacept, Inc. 2006 Stock Incentive Plan (the 2006 Plan). The 2000 Plan and the 2006 Plan are described more fully in Note 12.

Prior to January 1, 2005, the Company accounted for the 2000 Plan under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS 123). No stock-based employee compensation cost was recognized in the Statement of Operations for the year ended December 31, 2004, as all options granted under the 2000 Plan to employees had an exercise price equal to the fair market value of the underlying common stock on the date of grant.

Effective January 1, 2005, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), using the modified-prospective-transition method. Under that transition method, compensation cost recognized in 2005 includes: (a) compensation cost for all stock-based payments granted prior to, but not yet vested as of, January, 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of Statement 123; (b) compensation cost for all stock-based payments granted subsequent to January 1, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R; and (c) compensation cost for awards modified on April 7, 2005, based on the modification provisions in accordance with SFAS 123R. Results for prior periods have not been restated.

As a result of adopting SFAS 123R effective January 1, 2005, the Company recorded stock-based compensation expense of $690,000 and $919,000 for 2005 and 2006, respectively.

SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under pre-existing literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While the Company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options and the tax deductions for the Company at those times), no amount of operating cash flows have been recognized in prior periods for such excess tax deductions because of net operating losses generated since inception.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

2. Summary of Significant Accounting Policies—(continued)

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to options granted under the Company's stock-based incentive plans in all periods presented. For purposes of the pro forma disclosure, the value of the options is estimated using a Black-Scholes-Merton option pricing formula and amortized into expense over the options' respective vesting periods.

	Year ended December 31, 2004
Net loss attributable to common stockholders, as reported	$ (43,081,447)
Add: stock-based employee compensation expense included in reported net income, net of related tax effects of $0	50,623
Deduct: stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(916,988)
Pro forma net loss	$ (43,947,812)
Net loss per share:	
Basic and diluted, as reported	$ (196.53)
Basic and diluted, pro forma	$ (200.48)

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 123(R)-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*. This FSP provides an elective alternative transition method for calculating the pool of excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123R and reported in the Statements of Cash Flows. This method includes simplified procedures to establish the beginning balance of the pool of excess tax benefits and to determine the subsequent effect on the pool and cash flows resulting from the tax effects of employee stock-based compensation awards that were outstanding upon adoption of SFAS 123R. The Company has elected to adopt the alternative transition method provided in the FSP.

Recent Accounting Pronouncements

In July 2006, the FASB issued Financial Accounting Standards Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosures and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not currently expect FIN 48 to have any impact on its financial reporting for at least the next several years.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact, if any, of the provisions of SFAS 157.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

2. Summary of Significant Accounting Policies—(continued)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

3. Short-term investments

The Company's short-term investments consisted of $0 and $12,445,000 in Certificates of Deposit and related accrued interest at December 31, 2005 and 2006.

4. Inventories

Inventories consisted of the following:

	Year ended December 31,	
	2005	2006
Raw materials	$ 6,400	$ —
Finished goods	35,540	3,600
Work-in-progress	—	170,093
	$ 41,940	$ 173,693

5. Property and equipment

Property and equipment consists of the following:

	Year ended December 31,	
	2005	2006
Lab equipment	$ 5,006,167	$ 5,908,860
Office furniture and fixtures	1,474,655	1,593,486
Leasehold improvements	138,790	190,434
	6,619,612	7,692,780
Less: accumulated depreciation	(4,872,088)	(5,652,425)
Property and equipment, net	$ 1,747,524	$ 2,040,355

The Company recorded $729,000, $765,000 and $783,000 of depreciation expense during 2004, 2005 and 2006, respectively.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

6. Intangible Assets

Intangible assets consist of the following:

	Year ended December 31,	
	2005	2006
Patents	$ 642,000	$ 642,000
Less: accumulated amortization	(129,027)	(166,791)
Total	$ 512,973	$ 475,209

The Company recognized amortization expense of $38,000 for each of 2004, 2005 and 2006. The Company expects to recognize $38,000 of amortization expense for each of the next five years.

7. Accrued Expenses

Accrued expenses consists of the following:

	Year ended December 31,	
	2005	2006
Clinical trials cost	$ 1,688,277	$ 1,793,538
Employee compensation	1,045,967	1,923,345
Other	115,503	172,231
Total	$ 2,849,747	$ 3,889,114

8. Long-term debt

During 2002, the Company entered into agreements to borrow $500,000 from the City of Winston-Salem and $2,500,000 from R.J. Reynolds Tobacco Holdings, Inc. (RJRT). The note payable to the City of Winston-Salem matures on April 19, 2012, is non-interest bearing until April 2007 and, thereafter, bears interest at an annual rate of 5% or 7% depending on the gross revenue of the Company until maturity. No payments are due on the City of Winston-Salem note until the 5-year anniversary of the loan. The note payable to RJRT was amended in January 2004 to allow for up to three additional tranches to be advanced to the Company for up to a total of $2,000,000. The Company was advanced an additional tranche on April 1, 2004 in the amount of $1,027,000. This additional tranche accrues interest at 5.87% and is repayable in monthly payments of $24,000 through the maturity date of April 1, 2008. The Company was advanced another additional tranche on December 23, 2004 in the amount of $973,000. This tranche accrues interest at 6.89% and is repayable in monthly payments of $23,000 through the maturity date of January 1, 2009. The original borrowing of $2,500,000 matured on May 1, 2006 and was paid and satisfied in full. In June 2006, the note payable to RJRT was further amended to permit the Company to borrow an additional $2,000,000 on or before June 30, 2007 in up to three separate borrowings. Each borrowing would accrue interest at a per annum rate that approximates the hypothetical four-year U.S. Treasury rate, determined as of the date of the borrowing, plus 2.5% and be payable in equal monthly installments of principal and accrued interest over 48 months beginning on the first day of the month following the borrowing. As of December 31, 2006, the Company has not made any borrowing under the RJRT note as further amended. The Company paid $133,000, $146,000 and $81,000 in interest under the RJRT note during 2004, 2005 and 2006, respectively.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

8. Long-term debt—(continued)

The note payable to RJRT is secured by equipment owned by the Company with a book value of approximately $1,030,000, net of accumulated depreciation, at December 31, 2006.

On December 15, 2004, the Company entered into a development agreement with The Stanley Medical Research Institute (SMRI). In connection with the agreement, SMRI paid the Company $1,250,000 in return for the issuance by the Company of a convertible promissory note in an equal principal amount. The note bore interest at 10% per annum. The note's principal balance plus accrued interest of $84,000 was paid and satisfied in full on August 18, 2005 and the development agreement with SMRI was terminated in December 2005.

Maturities of long-term debt were as follows at December 31, 2006:

2007	$ 593,330
2008	456,223
2009	121,748
2010	103,677
2011	108,982
Thereafter	25,442
	$ 1,409,402

9. Redeemable Preferred Stock

In August 2000, the Company issued 5,000,000 shares of its Series A redeemable convertible preferred Stock (the Series A) to RJRT, and completed a private placement of 6,537,634 of its Series B redeemable convertible preferred stock (the Series B) generating cash of $29,073,000, net of offering costs.

In January 2001, the Company issued 29,333 shares of Series B to three consultants in partial payment of consulting fees owed by the Company.

In November 2002, the Company completed a private placement of 37,764,180 shares of its Series C redeemable convertible preferred stock (the Series C) and received cash of $45,488,000, net of offering costs.

In March 2003, the Company completed a private placement of an additional 11,404,958 shares of Series C and received cash of $13,767,000, net of offering costs.

In December 2004, the Company completed a private placement of an additional 27,272,728 shares of Series C and received cash of $32,900,000 net of offering costs. Pursuant to EITF Issue No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features* , and EITF 00-27, *Application of Issue No. 98-5 to Certain Convertible Instruments* , the Company recorded a deemed dividend at the date of issuance of $10,312,499, which is the difference in the $8.40 conversion price of the Series C and the underlying value of the common stock issuable upon conversion of the Series C of $11.03. The deemed underlying per share value of the common stock as of the date of issuance was determined by reference to the proposed offering price for a proposed initial public offering that was subsequently terminated in March 2005.

In May 2005, the Company completed a private placement of an additional 496,132 shares of Series C and received cash of $612,000, net of offering costs.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

9. Redeemable Preferred Stock—(continued)

As of December 31, 2005 and 2006, the Company had 5,000,000 and 0 shares of Series A authorized, issued and outstanding, respectively, with an aggregate liquidation preference of $31,836,985, or $4.65 per share plus accreted redemption value, and $0, respectively.

As of December 31, 2005 and 2006, the Company had 6,567,567 and 0 shares of Series B authorized, issued and outstanding, respectively, with an aggregate liquidation preference of $41,759,905, or $4.65 per share plus accreted redemption value, and $0, respectively.

As of December 31, 2005 and 2006, the Company had 81,747,965 and 0 shares of Series C authorized, respectively, and 76,937,998 and 0 issued and outstanding, respectively, with an aggregate liquidation preference of $110,031,263, or $1.21 per share plus accreted redemption value, and $0, respectively.

The following is a summary of the rights, preferences and terms of the Company's series of redeemable convertible preferred stock:

Conversion

Each share of Series A, Series B and Series C was convertible, at the option of the holder thereof, at any time and from time to time, and without the payment of additional consideration by the holder thereof, into fully paid and nonassessable shares of the Company's common stock.

Automatic conversion of the Series A, Series B and Series C into fully paid and nonassessable shares of common stock, without the payment of additional consideration by the holders thereof, would occur immediately upon the closing of the sale of the Company's common stock in a firm commitment, underwritten public offering registered under the Securities Act of 1933 in which (i) the price per share equaled or exceeded $11.00 (subject to certain adjustments) or such lesser amount as is approved by the holders of (a) a majority of then outstanding shares of Series A and Series B, considered together as a single class on an as-converted basis, and (b) at least sixty-five percent (65%) of the then outstanding shares of Series C, and (ii) the gross proceeds to the Company were not less than $50,000,000 or such lesser amount approved by the holders of (a) a majority of then outstanding shares of Series A and Series B, considered together as a single class on an as-converted basis, and (b) at least sixty-five percent (65%) of the then outstanding shares of Series C.

Dividends

Each share of Series C accrued dividends daily on a cumulative basis at the rate of 8% per annum, which were recorded as an increase to Series C and an increase to accumulated deficit. At December 31, 2005, cumulative accrued dividends on the Series C stock totaled $17,264,000. The accrued but unpaid cumulative dividend on the Series C was forfeited upon conversion of the Series C.

Dividends on the Series A, Series B and Series C were payable when and if declared by the Company's Board of Directors. No dividend was permitted to have been paid on the common stock without the approval of the holders of a majority of the then outstanding shares of Series A and Series B, considered together on an as-converted basis, and the holders of 65% of the Series C. No dividend was permitted to have been declared or paid on either the Series A or the Series B unless, simultaneously with such declaration or payment, the same dividend per share was declared or paid on both the Series A and the Series B, as well as the Series C, and any unpaid cumulative dividends on the Series C were declared and paid in full.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

9. Redeemable Preferred Stock—(continued)

Voting

Each holder of the Series A, Series B and Series C was entitled to the number of votes equal to the number of shares of common stock into which such holder's shares were convertible on the applicable record date. In addition, certain actions by the Company required the approval of one or more of (i) the holders of a majority of the outstanding shares of Series A, (ii) the holders of at least two-thirds of the outstanding shares of Series B, (iii) the holders of a majority of the outstanding shares of Series A and Series B, considered together on an as-converted basis, and/or (iv) the holders of at least 65% of the outstanding shares of Series C.

Liquidation Preference

In the event of any liquidation, dissolution or winding up of the Company, the holders of the Series C shares had preference and were entitled to receive an amount per share equal to the greater of (i) their initial purchase price per share plus any accrued or declared and unpaid dividends on such share or (ii) the amount per share of Series C that such holders would have received if all of the Series A, Series B and Series C were converted to common stock immediately prior to such liquidation, dissolution or winding up.

Next, the holders of Series A and Series B were entitled to receive, on a *pari passu* basis, an amount equal to their initial purchase price per share plus any declared and unpaid dividends on such shares. Any assets of the Company remaining after the payments specified above would have been distributed on a *pari passu* basis among the holders of common stock and, on an as-converted to common stock basis, Series A, Series B and Series C. Unless the holders of a prescribed number of shares of Series A, Series B and/or Series C had otherwise elected, certain fundamental transactions involving the Company would have been treated as a liquidation for the Series A, Series B and/or Series C, as the case may have been.

Mandatory Redemption

At any time after November 26, 2008, upon demand by the holders of at least 65% of the outstanding shares of Series C, all of the outstanding shares of Series C would have been redeemed in cash in an amount per share equal to the initial purchase price per share (subject to certain adjustments) plus any accrued or declared and unpaid dividends on such shares.

At any time after the later of August 22, 2005 or the date on which no shares of Series C were outstanding, a number of outstanding shares of Series A or Series B elected upon demand by the holders of a majority of the outstanding shares of Series A (in the case of Series A) or a majority of the outstanding shares of Series B (in the case of Series B) would have been redeemed in an amount per share equal to $4.65 (subject to certain adjustments) plus (i) any previously declared but unpaid dividends on such share and (ii) an amount equal to $0.081375 per share (subject to certain adjustments) multiplied by the number of complete three-month periods that have elapsed from the date such share was originally issued to the redemption date. The Company was permitted to have satisfied its redemption obligation with respect to the Series A and/or the Series B in cash or by paying a portion in cash and issuing a promissory note that met certain prescribed conditions for the remaining amount.

All outstanding shares of the Company's Preferred Stock automatically converted into shares of common stock upon completion of the IPO, as described more fully in Note 2. Based on the terms of the Preferred Stock, accrued dividends totaling $39,830,000 were forfeited in connection with the conversion. Upon completion of the IPO, all outstanding warrants expired unexercised.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

9. Redeemable Preferred Stock—(continued)

Common stock issued upon automatic conversion of the Preferred Stock was as follows:

Series	Shares Outstanding	Carrying Amount	Conversion Ratio	Shares of Common Stock Issued
A	5,000,000	$ 32,320,714	0.133	666,666
B	6,567,567	42,395,290	0.318 or 0.133	2,082,623
C	76,937,998	112,244,854	0.144	11,082,724
	88,505,565	$ 186,960,858		13,832,013

10. Stockholders' Equity (Deficit)

On December 6, 2004, the Company amended its Certificate of Incorporation to increase the number of authorized shares of common stock to 16,666,666 and Preferred Stock to 93,309,532 and issued 27,272,728 shares of Series C.

On February 2, 2005 the Company's Board of Directors adopted and the stockholders approved a 1 for 7.5 share reverse stock split of the Company's common stock effective as of February 3, 2005. All common stock and per common share amounts for all periods presented in the accompanying financial statements have been restated to reflect the effect of this reverse stock split.

On April 18, 2006, the Company amended its Certificate of Incorporation to increase the number of authorized shares of common stock to 100,000,000 and to set the number of authorized shares of undesignated preferred stock at 5,000,000. As discussed in Note 9, all Series A, Series B and Series C stock converted into shares of common stock upon completion of the IPO.

In conjunction with the issuance of Series A, the Company issued a warrant to purchase 215,054 shares of the Company's common stock at an original exercise price of $34.88 per share (subject to certain adjustments). In connection with the Company's issuance of Series C and price adjustment provisions of the warrant, the conversion price of the warrant was adjusted to $14.63. The warrant was exercisable only upon the earlier of an initial public offering or a change in control. The fair value of the warrant was a direct cost of obtaining capital. As such, the fair value was recorded in stockholders' equity, with the offset recorded as a decrease in the redemption value of the Series A. The fair value of the warrant to purchase 215,054 shares of the Company's common stock was estimated at the grant date to be $213,710 or $0.99 per share. The Company considered the anti-dilution features, the contingencies surrounding the limited opportunities for exercise, and the warrant's priorities over common stock options in relation to the fair value of the Company's common stock at the date of issuance when estimating the fair value of the warrant. As discussed in Note 9, the warrant expired unexercised upon completion of the IPO.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

10. Stockholders' Equity (Deficit)—(continued)

At December 31, 2005 and 2006, the Company had reserved shares of common stock for future issuance as follows:

	Year ended December 31,	
	2005	2006
Convertible preferred stock	13,832,013	—
Warrant	215,054	—
Options	1,664,474	2,476,977
Total	15,711,541	2,476,977

11. Income Taxes

For the years ended December 31, 2004 and 2005, there was no provision (benefit) for federal or state income taxes, as the Company had incurred operating losses since inception. For the year ended December 31, 2006, there is no provision (benefit) for federal or state income taxes because taxable income was offset by operating loss carryforwards.

The Company's effective tax rate differs from the federal income tax rate for the following reasons:

	Year Ended December 31,		
	2004	2005	2006
Expected federal income tax benefit at statutory rate	34%	34%	34%
Increase (decrease) resulting from:			
Research and development credits	3	3	(32)
Stock based compensation	—	(1)	11
State income tax expense, net of federal benefit	5	4	6
Change in valuation allowance	(42)	(41)	(20)
Other	—	1	1
	— %	— %	— %

At December 31, 2004, 2005 and 2006, the Company had net operating loss carryforwards for federal income tax purposes of approximately $70,870,000, $98,373,000 and $94,571,000, respectively, and for state income tax purposes of approximately $70,866,000, $98,368,000 and $94,566,000, respectively, and research and development federal income tax credits of approximately $1,357,000, $2,131,000 and $2,799,000, respectively. The federal net operating loss carryforwards begin to expire in 2020. The state net operating loss carryforwards begin to expire in 2015. The research and development tax credits begin to expire in 2021.

Utilization of the net operating loss carryforwards and credits may be subject to a substantial annual limitation due to ownership change limitations provided by Section 382 of the Internal Revenue Code of 1986, as amended, and similar state provisions. As a result of a series of stock issuances, the Company had such an ownership change on November 30, 2002. Consequently, an annual limitation is imposed on the Company's use of net operating loss and credit carryforwards attributable to periods before the change.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

11. Income Taxes—(continued)

Company's net deferred tax assets relate primarily to its net operating loss carryforwards. A valuation allowance has been recognized to offset the deferred tax assets related primarily to the net operating loss carryforwards. If and when recognized, the tax benefit for those items will be reflected in current operations of the period in which the benefit is recorded as a reduction of income tax expense. The utilization of the loss carryforwards to reduce future income taxes will depend on the Company's ability to generate sufficient taxable income prior to the expiration of the net operating loss carryforwards. For the years ended December 31, 2004, 2005 and 2006, the valuation allowance increased (decreased) approximately $9,600,000, $11,750,000 and $(410,000), respectively.

Significant components of the Company's deferred tax assets (liabilities) are as follows:

	Year ended December 31,	
	2005	2006
Deferred tax assets:		
Net operating loss carryforward	$ 35,299,808	$ 33,849,517
Research and development tax credit	2,130,640	2,798,861
Patents	914,069	1,172,145
Stock based compensation	88,129	160,356
Total gross deferred tax assets	38,432,646	37,980,879
Valuation allowance	(38,347,057)	(37,937,051)
Net deferred tax asset	85,589	43,828
Deferred tax liabilities:		
Equipment and other	(85,589)	(43,828)
Net deferred tax asset	$ —	$ —

12. Stock-Based Incentive Plans

On August 22, 2000, the Company established the 2000 Plan and authorized the issuance of up to 268,168 shares under the 2000 Plan to attract and retain employees, directors and certain independent contractors, consultants and advisors and to allow them to participate in the growth of the Company. During 2001, the number of shares authorized for issuance under the 2000 Plan was increased to 348,168. In conjunction with the November 2002 Series C financing, the Company authorized the issuance of an additional 400,000 shares, increasing the number of authorized shares to 748,168. Upon the issuance of additional Series C shares in March 2003, the number of authorized shares was increased to 1,228,888. In March 2005, the number of authorized shares was increased to 1,878,888.

On April 7, 2005 the Company's Board of Directors authorized an amendment to each stock option agreement held by current employees that changed the exercise price per share for each unvested portion as of March 31, 2005 to $1.75. As of March 31, 2005, there were 354,672 shares issued to 75 employees subject to the unvested portions of employee options ranging from an original option price of $5.10 to $5.63 that were affected by the amendments. Each affected option was required to be accounted for as a modification of an award under SFAS 123R. The fair market value was calculated immediately prior to the modification and immediately after the modification to determine the incremental fair market value. This incremental value of $147,000 and the fair

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

12. Stock-Based Incentive Plans—(continued)

market value of each modified option will be expensed as compensation on a quarterly basis, until the date that the option is exercised or forfeited or expires unexercised.

The 2006 Plan became effective in April 2006 and is the successor equity incentive program to the 2000 Plan. All shares previously reserved under the 2000 Plan and not subject to outstanding awards under the 2000 Plan are now reserved for grant under the 2006 Plan. The maximum number of shares of Common Stock that may be issued under the 2006 Plan is 4,362,078. Awards may be made to participants under the Plans in the form of incentive and nonqualified stock options, restricted stock, stock appreciation rights, stock awards, and performance awards. Eligible participants under the Plans include employees, directors and certain independent contractors, consultants or advisors of the Company or a related corporation. Awards made under the Plans have vesting periods that are determined at the discretion of the administrator and range from 0 to 5 years and most commonly have 10-year contractual terms or, in some cases, shorter terms designed to comply with Section 409A of the Internal Revenue Code. The exercise price of incentive options granted under the Plans may not be less than 100% of the fair market value of the common stock on the date of grant, as determined by the administrator.

The Company uses the Black-Scholes-Merton formula to estimate the fair value of its stock-based payments. The volatility assumption used in the Black-Scholes-Merton formula is based on the calculated historical volatility of twelve benchmark biotechnology companies that have been identified as comparable public entities. The expected term of options granted is derived from the simplified method allowable under Staff Accounting Bulletin No. 107. Under this approach, the expected term would be the mid-point between the weighted average of vesting period and the contractual term. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

The following table illustrates the weighted-average assumptions for the Black-Scholes-Merton model used in determining the fair value of options granted to employees:

	Year ended December 31,	
	2005	2006
Dividend yield	—	—
Risk-free interest rate	4.1%	4.7%
Volatility	0.7	0.7
Expected life	6.25-6.5 years	6.25 years

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

12. Stock-Based Incentive Plans—(continued)

A summary of option activity and changes during each of the years ended December 31, 2004, 2005 and 2006 is presented below:

	Options Granted	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2004	1,041,138	$ 4.88		
Granted	65,200	5.33		
Forfeited	(6,066)	21.53		
Exercised	(112,472)	4.73		
Outstanding at December 31, 2004	987,800	4.88		
Granted	653,743	1.76		
Forfeited	(17,923)	5.00		
Exercised	(13,611)	1.75		
Outstanding at December 31, 2005	1,610,009	2.88		
Granted	935,596	5.55		
Forfeited	(38,835)	3.07		
Exercised	(29,793)	2.07		
Outstanding at December 31, 2006	2,476,977	$ 3.89	7.998	$12,776,607
Vested and exercisable at December 31, 2006	1,316,216	$ 3.40	6.996	$ 7,442,500

The weighted average grant date fair value of options granted during 2004, 2005 and 2006 was $5.33, $1.20 and $3.80, respectively. The total intrinsic value of options exercised during the years ended December 31, 2004, 2005 and 2006 was $113,000, $13,000 and $141,000, respectively.

A summary of the status of non-vested stock options granted under the Plans as of December 31, 2006 and changes during the year ended December 31, 2006 is presented below:

	Options Granted	Weighted Average Grant-Date Fair Value
Non-vested at January 1, 2006	630,258	$ 1.18
Granted	935,596	3.80
Vested	(388,572)	1.91
Forfeited	(16,521)	1.19
Non-vested at December 31, 2006	1,160,761	$ 3.05

As of December 31, 2006, there was $3,546,000 of total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted under the Plans. That cost is expected to be recognized over a weighted-average period of 1.6 years. The total fair value of shares subject to stock-based compensation arrangements granted under the Plans that vested during the year ended December 31, 2006 was $2,825,000.

12. Stock-Based Incentive Plans—(continued)

During 2004, the Company granted options to purchase 10,333 shares of common stock at an exercise price of $0.08, below the fair value of $5.63 per share of common stock. During 2005, the Company granted options to purchase 6,000 shares of common stock at an exercise price of $0.08, below the fair value of $1.75 per share of common stock. The fair value of these shares was recorded as compensation expense in the amounts of $51,000 and $46,000 during the twelve months ended December 31, 2004 and 2005, respectively.

13. Commitments and Contingencies

Operating Lease

On March 1, 2002, the Company entered into an agreement with Wake Forest University Health Sciences to lease an office and research facility in Winston-Salem, North Carolina with an initial term that extends through July 31, 2007. The lease contains a renewal option for up to one additional five-year term, with a lease rate similar to the original agreement. In December 2004, the Company amended the terms of the lease to include 1,000 square feet and an option on additional space in this facility. The lease amendment increased annual rent by $15,000 per year and included a $37,000 hold fee in the first year. Rent expense incurred by the Company under the lease was $1,456,000, $1,500,000 and $1,500,000 for the years ended December 31, 2004, 2005 and 2006, respectively. Rent expense is offset by the monthly recognition of the deferred rent incentive discussed in Note 2.

On January 22, 2007, the Company amended its lease with Wake Forest University Health Sciences to lease approximately 14,000 square feet of additional space effective January 1, 2007 and approximately 3,000 square feet of additional space effective August 1, 2007. In connection with the lease amendment, the Company exercised its option to extend the term of the lease, as applied to all of the leased premises, through July 31, 2012.

The following table illustrates expected future lease payments under the lease:

2007	$ 2,184,782
2008	2,159,390
2009	2,159,390
2010	2,159,390
2011	2,159,390
2012	1,259,643
	$ 12,081,985

Employment Arrangements

The Company has entered into employment agreements with certain of its executive officers. Under the agreements, if the Company terminates the employment of the executive officer other than for just cause or if the executive officer terminates his employment for good reason, in each case as that term is defined in the agreement, the executive officer is entitled, among other things, to receive severance equal to his current base salary for nine to twelve months following termination or, if shorter, until he secures other employment. The executive officer would also be entitled to continuation of the health and life insurance benefits coverage provided to him as of the date of termination for the period during which he receives severance.

14. Retirement Savings Plan

The Company has a 401(k) retirement plan in which all of its employees are eligible to participate. The plan provides for the Company to make 100% matching contributions up to a maximum of 6% of employees' eligible compensation. The Company contributed $368,000, $412,000 and $539,000 to the plan for the years ended December 31, 2004, 2005 and 2006, respectively.

15. Collaborative Research and License Agreements

AstraZeneca AB

In December 2005, the Company entered into a collaborative research and license agreement with AstraZeneca AB under which the Company granted AstraZeneca exclusive development and worldwide commercialization rights to the Company's product candidate known as AZD3480 (TC-1734) as a treatment for Alzheimer's disease, cognitive deficits in schizophrenia and potentially other conditions marked by cognitive impairment such as attention deficit hyperactivity disorder, age associated memory impairment and mild cognitive impairment. The collaboration agreement also provides for a multi-year preclinical research collaboration between the Company and AstraZeneca.

The Company is eligible to receive future research fees, license fees and milestone payments under its collaboration agreement with AstraZeneca. The amount of research fees, license fees and milestone payments will depend on the extent of the Company's research activities and the timing and achievement of development, regulatory and first commercial sale milestone events.

AstraZeneca paid the Company an initial fee of $10,000,000 in February 2006. Based on the collaboration agreement terms, the Company allocated $5,000,000 of the initial fee to the research collaboration, which the Company expects to recognize as revenue over the four-year term of the research collaboration. The Company deferred recognition of the remaining $5,000,000 of the initial fee, which was allocated to the AZD3480 (TC-1734) license grants, until AstraZeneca made a determination whether to proceed with further development of AZD3480 (TC-1734) following the completion of additional clinical and non-clinical studies that AstraZeneca conducted during 2006. On December 27, 2006, AstraZeneca communicated its decision to proceed with further development of AZD3480 (TC-1734) to the Company. As a result of AstraZeneca's decision, the Company plans to begin in 2007 amortizing the $5,000,000 of the initial fee that it had previously deferred as revenue over the 5-year expected development period for AZD3480 (TC-1734).

The Company expects to recognize any revenue based on the achievement of milestones under the collaboration agreement upon achievement of the milestone event, if the Company determines that the revenue satisfies the revenue recognition requirements of SAB 101, as amended by SAB 104. In December 2006, AstraZeneca made its determination to proceed with further development of AZD3480 (TC-1734). This milestone event triggered a $20,000,000 payment in accordance with the agreement, and the Company recorded milestone revenue of $20,000,000 in December 2006. The payment was received in January 2007 in accordance with the terms of the agreement.

Under the agreement, the Company is also eligible to receive other payments of up to $249,000,000 (unaudited), contingent upon the achievement of development, regulatory and first commercial sale milestones for AZD3480 (TC-1734), as well as stepped double-digit royalties dependent on sales achieved following regulatory approval. Under the terms of a sponsored research agreement and a subsequent license agreement

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

15. Collaborative Research and License Agreements—(continued)

between the Company and the University of Kentucky Research Foundation, or UKRF, Targacept is required to pay UKRF a low single digit percentage of any of these payments that are received from AstraZeneca. At December 31, 2006, the Company had recorded $758,000 in license fees payable to UKRF.

Until December 2006, the Company deferred revenue recognition of research fees that were received from AstraZeneca due to uncertainty regarding the continued development of AZD3480 (TC-1734). As a result of AstraZeneca's decision to proceed with further development of AZD3480 (TC-1734), in December 2006, the Company recognized $4,672,000 of research fees and plans to recognize future research fee revenue as the research is performed and related expenses are incurred.

Stanley Medical Research Institute

On December 15, 2004, the Company entered into a development agreement with The Stanley Medical Research Institute (SMRI). In connection with the agreement, SMRI paid the Company $1,250,000 in return for the issuance by the Company of a convertible promissory note in an equal principal amount. The note bore interest at 10% per annum. In August 2005, the Company repaid the promissory note in full. The Company and SMRI terminated the development agreement in December 2005.

Aventis Pharma

The Company had previously entered into two collaboration agreements with Aventis Pharma (Aventis). One of the agreements with Aventis terminated effective January 2, 2005, and the research term for the other agreement with Aventis expired on December 31, 2004. These agreements provided for payment to the Company of research fees on a "fee for service" basis for activities that the Company agreed to perform. For the years ended December 31, 2004, 2005 and 2006, research fees were $338,000, $0 and $0, respectively. The Company will not receive any additional amounts under the agreements.

The Company received a one-time non-refundable upfront license fee payment of $2,000,000 under one of the agreements with Aventis. The Company deferred recognition of the license fee and was amortizing it over the expected term of the research and development period for the agreement. As a result of the termination of the agreement, the Company recognized remaining deferred revenue of $825,000 related to the agreement during the fourth quarter of 2004.

Dr. Falk Pharma

The Company previously entered into a collaborative research development and license agreement with Dr. Falk Pharma GmbH (Dr. Falk Pharma), a German corporation, in 2001. Upon execution of the agreement, Dr. Falk Pharma paid the Company a $1,000,000 upfront license fee and purchased 14,815 shares of the Company's common stock for $1,000,000. The Company deferred recognition of the upfront license fee payment and was amortizing it over the expected term of the research and development period. To account for the $1,000,000 in proceeds for the common stock, the Company used the estimated fair value of the common stock to value the shares issued to determine a total equity value of $76,000, with the remaining proceeds of $924,000 allocated to deferred revenue. This deferred revenue was also being amortized over the expected term of the research and development period of the product candidate subject to the agreement.

15. Collaborative Research and License Agreements—(continued)

The Company and Dr. Falk Pharma mutually agreed to discontinue the development of the lead compound subject to the agreement, resulting in the recognition of the remaining deferred revenue of $890,000 during the fourth quarter of 2004, and terminated the collaboration agreement in November 2005. The Company recognized $1,017,000 of deferred revenue under this agreement during 2004.

16. Related Party Transactions

Prior to completion of the IPO, R.J. Reynolds Tobacco Holdings, Inc. (RJRT) was the holder of record of more than 5% of the Company's outstanding shares of common stock. As of December 31, 2006, RJRT was the holder of 909,094 shares of the Company's common stock. The Company has entered into the following transactions and agreements with RJRT in the ordinary course of business.

During 2002, the Company entered into a facility to borrow $2,500,000 from RJRT accruing interest at 6.6%. This note has been amended and the terms and borrowings are described in Note 8. As of December 31, 2004, 2005 and 2006, the Company owed RJRT $2,807,000, $1,693,000 and $909,000 under the note payable. The Company paid $133,000, $146,000 and $81,000 in interest during 2004, 2005 and 2006, respectively.

A member of the Company's board of directors served as an officer of RJRT and its parent company, Reynolds American, Inc., until retiring from RJRT and Reynolds American effective as of August 31, 2006. Equity compensation for such director's service has previously been made, at the director's request, directly to RJRT. The number of shares subject to stock options granted to RJRT in connection with the director's services was 1,000 shares per year. In connection with the issuance of the stock options, the Company recognized compensation expense of $4,000, $5,000 and $1,000 during the years ended December 31, 2004, 2005 and 2006, respectively.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS—(continued)
DECEMBER 31, 2006

17. Selected Quarterly Financial Data (unaudited)

	2005 Quarter			
	First	Second	Third	Fourth
Net Revenue	$ 303,233	$ 299,646	$ 338,310	$ 238,728
Gross profit (loss) on product sales	157,518	62,477	39,768	(59,411)
Operating loss(1)	(7,656,423)	(8,339,228)	(7,170,082)	(6,775,183)
Net loss	(7,437,771)	(8,105,493)	(6,920,200)	(6,528,059)
Net loss attributable to common stockholders	(10,239,660)	(10,913,785)	(9,734,099)	(9,341,955)
Basic and diluted net loss per share attributable to common stockholders(2)	$ (39.51)	$ (41.95)	$ (37.28)	$ (35.29)
Weighted average common shares outstanding—basic and diluted(3)	259,173	260,140	261,094	264,739

	2006 Quarter			
	First	Second	Third	Fourth
Net Revenue(4)	$ 606,124	$ 589,407	$ 998,293	$25,343,740
Gross profit (loss) on product sales	(14,028)	153,039	29,424	(40,371)
Operating income (loss)	(5,513,488)	(5,315,043)	(5,651,697)	16,076,536
Net income (loss)	(5,238,100)	(4,616,818)	(4,865,602)	16,817,049
Net income (loss) attributable to common stockholders	(8,041,310)	(5,146,313)	(4,865,602)	16,817,049
Basic net income (loss) per share attributable to common stockholders(2)	$ (29.42)	$ (0.33)	$ (0.25)	$ 0.88
Diluted net income (loss) per share attributable to common stockholders(2)	$ (29.42)	$ (0.33)	$ (0.25)	$ 0.83
Weighted average common shares outstanding—basic	273,368	15,595,020	19,118,854	19,126,972
Weighted average common shares outstanding—diluted	273,368	15,595,020	19,118,854	20,224,805

(1) Net loss for the first quarter of 2005 includes $1,635,000 of expenses incurred in connection with a public offering that was terminated.

(2) Per common share amounts for the quarters and full years have been calculated separately. Accordingly, quarterly amounts do not add to the annual amount because of differences in the weighted average common shares outstanding during each period principally due to the effect of the Company's issuing shares of its common stock during the year.

(3) In 2005, Diluted EPS is identical to Basic EPS since common share equivalents are excluded from the calculation, as their effect is antidilutive.

(4) Net revenue for the fourth quarter of 2006 includes $20,000,000 in milestone revenue and $4,672,000 in research fee revenue under the AstraZeneca agreement recognized as a result of AstraZeneca's determination to proceed with further development of AZD3480 (TC-1734).

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

Not applicable.

Item 9A. Controls and Procedures.

(a) *Evaluation of Disclosure Controls and Procedures*. Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures in accordance with Rule 13a-15 under the Exchange Act as of the end of the period covered by this annual report. In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and our management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of the end of the period covered by this annual report, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is (a) accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure and (b) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) *Changes in Internal Controls*. No change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) occurred during the quarter ended December 31, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information.

Not applicable.

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

Information called for by this Item may be found in our definitive Proxy Statement in connection with our 2007 Annual Meeting of Stockholders to be filed with the SEC and is incorporated herein by reference.

Code of Business Conduct and Ethics

We have adopted a code of business conduct and ethics that applies to all of our directors and officers and other employees, including our principal executive officer, principal financial officer and principal accounting officer. This code is publicly available on our website at *www.targacept.com*. We intend to post on our website any amendment to the code of business conduct and ethics, or any grant of a waiver from a provision of the code of business conduct and ethics, that requires disclosure under applicable law, the rules of the SEC or NASDAQ listing standards.

Item 11. Executive Compensation.

Information called for by this Item may be found in our definitive Proxy Statement in connection with our 2007 Annual Meeting of Stockholders to be filed with the SEC and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Information called for by this Item may be found in our definitive Proxy Statement in connection with our 2007 Annual Meeting of Stockholders to be filed with the SEC and is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

Information called for by this Item may be found in our definitive Proxy Statement in connection with our 2007 Annual Meeting of Stockholders to be filed with the SEC and is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services.

Information called for by this Item may be found in our definitive Proxy Statement in connection with our 2007 Annual Meeting of Stockholders to be filed with the SEC and is incorporated herein by reference.

PART IV

Item 15. Exhibits, Financial Statement Schedules

(a)(1) *Financial Statements.* For a list of the financial statements included herein, see “Index to Financial Statements” on page 75 of this annual report.

(a)(2) *Financial Statement Schedules.* All schedules are omitted because they are not applicable or the required information is shown under Item 8, “Financial Statements and Supplementary Data.”

(a)(3) *Exhibits.* The list of exhibits filed as a part of this annual report is set forth on the Exhibit Index immediately preceding such exhibits and is incorporated herein by this reference.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: March 22, 2007

Targacept, Inc.

By: /s/ J. DONALD DEBETHIZY
J. Donald deBethizy
Chief Executive Officer and President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated below and on the dates indicated.

Signature	Title	Date
/s/ J. DONALD DEBETHIZY **J. Donald deBethizy**	Chief Executive Officer, President and Director (principal executive officer)	March 22, 2007
/s/ ALAN A. MUSSO **Alan A. Musso**	Vice President, Chief Financial Officer, Secretary and Treasurer (principal financial officer and principal accounting officer)	March 22, 2007
/s/ MARK SKALETSKY **Mark Skaletsky**	Chairman of the Board of Directors	March 22, 2007
/s/ M. JAMES BARRETT **M. James Barrett**	Director	March 22, 2007
/s/ CHARLES A. BLIXT **Charles A. Blixt**	Director	March 22, 2007
/s/ G. STEVEN BURRILL **G. Steven Burrill**	Director	March 22, 2007
/s/ ERROL B. DE SOUZA **Errol B. De Souza**	Director	March 22, 2007
/s/ ALAN W. DUNTON **Alan W. Dunton**	Director	March 22, 2007
/s/ ELAINE V. JONES **Elaine V. Jones**	Director	March 22, 2007
/s/ JOHN P. RICHARD **John P. Richard**	Director	March 22, 2007

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EXHIBIT INDEX

Exhibit Number	Description
3.1	Fourth Amended and Restated Certificate of Incorporation of the Company (incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, as filed with the SEC on May 8, 2006 (Registration No. 333-133881))
3.2	Bylaws of the Company (incorporated by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-8, as filed with the SEC on May 8, 2006 (Registration No. 333-133881))
4.1	Specimen common stock certificate (incorporated by reference to Exhibit 4.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1/A, as filed with the SEC on March 16, 2006 (Registration No. 333-131050))
4.2(a)	Third Amended and Restated Investor Rights Agreement, dated as of May 12, 2004, by and among the Company and certain stockholders of the Company (incorporated by reference to Exhibit 4.2(a) to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
4.2(b)	Amendment No. 1, dated December 6, 2004, to Third Amended and Restated Investor Rights Agreement, dated May 12, 2004 (incorporated by reference to Exhibit 4.2(b) to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
4.2(c)	Amendment No. 2, dated March 16, 2006, to Third Amended and Restated Investor Rights Agreement, dated May 12, 2004 (incorporated by reference to Exhibit 4.2(c) to Amendment No. 4 to the Company's Registration Statement on Form S-1/A, as filed with the SEC on March 24, 2006 (Registration No. 333-131050)
10.1*	Form of Indemnification Agreement between the Company and each of its directors and officers (incorporated by reference to Exhibit 10.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1/A, as filed with the SEC on March 16, 2006 (Registration No. 333-131050))
10.2(a)	Lease Agreement, effective August 1, 2002, by and between the Company and Wake Forest University Health Sciences (incorporated by reference to Exhibit 10.2(a) to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.2(b)	First Lease Amendment, effective as of January 1, 2005, to Lease Agreement effective August 1, 2002, by and between the Company and Wake Forest University Health Sciences (incorporated by reference to Exhibit 10.2(b) to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.2(c)	Second Lease Amendment, executed June 30, 2006 effective as of March 31, 2006, to Lease Agreement effective August 1, 2002, by and between the Company and Wake Forest University Health Sciences (incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the Quarter Ended June 30, 2006)
10.2(d)#	Third Lease Amendment, dated January 22, 2007 effective as of January 1, 2007, to Lease Agreement, effective August 1, 2002, by and between the Company and Wake Forest University Health Sciences
10.3	Loan Agreement, dated as of April 19, 2002, between the Company and the City of Winston-Salem (incorporated by reference to Exhibit 10.3 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.4	Second Amended and Restated Note and Security Agreement, dated June 30, 2006, between the Company and R.J. Reynolds Tobacco Holdings, Inc. (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed July 7, 2006)

Exhibit Number	Description
10.5(a)*	Amended and Restated Targacept, Inc. 2000 Equity Incentive Plan (incorporated by reference to Exhibit 99 to the Company's Registration Statement on Form S-8, as filed with the SEC on May 8, 2006 (Registration No. 333-133882))
10.5(b)*	Form of Incentive Stock Option Agreement under Targacept, Inc. 2000 Equity Incentive Plan (incorporated by reference to Exhibit 10.5(b) to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.5(c)*	Form of Non-employee Director Nonqualified Stock Option Agreement under Targacept, Inc. 2000 Equity Incentive Plan (incorporated by reference to Exhibit 10.5(c) to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.5(d)*	Form of Restricted Stock Award Agreement under Targacept, Inc. 2000 Equity Incentive Plan (incorporated by reference to Exhibit 10.5(d) to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.6(a)*	Targacept, Inc. 2006 Stock Incentive Plan (incorporated by reference to Exhibit 99 to the Company's Registration Statement on Form S-8, as filed with the SEC on May 8, 2006 (Registration No. 333-133881))
10.6(b)*	Form of Incentive Stock Option Agreement under Targacept, Inc. 2006 Stock Incentive Plan (incorporated by reference to Exhibit 10.6(a) to Amendment No. 3 to the Company's Registration Statement on Form S-1/A, as filed with the SEC on March 16, 2006 (Registration No. 333-131050))
10.6(c)*	Form of Nonqualified Stock Option Agreement under Targacept, Inc. 2006 Stock Incentive Plan (incorporated by reference to Exhibit 10.6(b) to Amendment No. 3 to the Company's Registration Statement on Form S-1/A, as filed with the SEC on March 16, 2006 (Registration No. 333-131050))
10.6(d)*	Form of Non-employee Director Nonqualified Stock Option Agreement under Targacept, Inc. 2006 Stock Incentive Plan (incorporated by reference to Exhibit 10.6(c) to Amendment No. 3 to the Company's Registration Statement on Form S-1/A, as filed with the SEC on March 16, 2006 (Registration No. 333-131050))
10.6(e)*	Form of Restricted Stock Award Agreement under Targacept, Inc. 2006 Stock Incentive Plan (incorporated by reference to Exhibit 10.6(d) to Amendment No. 3 to the Company's Registration Statement on Form S-1/A, as filed with the SEC on March 16, 2006 (Registration No. 333-131050))
10.7*	Employment Agreement, dated as of August 22, 2000, by and between the Company and J. Donald deBethizy (incorporated by reference to Exhibit 10.7 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.8*	Employment Agreement, dated as of August 22, 2000, by and between the Company and Merouane Bencherif (incorporated by reference to Exhibit 10.8 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.9*	Employment Agreement, dated as of August 22, 2000, by and between the Company and William S. Caldwell (incorporated by reference to Exhibit 10.9 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.10*	Employment Agreement, dated as of April 24, 2001, by and between the Company and Geoffrey C. Dunbar (incorporated by reference to Exhibit 10.10 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.11*	Employment Agreement, dated as of February 8, 2002, by and between the Company and Alan A. Musso (incorporated by reference to Exhibit 10.11 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))

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Exhibit Number	Description
10.12*	Employment Agreement, dated as of September 1, 2003, by and between the Company and Jeffrey P. Brennan (incorporated by reference to Exhibit 10.7 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.13+	Asset Purchase and Trademark Assignment Agreement, dated March 19, 1998, by and between the Company (as assignee of Layton Bioscience, Inc.) and Merck & Co., Inc. (incorporated by reference to Exhibit 10.15 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.14+	Amended and Restated License Agreement, dated as of March 9, 2004, by and between the Company and the University of South Florida Research Foundation, Inc. (incorporated by reference to Exhibit 10.16 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.15(a)+	License Agreement, dated October 6, 1997, by and between the Company (as assignee of R.J. Reynolds Tobacco Company) and Virginia Commonwealth University Intellectual Property Foundation (incorporated by reference to Exhibit 10.17(a) to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.15(b)+	Amendment to License Agreement, dated February 11, 2004, to the License Agreement, dated October 6, 1997, by and between the Company (as assignee of R.J. Reynolds Tobacco Company) and Virginia Commonwealth University Intellectual Property Foundation (incorporated by reference to Exhibit 10.17(b) to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.16(a)+	License Agreement, dated May 26, 1999, by and between the Company and the University of Kentucky Research Foundation (incorporated by reference to Exhibit 10.18(a) to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.16(b)+	Amendment No. 1, dated August 16, 2005, to License Agreement, dated May 26, 1999, by and between the Company and the University of Kentucky Research Foundation (incorporated by reference to Exhibit 10.18(b) to Amendment No. 5 to the Company's Registration Statement on Form S-1/A, as filed with the SEC on April 6, 2006 (Registration No. 333-131050))
10.17+	License Agreement, effective as of August 12, 2002, between the Company and Wake Forest University Health Sciences (incorporated by reference to Exhibit 10.19 to Amendment No. 5 to the Company's Registration Statement on Form S-1/A, as filed with the SEC on April 6, 2006 (Registration No. 333-131050))
10.18^	Development and Production Agreement for Active Pharmaceutical Ingredients, dated as of February 1, 2004, by and between the Company and Siegfried Ltd. (incorporated by reference to Exhibit 10.20 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050))
10.19(a)+	Collaborative Research and License Agreement, dated as of December 27, 2005, by and between the Company and AstraZeneca AB (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the Quarter Ended March 31, 2006)
10.19(b)	Amendment No. 1 dated November 10, 2006 to Collaborative Research and License Agreement between the Company and AstraZeneca AB dated December 27, 2005 (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2006)
10.20#	Exclusive License Agreement, dated January 22, 2007, by and between the Company and Yale University

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Exhibit Number	Description
10.21	Modified AIA Document B141 Standard Form of Agreement Between Owner and Architect, dated January 22, 2007, by and between the Company and O'Brien Atkins Associates, PA
10.22	Modified AIA Document A111 Standard Form of Agreement Between Owner and Contractor where the basis of payment is Cost of the Work Plus a Fee and modified AIA Document A201 General Conditions of the Contract for Construction, dated January 22, 2007, by and between the Company and Shelco, Inc.
10.23*	Description of Annual Cash Incentive Program
10.24*	Description of Non-Employee Director Compensation Program
23.1	Consent of Ernst & Young LLP
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

+ Confidential treatment has been granted with respect to certain portions of this Exhibit, which portions have been omitted and filed separately with the SEC as part of an application for confidential treatment.

^ Confidential treatment has previously been granted with respect to certain portions of this Exhibit, which portions have been omitted and filed separately with the SEC as part of an application for confidential treatment. A request for an extension of the previously granted term of confidential treatment has been filed with the SEC.

Portions of this Exhibit have been omitted and filed separately with the SEC as part of an application for confidential treatment.

* Denotes management compensation plan or contract

Our SEC file number for documents filed with the SEC pursuant to the Securities Exchange Act of 1934, as amended, is 000-51173.

[********] Certain confidential information contained in this document, marked by brackets, has been omitted and filed separately with the Securities and Exchange Commission pursuant to Rule 24b-2 of the Securities Exchange Act of 1934, as amended.

NORTH CAROLINA)
) THIRD LEASE AMENDMENT
FORSYTH COUNTY)

This Third Lease Amendment ("**Amendment**") is made effective as of the 1st day of January, 2007 (the "**Amendment Date**"), by and between Wake Forest University Health Sciences, a North Carolina non-profit corporation having its principal office in Winston-Salem, North Carolina ("**Landlord**"), and Targacept, Inc., a Delaware corporation having its principal office in Winston-Salem, North Carolina ("**Tenant**"). Unless otherwise defined herein, all of the capitalized terms of this Amendment shall have the same meanings ascribed to them in the Lease effective August 1, 2002, as amended by the First Lease Amendment effective January 1, 2005 (the "**First Lease Amendment**") and the Second Lease Amendment effective March 31, 2006 (the "**Second Lease Amendment**"), which is hereinafter referred to as the "**Lease**."

WITNESSETH:

WHEREAS, pursuant to the Lease, Tenant has an option to lease up to 12,338 additional rentable square feet of space on the first floor of the Building (the "**First Floor Option Space**"); and

WHEREAS, pursuant to the Lease, Tenant also has an option to lease up to 4,387 additional rentable square feet of space on the first floor of the Building (the "**PTRP Option Space**"); and

WHEREAS, Tenant provided Landlord notice on July 3, 2006, of its exercise of its Option to Lease as to all of the First Floor Option Space and of its exercise of its Option to Lease as to a portion of the PTRP Option Space, all such space (together with some additional space determined in connection with the BOMA Plan referenced below) as further described in this Amendment (the "**January 2007 Expansion Space**"), Tenant's lease of the January 2007 Expansion Space to become effective on January 1, 2007 and through the Renewal Term; and

WHEREAS, Tenant in such written notice also exercised its Option to Lease as to the remaining PTRP Option Space, as further described in this Amendment (the "**August 2007 Expansion Space**" and, together with the January 2007 Expansion Space, the "**Expansion Space**"), Tenant's lease of the August 2007 Expansion Space to be effective August 1, 2007 and through the Renewal Term; and

WHEREAS, Landlord is willing to provide an amount to Tenant for certain Tenant improvements to the Expansion Space in consideration of the rents agreed to be paid for such Expansion Space by Tenant as further provided herein; and

WHEREAS, per a BOMA Plan of the first floor prepared in August 2006 by Specialty Operations Solutions (which BOMA Plan is attached hereto as part of Exhibit A-2), the Expansion Space totals 16,924 square feet (which number does not include approximately 6,564 of square feet comprised of building and floor common area and vertical penetrations); and

WHEREAS, Tenant desires to Lease from Landlord and Landlord desires to lease to Tenant the Expansion Space, upon the terms and for the rents as further set forth herein; and

WHEREAS, Tenant has agreed that its execution of this Lease Amendment constitutes written notice of the exercise of its Renewal Option, resulting in a Renewal Term ending July 31, 2012; and

WHEREAS, in connection with Tenant's exercises of the Options to Lease described herein and Tenant's exercise of the Renewal Option, Landlord is willing to provide Tenant with the right, but not the obligation, to extend the term of the Lease for a second additional five (5) year term (the "**Second Renewal Term**");

NOW, THEREFORE, for and in consideration of the premises, of the rents reserved and to be paid by Tenant to Landlord, and of the additional mutual covenants of the parties, the parties hereby agree to amend the Lease as follows:

1. The Lease is amended by:

A. Deleting Exhibit A of the Lease, as amended, and substituting in lieu thereof the attached Exhibit A, describing the Demised Premises.

B. Deleting Exhibit A-2 ("One Technology Place First Level Floor Plan") and substituting in lieu thereof the attached Exhibit A-2, which reflects modifications to the first and second pages only. In particular, the new first page of such Exhibit shows the allocation of additional pro rata parking spaces based upon the additional occupancy by Tenant upon execution of this Amendment.

C. Revising the caption of paragraph 2 of the Lease to read: "INITIAL TERM, OPTIONS TO RENEW, RIGHT OF FIRST REFUSAL ON ADDITIONAL SPACE."

D. Deleting paragraph 2.2 of the Lease and substituting in lieu thereof the following paragraph 2.2:

"2.2 Renewal Rights. So long as Tenant is not in default under this Lease, Tenant has the right, but not the obligation, to extend the term of this Lease (a "Renewal Option") under the same terms and conditions for an additional five (5) year term (the "Renewal Term") and, if the Renewal Option for the Renewal Term is exercised, for a second additional five (5) year term (the "Second Renewal Term"). Tenant must exercise its right for (i) the Renewal Term by written notice to Landlord given on or before the date that is one hundred eighty (180) days prior to the expiration of the Initial Term and (ii) the Second Renewal Term by written notice to Landlord given on or before the date that is one hundred eighty (180) days prior to the expiration of the Renewal Term. If Tenant does not exercise its right to extend in a timely manner, Tenant will have irretrievably lost its right to extend the term of this Lease. Rental payments applicable for the Renewal Term or the Second Renewal Term, in each case if exercised, shall be as set forth in paragraphs 3.1 and 3.2. Any extension of this Lease beyond the Second Renewal Term (if exercised) shall be upon the terms and conditions mutually agreed upon by Landlord and Tenant, and unless such agreement is reached, this Lease shall expire."

E. Deleting paragraph 2.4 of the Lease and its subparagraphs and Exhibit C, and substituting in lieu thereof the following.

"2.4 Except as otherwise provided in this subparagraph, Tenant shall have the unilateral right to terminate this Lease ("Termination Right") at any time after July 31, 2010 and upon payment as required by paragraph 6.2.2 of the Lease. In order to exercise the Termination Right, Tenant shall provide Landlord with not less than one hundred eighty (180) days prior written notice. Provided, however, Tenant shall have waived its Termination Right in each of the following circumstance and for the period stated upon Tenant's request pursuant to paragraph 6.1 to require Landlord to provide Tenant an allowance for redecorating or for upfitting of the Demised Premises, and continuing for the remainder of the Renewal Term."

F. Deleting the table appearing in paragraph 3.1 of the Lease and substituting in lieu thereof the following table and accompanying notes:

"3.1 Tenant will pay annual rental pursuant to the following schedule ("rsf" indicates "rentable square foot"):

Initial Term

	Demised Premises		
Effective Date	3rd & 4th Floors (40,432 rsf)	1,000 rsf 1st Floor	13,955 rsf 1st Floor (includes 1,000 rsf)
Commencement Date 8/1/02	$36.00/rsf	--	--
Amendment Date 1/1/05-12/31/06	$36.00/rsf	$15.00/rsf	--
1/1/07-7/31/07	$36.00/rsf	--	$[********]/rsf Base ($[********]/month)
1/1/07-7/31/07	$36.00/rsf	--	$[********]/rsf Upfit Amortized (a total of $[********]for the 7-month period)

Renewal Term

ONE TECH SPACE TERM	SF	RENT	COMMENTS	TOTAL ANNUAL (per month)
1st Floor:				
8/1/07-7/31/12	13,955	$[********]/rsf Base		$[********] ($[********]/mo)
8/1/07-7/31/12	13,955	$[********]/rsf Upfit Amortized	Upfit costs of $2.5 million @ [********]	$[********]

SUBTOTAL				**$[********]**
3rd and 4th Floor: 8/1/07-7/31/12	40,432	$[********]/rsf	Current rate is $36.00/sf to 7/31/07	$[********] ($[********])
1st Floor: 8/1/07-7/31/12	2,969	$[********]/rsf		$[********] ($[********])
SUBTOTAL				**$[********]**
TOTAL:				**$[********]**
Second Floor*	20,669	[********]/rsf		$[********] ($[********])

* if corresponding Option to Lease is exercised by Tenant

Second Renewal Term

The annual rent per rentable square foot for all of the space leased during the Second Renewal Term, if any, shall be equal to the then-existing market rate for similar space in the Piedmont Triad in North Carolina, as mutually determined in good faith by Landlord and Tenant. Unless Tenant does not have an interest in extending the term of the Lease for the Second Renewal Term, Landlord and Tenant shall exercise the requisite diligence to ensure that they mutually determine the annual rent per rentable square foot applicable to the Second Renewal Term, in writing, on or before July 31, 2011.

The annual rent payable during the Initial Term, the Renewal Term, and, if applicable, the Second Renewal Term (herein collectively "Rent") is payable in equal monthly installments in advance on the first day of each calendar month of each calendar year during the Initial Term, the Renewal Term, and, if applicable, the Second Renewal Term, prorated for any partial month. Any increases or decreases in the amount of square footage leased during a month will be adjusted in the subsequent monthly payment. Rent payments shall be payable to "Wake Forest University Health Sciences" and sent to Landlord in care of Controller's Office, Attention: Doug Edgeton, Medical Center Boulevard, Winston-Salem, NC 27157.

G.

- deleting each reference to "Renewal Term" in paragraph 2.3.3 and replacing it with a reference to "Renewal Term and, if applicable, Second Renewal Term";
- deleting "During the Initial Term and the Renewal Term" from paragraph 3.2.1 and replacing it with "During the Initial Term and, if any, the Renewal Term and the Second Renewal Term";
- deleting "During the Initial Term and the Renewal Term" from paragraph 3.2.2.1 and replacing it with "During the Initial Term and, if any, the Renewal Term and the Second Renewal Term";
- deleting "any Renewal Term" from paragraph 18.1 and replacing it with ", if any, the Renewal Term and the Second Renewal Term";
- deleting "Renewal Term (as applicable)" from paragraph 19 and replacing it with "Renewal Term or Second Renewal Term (as applicable)";

- deleting “a Renewal Term” from paragraph 33 and replacing it with “the Renewal Term or Second Renewal Term”; and
- deleting “any Renewal Term” from paragraph 38 and replacing it with “, if any, Renewal Term or Second Renewal Term.”

H. Adding the following sentence to the end of paragraph 6.1: “In addition to, and not in substitution for, the allowance provided pursuant to the preceding sentence, at any time during 2014, Landlord shall provide Tenant, upon Tenant’s request, an allowance of [********] ($[********]) per rentable square foot of the Demised Premises located on the first floor of the Building for use by Tenant in the redecoration of such first floor Demised Premises.”

I. Deleting “the Amendment Date” from paragraph 6.2 of the Lease and replacing it with “January 1, 2005” and then adding the following subparagraphs 6.2.1 and 6.2.2:

6.2.1 Landlord has agreed to pay directly to third parties designated by Tenant, or alternatively at Tenant’s discretion to reimburse Tenant, amounts incurred in connection with the upfitting and improvement of the Expansion Space (the “**2007 Upfitting Funding**”); provided that the 2007 Upfitting Funding shall be equal to two million, five hundred thousand dollars ($2,500,000) in the aggregate.

6.2.2 Landlord’s recovery of the 2007 Upfitting Funding is reflected in the rental rate for the January 2007 Expansion Space over a period of eighty-four (84) months. The parties acknowledge that the remaining Lease Term (inclusive of the Renewal Term) extends for sixty-seven (67) months; therefore, if the lease is terminated prior to the expiration of the Renewal Term, Tenant agrees to pay to Landlord, in addition to any other amounts which may be due Landlord, that portion of the 2007 Upfitting Funding which is unpaid as of the date of such termination. If the Lease terminates upon expiration of the Renewal Term, the amount payable to Landlord will be $[********], provided that all installments of Rent have been timely paid. Landlord has previously provided to Tenant a schedule depicting the amortization of the 2007 Upfitting Funding.

3. The sum of $7,402.80 (three (3) months times $2,467.60, the monthly amount (when amortized over twelve (12) months) of the $29,611.20 additional space hold fee) shall be applied as a credit against the first Rent due for the First Floor Option Space.

4. Landlord affirms and acknowledges its obligations pursuant to paragraphs 6.3 and 6.4 of the Lease.

5. Landlord shall pay directly to third parties designated by Tenant, or alternatively at Tenant’s discretion shall reimburse Tenant, within fifteen (15) days following the date of each invoice provided by Tenant to Landlord therefor from time to time after the date hereof, the 2007 Upfitting Funding (as defined in the Lease); provided that Landlord’s obligation under this paragraph 5 shall be equal to two million, five hundred thousand dollars ($2,500,000) in the aggregate.

6. Except as amended herein, all of the terms and conditions of the Lease remain in full force and effect.

[signature page follows]

IN WITNESS WHEREOF, Landlord and Tenant have caused this Amendment to be executed, pursuant to authority duly granted, effective as of the Amendment Date set forth above.

LANDLORD:

Wake Forest University Health Sciences

By: /s/ Richard H. Dean
Richard H. Dean, M.D.
President

Date: 1-18-07

TENANT:

Targacept, Inc.

By: /s/ J. Donald deBethizy
J. Donald deBethizy
President

Date: January 22, 2007

Exhibit A

Demised Premises

The Demised Premises consist of the following:

- As of the Commencement Date, all of the third and fourth floors, consisting of 40,432 rentable square feet, including within the meaning of "Premises" or "Demised Premises" the entire fourth floor of the Building, to be utilized as Tenant's laboratory facilities, encompassing 20,216 rentable square feet, and 20,216 rentable square feet of general office space on the third floor;
- As of January 1, 2005, an additional 1,000 rentable square feet on the first floor of the Building, to be utilized as "Tenant's Storage Space";
- As of January 1, 2007, additional space located on the first floor of the Building, consisting of 13,955 rentable square feet (inclusive of the 1,000 rentable square feet described above), as depicted on the attached First Level Floor Plan attached hereto as a part of Exhibit A-2:

Rentable square footage*	Designation on Exhibit A-2 First Floor Plan	Color of Designated Space on Plan
6,555	Lab-1	blue
2,293	Office-1	purple
3,171	Office-2	olive
1,936	Office-5	yellow

; and

- As of August 1, 2007, further additional space located on the first floor of the Building, consisting of 2,969 rentable square feet, as depicted on the attached First Level Floor Plan attached hereto as a part of Exhibit A-2:

Rentable square footage	Designation on Exhibit A-2 First Floor Plan	Color of Designated Space on Plan
741	Office-3	beige
2,228	Office-4	salmon

; in each case together with rights of use of and subject to the rights of others in and to the Common Areas of the Building. Diagrams of the Demised Premises and Common Areas are as shown on the attached Exhibit A-2 (5 pages).

Exhibit A-2

(5 pages)

[GRAPHIC OF FLOOR PLANS]

[********] Certain confidential information contained in this document, marked by brackets, has been omitted and filed separately with the Securities and Exchange Commission pursuant to Rule 24b-2 of the Securities Exchange Act of 1934, as amended.

EXCLUSIVE LICENSE AGREEMENT

THIS AGREEMENT (the "Agreement") by and between YALE UNIVERSITY, a corporation organized and existing under and by virtue of a charter granted by the general assembly of the Colony and State of Connecticut and located in New Haven, Connecticut ("YALE"), and Targacept, Inc., a corporation organized and existing under the laws of the State of Delaware with principal offices located in Winston-Salem, North Carolina ("LICENSEE"), is effective as of the date of final signature below ("EFFECTIVE DATE").

ARTICLE 1 BACKGROUND

1.1. In the course of research conducted under YALE auspices, Drs. Tony George, Kristi Sacco, and Jennifer Vessicchio, in the Department of Psychiatry at YALE (the "INVENTORS"), have produced an invention entitled "Mecamylamine and Other Nicotinic Antagonists for Augmentation of SSRI, MAOIs, TCA and Other Antidepressants (OCR 1625)" (the "INVENTION").

1.2. The INVENTORS have assigned to YALE all of all INVENTORS' right, title and interest in and to the INVENTION and any resulting patents.

1.3. YALE wishes to have the INVENTION and any resulting patents commercialized to benefit the public good.

1.4. LICENSEE has agreed with YALE to induce YALE to enter into this Agreement that it shall, solely to the extent expressly provided in Article 7, act diligently to develop and commercialize the LICENSED PRODUCTS for public use.

1.5. YALE is willing to grant a license to LICENSEE, subject to the terms and conditions of this Agreement.

1.6. In consideration of these statements and mutual promises, YALE and LICENSEE agree to the terms of this Agreement.

ARTICLE 2 DEFINITIONS

The following terms used in this Agreement shall be defined as set forth below:

2.1. "AFFILIATE" shall mean, with respect to any entity (including, without limitation, either party hereto), any entity or person that directly or indirectly controls, is controlled by or is under common control with such entity. For purposes of this definition, "control" means possession of the power to direct the management of an entity, whether through ownership of more than fifty percent (50%) of voting securities, by contract or otherwise.

2.2. "CONFIDENTIAL INFORMATION" shall mean all information disclosed by one party to the other during the negotiation of, or under, this Agreement in any manner, whether orally,

visually or in tangible form, that directly relates to LICENSED PATENTS, LICENSED PRODUCTS or LICENSED METHODS or the Agreement itself, unless such information is subject to an exception described in Article 8.2; provided, however, that CONFIDENTIAL INFORMATION that is disclosed in tangible form shall be marked "Confidential" at the time of disclosure and CONFIDENTIAL INFORMATION that is disclosed orally or visually shall be identified as confidential at the time of disclosure and subsequently reduced to writing (including, for this purpose, email), marked confidential and delivered to the other party within thirty (30) days after such disclosure. Subject to Article 8.2, CONFIDENTIAL INFORMATION shall include, without limitation, materials, know-how and data, technical or non-technical, trade secrets, inventions, methods and processes, whether or not patentable.

2.3. "EARNED ROYALTY" is defined in Article 6.1.

2.4. "EFFECTIVE DATE" is defined in the introductory paragraph of this Agreement.

2.5. "FIELD" shall mean all therapeutic uses in humans.

2.6. "FIRST SALE" shall mean, with respect to a LICENSED PRODUCT or LICENSED METHOD, the first sale, that results in NET SALES, to a third party of such LICENSED PRODUCT or LICENSED METHOD after all regulatory approvals necessary for the commercialization of such LICENSED PRODUCT or LICENSED METHOD in the country in which such sale is made have been obtained. For purposes of clarity, for each LICENSED PRODUCT developed by LICENSEE, there can only be one FIRST SALE under this Agreement.

2.7. "INSOLVENT" shall mean that LICENSEE is insolvent as defined by the United States Bankruptcy Code, as amended from time to time

2.8. "INVENTION" and "INVENTOR" are defined in Article 1.1.

2.9. "LICENSE" refers to the license granted under Article 3.1.

2.10. "LICENSED INFORMATION" shall mean all preclinical and clinical data controlled by Yale as of the EFFECTIVE DATE and directly relating to the INVENTION.

2.11. "LICENSED METHODS" shall mean any method, procedure, service or process the practice of which, in the absence of a license from YALE, would infringe a VALID CLAIM of a LICENSED PATENT.

2.12. "LICENSED PATENTS" shall mean: (i) the patent applications listed in Appendix A, together with all continuations, divisionals and continuations-in-part that include any claim that is directed to subject matter described in the patent applications listed on Appendix A (collectively, the "Applications"); (ii) all patents issuing from or claiming priority to any of the Applications during the TERM, together with all reissues, re-examinations or extensions thereof or substitutes therefor (the "Patents") and (iii) the relevant international counterparts of each of the Applications and Patents. Appendix A is incorporated into this Agreement herein by reference.

2.13. "LICENSED PRODUCT" shall mean any product (including any apparatus or kit), or component part thereof, the manufacture, use or sale of which, in the absence of a license from YALE, would infringe a VALID CLAIM of a LICENSED PATENT.

2.14. “LICENSED TERRITORY” shall mean the entire world.

2.15. “NDA” shall mean a new drug application filed with the United States Food and Drug Administration to obtain marketing approval for a LICENSED PRODUCT in the United States.

2.16. “NET SALES” shall mean:

(a) gross invoice price from the sale or other transfer or disposition of the LICENSED PRODUCTS or LICENSED METHODS, or from services performed using LICENSED PRODUCTS or LICENSED METHODS, by LICENSEE, SUBLICENSEES or its AFFILIATES to third parties, except as set forth in Article 2.16(b), less the following deductions, provided they actually pertain to the disposition of the LICENSED PRODUCTS or LICENSED METHODS:

(i) all discounts (including chargebacks), credits and allowances on account of returns;

(ii) all amounts repaid or credited by reason of rejection, returns or recalls of goods, rebates or bona fide price reductions determined by LICENSEE or a SUBLICENSEE or an AFFILIATE in good faith;

(iii) all rebates and similar payments made with respect to sales paid for by any governmental or regulatory authority such as, by way of illustration and without limitation, Federal or state Medicaid, Medicare or similar state program in the United States or equivalent governmental program in any other country;

(iv) all invoiced amounts that are not collected by LICENSEE or a SUBLICENSEE or an AFFILIATE, including bad debts (provided that deductions for bad debt in any calendar quarter shall not exceed [********]of aggregate gross sales for such quarter pursuant to clause (a) (i.e., before application of sub clauses (i-v)));

(v) all duties, taxes and other governmental levies, fees or charges levied on the sale, transportation or delivery of LICENSED PRODUCTS or practice of the LICENSED METHODS (to the extent included separately on the applicable invoice), but not including income taxes; and

(vi) [********]of the amount arrived at after application of the provisions of items (i) through (v) above as an allowance for transportation costs, distribution expenses, special packaging and related insurance charges; provided that, if such costs, expenses and charges are itemized separately on the applicable invoice, such deduction shall instead be equal to the aggregate amount therefor shown on such invoice.

No deductions shall be made for any other costs or expenses, including but not limited to commissions to independents, agents or those on LICENSEE’s, SUBLICENSEE’s or an AFFILIATE’s payroll or for the cost of collection.

NET SALES shall be calculated using the selling party’s (LICENSEE’s or a SUBLICENSEE’s or an AFFILIATE’s) internal audited systems used to report such sales, as adjusted for any of items (i) to (vi) (inclusive) above not taken into account in such systems. Deductions pursuant to clause (iv) above shall be taken in the quarter in which such sales are no longer recorded as a receivable.

For purposes of clarity, sales of a LICENSED PRODUCT or LICENSED METHOD in any country in the LICENSED TERRITORY in which the sale of such LICENSED PRODUCT or LICENSED METHOD would not infringe a VALID CLAIM of a LICENSED PATENT shall not be taken into account in determining NET SALES.

(b) "NET SALES" shall not include the gross invoice price for LICENSED PRODUCTS or LICENSED METHODS sold to, or services performed using LICENSED PRODUCTS or LICENSED METHODS for, any SUBLICENSEE or AFFILIATE unless such SUBLICENSEE or AFFILIATE is the end user of any LICENSED PRODUCT or LICENSED METHOD, in which case such consideration shall be included in NET SALES at the average selling price charged to a third party during the same quarter. Also, none of (i) the use of any LICENSED PRODUCT in a clinical trial, preclinical study or other research or development activity, (ii) the disposal or transfer of a LICENSED PRODUCT for purposes of a sampling program or for charitable, manufacturing, testing or qualification, regulatory or governmental purposes, or (iii) the sale, disposal or transfer of a LICENSED PRODUCT on a treatment investigational new drug application, named patient or compassionate use or other similar basis, shall give rise to any NET SALES.

2.17. "QUALIFIED SUBLICENSEE" shall mean any entity that is, or is an Affiliate of, either (i) one of the [********] largest biotechnology or pharmaceutical companies in the world, as measured by annual sales, or (ii) any other entity that has assets of at least $[********].

2.18. "REASONABLE COMMERCIAL EFFORTS" shall mean documented efforts that are consistent with those typically utilized by companies of similar size and with similar resources and expertise in the development of products and services with market potential similar to LICENSED PRODUCTS and LICENSED METHODS, taking into account all relevant scientific, clinical, regulatory, financial, competitive and commercial factors.

2.19. "ROYALTY TERM" is defined in Article 3.4.

2.20. "SUBLICENSE INCOME" shall mean all amounts (excluding Excluded Amounts, as described below) received by LICENSEE from a SUBLICENSEE, but only if the sublicense to LICENSED PATENTS or LICENSED METHODS is not combined, whether or not in the same agreement, with (i) a license to issued patents or pending patent applications owned or licensed by LICENSEE or its AFFILIATES (other than LICENSED PATENTS) that claim or cover compounds or their use in the FIELD or (ii) an agreement by LICENSEE or its AFFILIATES to collaborate with such SUBLICENSEE to discover, research, develop or commercialize compounds or products for use in the FIELD.

"Excluded Amounts" means all payments made to LICENSEE or its AFFILIATES: (i) as royalties on the sale of products; (ii) upon the achievement of, or based on, clinical, regulatory, commercialization or sales milestones; (iii) under a credit facility; (iv) in consideration of (A) any issuance of equity or debt securities by LICENSEE or its AFFILIATES, (B) any supply of compounds or related materials by or on behalf of LICENSEE or its AFFILIATES, or (C) any research, development or other activities that LICENSEE or its AFFILIATES may perform on behalf of a SUBLICENSEE, provided that such payments do not exceed the fair market value of such securities, supply or activities, as applicable; (v) that LICENSEE or its AFFILIATES may be required to repay (e.g., a loan); (vi) as reimbursement of actual patent prosecution and maintenance costs and expenses; or (vii) in connection with awards or judgments in patent or other intellectual property right enforcement.

2.21. “SUBLICENSEE” shall mean any third party sublicensed by LICENSEE to make, have made, use, sell, have sold, import or export any LICENSED PRODUCT or to practice any LICENSED METHOD; provided that a contract research organization or contract manufacturer contracted by LICENSEE or a SUBLICENSEE or an AFFILIATE to perform services on a fee-for-service basis related to the manufacturing and/or research or development of LICENSED PRODUCTS only, and not sales of LICENSED PRODUCTS, shall not be a SUBLICENSEE.

2.22. “TARGACEPT PATENT” shall mean all issued and unexpired patents or pending patent applications owned or licensed by LICENSEE or any of its AFFILIATES during the TERM that contain a VALID CLAIM that would be infringed by the manufacture, use, sale or other exploitation of a LICENSED PRODUCT by a third party in the absence of a license from LICENSEE (or such AFFILIATE); provided that (i) LICENSED PATENTS are not TARGACEPT PATENTS, (ii) no pending patent application that solely covers a method of manufacture or delivery shall be a TARGACEPT PATENT and (iii) no issued patent that solely covers a method of manufacture or delivery shall be a TARGACEPT PATENT unless, with respect to a particular LICENSED PRODUCT, no third party could reasonably be expected to manufacture and market such LICENSED PRODUCT to treat the indication for which LICENSEE or any of its AFFILIATES or SUBLICENSEES is commercializing such LICENSED PRODUCT without infringing such patent in the absence of a license from LICENSEE or any of its AFFILIATES.

2.23. “TERM” is defined in Article 3.4.

2.24. “VALID CLAIM” shall mean a claim of a pending or issued and unexpired LICENSED PATENT so long as such LICENSED PATENT (i) if a pending patent application, is being prosecuted in good faith and shall not have been irrevocably abandoned or finally disallowed without the possibility of appeal or re-filing or (ii) if an issued and unexpired patent, shall not have been finally canceled, withdrawn, abandoned or rejected by any administrative agency or other authority of competent jurisdiction, shall not have been permanently revoked, declared to be invalid, unpatentable or unenforceable in an unappealable (or unappealed within the time allowed for appeal) decision of a court or other authority or competent jurisdiction through no challenge by LICENSEE.

ARTICLE 3 LICENSE GRANT AND TERM

3.1. Subject to the terms and conditions of this Agreement, YALE hereby grants to LICENSEE an exclusive license, with the right to sublicense, under the LICENSED PATENTS and a non-exclusive license, with the right to sublicense, under the LICENSED INFORMATION, in each case to make, have made, use, sell, have sold, import, export and otherwise exploit LICENSED PRODUCTS, and to practice any LICENSED METHOD, within the FIELD in the LICENSED TERRITORY (the “LICENSE”). YALE (i) represents to LICENSEE that The Donaghue Foundation (“TDF”) provided funding (but not any inventive contribution) to YALE in support of the research activities giving rise to the INVENTION and (ii) covenants to LICENSEE that TDF has irrevocably waived and disclaimed all of TDF’s right, title and interest in and to the INVENTION and the LICENSED PATENTS in a valid, binding and enforceable written agreement between TDF and YALE so as to enable LICENSEE to enjoy the exclusivity intended by the LICENSE with no obligation, financial or otherwise, of LICENSEE to TDF.

3.2. To the extent that any invention included within the LICENSED PATENTS has been funded in whole or in part by the United States government, the United States government retains certain rights in such invention as set forth in 35 U.S.C. §200-212 and all regulations promulgated thereunder, as amended, and any successor statutes and regulations (the "Federal Patent Policy"). As a condition of the LICENSE granted hereby, LICENSEE acknowledges and shall comply with all aspects of the Federal Patent Policy applicable to the LICENSED PATENTS, including, solely if and to the extent applicable, the obligation that LICENSED PRODUCTS used or sold in the United States be manufactured substantially in the United States. Nothing contained in this Agreement obligates or shall obligate YALE to take any action that would conflict in any respect with its past, current or future obligations to the United States Government under the Federal Patent Policy with respect to the LICENSED PATENTS.

3.3. The LICENSE is expressly made subject to YALE's reservation of the right, on behalf of itself and all other non-profit academic research institutions, to make, use and practice the LICENSED PATENTS and LICENSED METHODS for research, clinical, teaching or other non-commercial purposes, and not for purposes, whether itself or through any licensee or other third party, of commercial development, use, manufacture or distribution. Nothing in this Agreement shall be construed to grant by implication, estoppel or otherwise any licenses under patents of YALE other than the LICENSED PATENTS.

3.4. Unless terminated earlier as provided in Article 13, the royalty term of this Agreement (the "ROYALTY TERM") shall commence on the EFFECTIVE DATE and shall automatically expire, for purposes of any country, on the date on which the last of the LICENSED PATENTS in such country that include at least one VALID CLAIM expires. The term of this Agreement (the "TERM") shall expire upon expiration of the last-to-expire ROYALTY TERM or, if earlier, upon the effective date of termination in accordance with Article 13.

3.5. Except as expressly provided in this Agreement, under no circumstances will LICENSEE, as a result of this Agreement, obtain any interest in or any other right to any technology, know-how, patents, patent applications, materials or other intellectual or proprietary property of YALE.

ARTICLE 4 SUBLICENSES

4.1. LICENSEE may sublicense the rights granted to it under this Agreement without the consent of YALE.

4.2. Any sublicense granted by LICENSEE shall include provisions designed to protect CONFIDENTIAL INFORMATION and substantially the same provisions on Patent Notices and Use of YALE's Name as are agreed to in this Agreement and such other provisions as are needed to enable LICENSEE to comply with this Agreement. LICENSEE will provide YALE with a copy of each sublicense agreement (and all amendments thereof) promptly after execution. LICENSEE shall remain responsible for the performance of all SUBLICENSEES under any such sublicense as if such performance were carried out by LICENSEE itself, including, without limitation, the payment of any royalties or other payments provided for hereunder, regardless of whether the terms of any sublicense provide for such amounts to be paid by the SUBLICENSEE directly to YALE.

4.3. LICENSEE shall pay royalties to YALE on NET SALES of SUBLICENSEES based on the same royalty rate as apply to NET SALES by LICENSEE and its AFFILIATES, regardless of the royalty rates payable by SUBLICENSEES to LICENSEE under a sublicense agreement. In addition, LICENSEE shall pay to YALE [********] ([********]) of any SUBLICENSE INCOME.

4.4. LICENSEE agrees that it has sole responsibility to promptly notify YALE of termination of any sublicense.

ARTICLE 5 LICENSE INITIATION FEE; MILESTONE; ROYALTIES

5.1. LICENSEE shall pay to YALE, (i) a non-refundable license initiation fee of [********] ($[********]) and (ii) the amount of [********] ($[********]) to reimburse YALE for all expenses incurred as of the EFFECTIVE DATE in the filing, prosecution, and maintenance of the LICENSED PATENTS.

5.2. LICENSEE shall make the following non-refundable milestone payments to YALE within thirty (30) days after the applicable milestone event(s) set forth below:

(a) [********] ($[********]) (i) upon the issuance of the first U.S. patent included in the LICENSED PATENTS that would be infringed, in the absence of a license from YALE, by the commercial sale by LICENSEE of mecamylamine hydrochloride together with citalopram hydrobromide or (ii) if the first to issue U.S. patent included in the LICENSED PATENTS would not be infringed, in the absence of a license from YALE, by the commercial sale by LICENSEE of mecamylamine hydrochloride together with citalopram hydrobromide, upon the sixtieth (60^{th}) day after the date on which LICENSEE pays the issuance fee (following receipt of the notice of allowance) for such U.S. patent.

(b) [********] ($[********]) when LICENSEE or any of its SUBLICENSEES or AFFILIATES files an NDA for each LICENSED PRODUCT developed by LICENSEE.

(c) [********] ($[********]) upon the FIRST SALE of each LICENSED PRODUCT developed by LICENSEE.

For purposes of clarity, the racemate and enantiomers of any compound shall be considered to be the same compound such that, to the extent that any of the racemate or either of the enantiomers is contained in or comprises a LICENSED PRODUCT, such racemate and enantiomers shall be considered together to be the same LICENSED PRODUCT and therefore subject to a single milestone stream hereunder.

For purposes of further clarity, with respect to each of the foregoing milestone payments, such milestone payment shall not be due or payable by LICENSEE if this Agreement is terminated pursuant to Article 13 and such termination becomes effective prior to the date on which the event (or, in the case of Article 5.2(a)(ii), the date) giving rise to such milestone payment occurs.

5.3. Neither the license initiation fee set forth in Article 5.1 nor the milestone payments set forth in Article 5.2 shall be credited against EARNED ROYALTIES payable under Article 6.

ARTICLE 6 EARNED ROYALTIES; MINIMUM ROYALTY PAYMENTS

6.1. During the TERM, as partial consideration for the LICENSE, LICENSEE shall pay to YALE an earned royalty on cumulative NET SALES of LICENSED PRODUCTS or LICENSED METHODS by LICENSEE or its SUBLICENSEES or AFFILIATES in each calendar (January 1 through December 31) year (“EARNED ROYALTIES”) according to the following schedule:

Annual NET SALES	Prior to Expiration of the Last TARGACEPT PATENT	After Expiration of the last TARGACEPT PATENT
$[********]	[********]%	[********]%
>$[********]	[********]%	[********]%
>$[********]	[********]%	[********]%
> $[********]	[********]%	[********]%

By way of example, if cumulative NET SALES of LICENSED PRODUCTS in a particular calendar year are $[********]and there is at least one unexpired TARGACEPT PATENT, EARNED ROYALTIES payable hereunder would be determined as follows:

[********]

For purposes of clarity, LICENSEE's obligation to pay EARNED ROYALTIES shall be imposed only once with respect to the same unit of a LICENSED PRODUCT or LICENSED METHOD regardless of how many LICENSED PATENTS or VALID CLAIMS pertain thereto.

6.2. Notwithstanding Article 6.1, if (i) the practice of any portion of the LICENSE (including, without limitation, the sale of LICENSED PRODUCTS or LICENSED METHODS), or the manufacture, use, sale or other exploitation of a LICENSED PRODUCT or LICENSED METHOD, by LICENSEE or any of its AFFILIATES or SUBLICENSEES in a particular country would or would reasonably be expected to infringe upon an issued patent of a third party in the absence of a license (whether or not any other LICENSED PRODUCT or LICENSED METHOD could be manufactured, used, sold or otherwise exploited without a license to such third party patent) and (ii) LICENSEE or any of its AFFILIATES or SUBLICENSEES obtains a license to such third party patent, the amount of EARNED ROYALTIES payable by LICENSEE shall be reduced by an amount equal to the lesser of (A) [********] ([********]) of the amounts paid to secure such third party license or (B) the amount that results in aggregate EARNED ROYALTIES of at least [********]of NET SALES for such calendar quarter.

6.3. LICENSEE shall pay all EARNED ROYALTIES accruing to YALE within ninety (90) days from the end of each calendar quarter (i.e., March 31, June 30, September 30 and December 31), beginning in the first calendar quarter in which NET SALES occur.

6.4. During the TERM, LICENSEE agrees to pay YALE annual Minimum Royalty Payments ("MRP"), commencing after the first anniversary of the date of the FIRST SALE of the first LICENSED PRODUCT or LICENSED METHOD. The MRP shall be in the following amounts:

1st anniversary of FIRST SALE	$[********]
2nd anniversary of FIRST SALE	$[********]
3rd anniversary of FIRST SALE and every anniversary of FIRST SALE thereafter	$[********]

Each MRP shall be payable by LICENSEE on the anniversary of the EFFECTIVE DATE that first occurs after the applicable anniversary of FIRST SALE.

6.5. LICENSEE shall continue to pay the MRP until the end of the TERM. YALE shall fully credit each MRP made against any EARNED ROYALTIES payable by LICENSEE in the same year and thereafter until exhausted.

6.6. All EARNED ROYALTIES and other payments due under this Agreement shall be paid to YALE in United States Dollars. In the event that conversion from foreign currency is required in calculating a payment under this Agreement, the exchange rate used shall be the Interbank rate quoted by Citibank at the end of the last business day of the quarter in which the royalty was earned. If overdue, the royalties and any other payments due under this Agreement shall bear interest until payment at a per annum rate two percent (2%) above the prime rate in effect at Citibank on the due date and YALE shall be entitled to recover reasonable attorneys' fees and costs related to the enforcement of this Agreement to collect such payment. The payment of such interest shall not foreclose YALE from exercising any other right it may have as a consequence of the failure of LICENSEE to make any payment when due.

ARTICLE 7 DUE DILIGENCE

7.1. LICENSEE shall use all REASONABLE COMMERCIAL EFFORTS to develop at least one LICENSED PRODUCT or LICENSED METHOD for commercialization in the United States. Failure to do so shall, if determined to be a material breach and subject to the applicable cure period, be subject to termination under Article 13.

7.2. Within sixty (60) days after each anniversary of the EFFECTIVE DATE, LICENSEE shall provide a written report to YALE summarizing LICENSEE's progress in its development or commercialization of at least one LICENSED PRODUCT or LICENSED METHOD; provided that such reporting obligation shall expire upon the FIRST SALE of at least one LICENSED PRODUCT.

7.3. LICENSEE shall immediately notify YALE if at any time LICENSEE finally abandons both its research, development or marketing of LICENSED PRODUCTS and LICENSED METHODS and its intent to research, develop and market such products or methods.

7.4. Without prejudice to YALE's rights under Article 13, LICENSEE agrees that YALE shall be entitled to terminate this Agreement if LICENSEE provides YALE with the notice set forth in Article 7.3.

ARTICLE 8 CONFIDENTIALITY AND PUBLICITY

8.1. Subject to the parties' rights and obligations pursuant to this Agreement, YALE and LICENSEE agree that during the TERM and for five (5) years thereafter, each of them:

(a) will keep confidential and will cause their AFFILIATES and, in the case of LICENSEE, its SUBLICENSEES, to keep confidential, CONFIDENTIAL INFORMATION disclosed to it by the other party, by taking whatever action the party receiving the CONFIDENTIAL INFORMATION would take to preserve the confidentiality of its own CONFIDENTIAL INFORMATION, which in no event shall be less than reasonable care; and

(b) will only disclose that part of the other party's CONFIDENTIAL INFORMATION to its officers, employees or agents that is necessary for those officers, employees or agents to carry out its responsibilities under this Agreement; and

(c) will not use the other party's CONFIDENTIAL INFORMATION other than as expressly set forth in this Agreement (including, in the case of LICENSEE, in the development or commercialization of LICENSED PRODUCTS OR LICENSED METHODS) or disclose the other party's CONFIDENTIAL INFORMATION to any third parties under any circumstance without advance written permission from the other party; provided that LICENSEE shall be permitted to disclose YALE's CONFIDENTIAL INFORMATION (including, solely for this purpose, the terms of this Agreement) (i) to its legal and financial advisors, (ii) to its auditor, (iii) in connection with any actual or potential debt or equity financing, (iv) to any actual or potential SUBLICENSEE or (v) in connection with any acquisition or business combination; provided that, in case of clauses (iv) or (v), any such disclosure is made subject to an obligation of confidentiality at least substantially similar to those contained herein; and

(d) will, within sixty (60) days of receipt of written request from a party following termination of this Agreement, return all the CONFIDENTIAL INFORMATION disclosed to it by the other party pursuant to this Agreement, except for one copy which may be retained by the recipient for monitoring compliance with this Article 8.

8.2. The obligations of non-use and confidentiality described above shall not pertain to that part of the CONFIDENTIAL INFORMATION that:

(a) was known to the recipient prior to the disclosure by the disclosing party; or

(b) is at the time of disclosure or has become thereafter publicly known through no fault or omission attributable to the recipient; or

(c) is rightfully given to the recipient from sources independent of the disclosing party; or

(d) is established by written evidence to have been independently developed by the receiving party without use of or reference to the CONFIDENTIAL INFORMATION of the other party; or

(e) is required to be disclosed by law, rule or regulation (including, in the case of LICENSEE or AFFILIATES, stock exchange or listing organization requirements) in the opinion of recipient's attorney, but only after the disclosing party is given prompt written notice and an opportunity to seek a protective order (in each case to the extent practicable under the circumstances).

8.3. Except as required by law, rule or regulation (including, in the case of LICENSEE or its AFFILIATES, stock exchange or listing organization requirements) or permitted by Article 8.1(c), neither party may disclose the financial terms of this Agreement without the prior written consent of the other party.

ARTICLE 9 REPORTS, RECORDS AND INSPECTIONS

9.1. LICENSEE shall, within ninety (90) days after the calendar year in which NET SALES first occur, and within ninety (90) days after each calendar quarter (i.e., March 31, June 30, September 30 and December 31) thereafter, provide YALE with a written report detailing the NET SALES and uses, if any, made by LICENSEE, its SUBLICENSEES and AFFILIATES of LICENSED PRODUCTS and LICENSED METHODS during the preceding calendar quarter and calculating the payments due pursuant to Article 6. NET SALES of LICENSED PRODUCTS or LICENSED METHODS shall be deemed to have occurred on the date of invoice for such LICENSED PRODUCTS or LICENSED METHODS. Each such report shall be signed by an officer of LICENSEE (or the officer's designee), and must include:

(a) the number of LICENSED PRODUCTS sold or otherwise transferred or disposed of, and the amount of LICENSED METHODS sold, by LICENSEE, SUBLICENSEES and AFFILIATES;

(b) a calculation of NET SALES for the applicable reporting period, including the gross invoice prices charged for the LICENSED PRODUCTS and LICENSED METHODS and detailing any permitted deductions made pursuant to Article 2.16;

(c) a calculation of total royalties or other payment due, including any exchange rates used for conversion; and

(d) names and addresses of all SUBLICENSEES and the type and amount of SUBLICENSE INCOME, if any, received from each SUBLICENSEE.

9.2. LICENSEE and its SUBLICENSEES shall keep and maintain complete and accurate records and books containing an accurate accounting of all data in sufficient detail to enable verification of EARNED ROYALTIES and other payments under this Agreement. LICENSEE shall preserve such books and records for three (3) years after the calendar year to which they pertain. Such books and records shall be open to inspection by YALE or an independent certified public accountant selected by YALE, at YALE's expense, during normal business hours upon thirty (30) days prior written notice, for the purpose of verifying the accuracy of the reports and computations rendered by LICENSEE. In the event LICENSEE underpaid the amounts due to YALE with respect to the audited period by more than five percent (5%), LICENSEE shall pay the reasonable cost of such examination, together with the deficiency not previously paid, within thirty (30) days of receiving notice thereof from YALE.

9.3. On or before the ninetieth (90^{th}) day following the close of LICENSEE's fiscal year, LICENSEE shall provide YALE with LICENSEE's certified financial statements for the preceding fiscal year including, at a minimum, a balance sheet and an income statement. This Article 9.3 shall not apply if and for so long as LICENSEE has a class of securities registered under Section 12 of the Securities Exchange Act of 1934.

ARTICLE 10 PATENT PROTECTION

10.1. From and after the EFFECTIVE DATE, LICENSEE shall be responsible for all actually incurred, reasonable costs of filing, prosecution and maintenance of all United States patent applications contained in the LICENSED PATENTS. Any and all such United States patent applications, and resulting issued patents, shall remain the property of YALE.

10.2. From and after the EFFECTIVE DATE, LICENSEE shall be responsible for all actually incurred, reasonable costs of filing, prosecution and maintenance of all foreign patent applications, and patents contained in the LICENSED PATENTS in countries outside the United States in the LICENSED TERRITORY selected by LICENSEE with the consent of YALE, not to be unreasonably withheld, conditioned or delayed. All such applications or patents shall remain the property of YALE.

10.3. If LICENSEE fails to pay the expenses of filing, prosecuting or maintaining a LICENSED PATENT in the United States, then LICENSEE's rights under this Agreement shall terminate automatically with respect to such LICENSED PATENT in the United States.

10.4. The costs mentioned in Articles 10.1 and 10.2 shall include, but are not limited to, taxes, annuities, working fees, maintenance fees and renewal and extension charges. Payment of such costs shall be made, at YALE's option, either directly to patent counsel or by reimbursement to YALE. In either case, LICENSEE shall make payment directly to the appropriate party within thirty (30) days after receiving its invoice.

10.5. (a) Subject to this Article 10.5, all pending patent applications and issued patents included in the LICENSED PATENTS shall be prepared, prosecuted, filed and maintained by outside patent counsel chosen by YALE subject to the approval of LICENSEE, not to be unreasonably withheld. YALE shall instruct patent counsel to (i) keep both YALE and LICENSEE regularly informed of the progress of the prosecution, issuance and maintenance of all such patent applications and patents, (ii) make itself available with reasonable notice, at reasonable times and with reasonable frequency for consultation with LICENSEE and its outside patent counsel, (iii) give both YALE and LICENSEE reasonable opportunity to review and comment on the type and scope of useful claims and the nature of supporting disclosures, (iv) give due consideration in good faith to comments received from LICENSEE or its outside patent counsel and (v) give LICENSEE at least thirty (30) days prior written notice of all meetings and material communications with any patent authorities concerning the LICENSED PATENTS and to permit LICENSEE to participate in such meetings or communications. YALE will not finally abandon any patent application included in the LICENSED PATENTS without LICENSEE's prior written consent. LICENSEE shall have the sole right, in good faith, to determine whether to seek or obtain any patent term extension(s), restoration(s) or the like that may be available in the future with respect to the LICENSED PATENTS in any part of the LICENSED TERRITORY. Neither party shall have any liability to the other party for damages, whether direct, indirect or incidental, consequential or otherwise, arising from its good faith decisions, actions and omissions in connection with patent prosecution hereunder if such party shall have complied with its obligations under this Article 10.5(a).

(b) Notwithstanding Article 10.5(a), upon thirty (30) days written notice to YALE, LICENSEE (or its AFFILIATES or SUBLICENSEES) shall have the right to assume the sole responsibility for the preparation, prosecution, filing and maintenance, by outside patent counsel chosen thereby and reasonably acceptable to YALE, of all pending patent applications and issued

patents included in the LICENSED PATENTS; provided that such rights shall be expressly subject to the obligations of LICENSEE (or, as applicable, its AFFILIATES or SUBLICENSEES) to instruct patent counsel to (i) [********], (ii) keep YALE regularly informed of the progress, issuance and maintenance of all such patent applications and patents, (iii) give YALE reasonable opportunity to comment on the type and scope of useful claims and the nature of supporting disclosures, (iv) give due consideration in good faith to comments received from YALE or its outside patent counsel, (v) not make any changes that would materially limit either the scope or number of claims without YALE's prior written consent and (vi) not to finally abandon any patent application included in the LICENSED PATENTS without YALE's prior written consent.

10.6. LICENSEE shall mark, and shall contract with its SUBLICENSEES to mark, all LICENSED PRODUCTS with the numbers of all patents included in LICENSED PATENTS that cover the LICENSED PRODUCTS. Without limiting the foregoing, all LICENSED PRODUCTS shall be marked in such a manner as to conform with the patent marking notices required by the law of any country where such LICENSED PRODUCTS are made, sold, used or shipped, including, but not limited to, the applicable patent laws of that country.

ARTICLE 11 INFRINGEMENT AND LITIGATION

11.1. Each party shall promptly notify the other in writing in the event that it obtains knowledge of infringing activity by third parties, or is sued or threatened with an infringement suit, in any country in the LICENSED TERRITORY as a result of activities that concern the LICENSED PATENTS and shall supply the other party with documentation of the infringing activities that it possesses, if any.

11.2. During the TERM:

(a) LICENSEE shall have the first right, but shall not be obligated, to defend the LICENSED PATENTS against infringement or interference in the FIELD and in the LICENSED TERRITORY by third parties. This right includes bringing any legal action for infringement and defending any counterclaim of invalidity or action of a third party for declaratory judgment for non-infringement or non-interference. If, in the reasonable opinion of LICENSEE's and YALE's respective counsels, YALE is required to be a named party to any such suit for standing purposes, LICENSEE may join YALE as a party; provided, however, that (i) YALE shall not be the first named party in any such action, (ii) the pleadings and any public statements about the action shall state that the action is being pursued by LICENSEE and that LICENSEE has joined YALE as a party; and (iii) LICENSEE shall keep YALE reasonably apprised of all material developments in any such action. LICENSEE may settle such suits, whether by agreement, consent, judgment, voluntary dismissal or otherwise, solely in its own name and solely at its own expense and through counsel of its own selection; provided, however, that any such settlement that imposes any restrictions or obligations on YALE shall be entered into only with YALE's prior written consent. LICENSEE shall bear the expense of such legal actions. Except for providing reasonable assistance, at the request and reasonable expense of LICENSEE, YALE shall have no obligation regarding the legal actions described in Article 11.2 unless required to participate by law. However, YALE shall have the right to participate in any such action through its own counsel and at its own expense. Any recovery shall first be applied to LICENSEE's out of pocket expenses and second to YALE's out of pocket expenses, in each case including legal fees. If there is any excess recovery following payment of such expenses: (A) any amount recovered specifically for lost profits or sales shall be treated as NET SALES in the calendar quarter in which such recovery is paid and shall be subject to EARNED

ROYALTIES payable to YALE in respect of such NET SALES; (B) any amount recovered specifically as punitive or treble damages shall be treated as SUBLICENSE INCOME; and (C) if both clause (A) and clause (B) apply, the amount of such excess recovery shall apply to clause (A) and clause (B) in the same proportion as (1) the amount recovered specifically for lost profits or sales bears to (2) the amount recovered specifically as punitive or treble damages.

(b) In the event LICENSEE fails to initiate and pursue commercially reasonable steps within one hundred twenty (120) days of (i) notification of infringement from YALE to eliminate the infringement or interference or (ii) the date LICENSEE otherwise first becomes aware of an infringement, whichever is earlier, YALE shall have the right to initiate such legal action at its own expense. If, in the reasonable opinion of YALE's and LICENSEE's respective counsel, LICENSEE is required to be a named party in any such suit for standing purposes, YALE may join LICENSEE as a party, subject to the same conditions to the joining of YALE set forth in Article 11.2(a). In such case, LICENSEE shall provide reasonable assistance to YALE if requested to do so. YALE may settle, whether by agreement, consent, judgment, voluntary dismissal or otherwise, such actions solely through its own counsel; provided, however, that any such settlement that imposes any restrictions or obligations on LICENSEE shall be entered into only with LICENSEE's prior written consent. Any recovery shall be retained by YALE.

11.3. In the event LICENSEE is permanently enjoined from exercising its LICENSE under this Agreement pursuant to an infringement action brought by a third party, or if both LICENSEE and YALE elect not to undertake the defense or settlement of a suit alleging infringement for a period of six (6) months from notice of such suit, then either party shall have the right to remove the country where the suit was filed from the LICENSED TERRITORY upon thirty (30) days written notice to the other party in accordance with the terms of Article 15.

ARTICLE 12 USE OF YALE'S NAME

LICENSEE shall not use the name "Yale" or "Yale University," or any variation or adaptation thereof, or any trademark, tradename or other designation owned by YALE, or the names of any of its trustees, officers, faculty, students, employees or agents, for any purpose without the prior written consent of YALE in each instance, except that LICENSEE may state that it has licensed from YALE one or more of the patents and applications comprising the LICENSED PATENTS. YALE shall not use the name "Targacept" or any variation or adaptation thereof, or any trademark, tradename or other designation owned by LICENSEE, or the names of any of its directors, officers, employees or agents, for any purpose without the prior written consent of LICENSEE in each instance, except that YALE may state that LICENSEE has licensed from it one or more of the patents and applications comprising the LICENSED PATENTS.

ARTICLE 13 TERMINATION

13.1. YALE shall have the right to terminate this Agreement upon written notice to LICENSEE in the event LICENSEE:

(a) fails to make any payment whatsoever due and payable pursuant to this Agreement unless LICENSEE shall make all such payments (and all interest due on such payments under Article 6.4) within the thirty (30) day period after receipt of written notice from YALE; or

(b) subject to Article 16.3, commits a material breach of any other provision of this Agreement which is not cured (if capable of being cured) within the one hundred twenty (120) day period after receipt of written notice thereof from YALE (or upon receipt of such notice if such breach is not capable of being cured);

(c) fails to obtain or maintain adequate insurance as described in Article 14 and does not cure such breach within the ten (10) day period after receipt of written notice thereof from YALE;

(d) as provided in Article 7.4.

13.2. This Agreement shall terminate automatically without any notice to LICENSEE in the event LICENSEE shall cease to carry on its business or becomes INSOLVENT, or a petition in bankruptcy is filed against LICENSEE and is consented to, acquiesced in or remains undismissed for sixty (60) days, or LICENSEE makes a general assignment for the benefit of creditors, or a receiver is appointed for LICENSEE.

13.3. LICENSEE shall have the right to terminate this Agreement upon thirty (30) days prior written notice to YALE.

13.4. Upon termination of this Agreement for any reason (but, for purposes of clarity, not expiration of the TERM), all rights and licenses granted to LICENSEE under the terms of this Agreement are terminated and YALE has the option, in its discretion, to terminate any sublicense granted by LICENSEE. Upon such termination (but not expiration of the TERM), LICENSEE shall cease to manufacture or sell LICENSED PRODUCTS and cease to practice LICENSED METHODS; provided that, as applied to the terms “LICENSED PRODUCTS” and “LICENSED METHODS” as used in this Article 13.4 and notwithstanding Article 2.24, “VALID CLAIM” shall, mean (i) a valid and enforceable claim of an issued and unexpired LICENSED PATENT or (ii) a claim of a pending application included in LICENSED PATENTS that is being prosecuted in good faith and that has not been irrevocably abandoned or finally disallowed without the possibility of appeal or re-filing where such claim, if such patent application were to issue as a patent, would be valid and enforceable. Within sixty (60) days after the effective date of termination LICENSEE shall deliver to YALE:

(a) the last report required under Article 7 or 9; and

(b) all payments incurred up to the effective date of termination.

13.5. Termination of this Agreement shall not affect any rights or obligations accrued prior to the effective date of such termination and specifically LICENSEE’s obligation to pay all such accrued royalties and other payments specified by Article 5 and 6. The following provisions shall survive any termination: Articles 2 and 8, Article 9.2, Article 10.5 (last sentence only), Article 12, this Article 13.5, Article 14, Article 15, Article 16.1, Article 16.3 and Article 17. The parties agree that claims giving rise to indemnification may arise after the TERM or termination of the LICENSE granted herein.

13.6. The rights provided in this Article 13 shall be in addition and without prejudice to any other rights which the parties may have with respect to any default or breach of the provisions of this Agreement.

13.7. Waiver by either party of one or more defaults or breaches shall not deprive such party of the right to terminate because of any subsequent default or breach.

ARTICLE 14 INDEMNIFICATION; INSURANCE; WARRANTIES AND DISCLAIMERS

14.1. LICENSEE shall defend, indemnify and hold harmless YALE, its trustees, directors, officers, employees, and agents and their respective successors, heirs and assigns ("Indemnified Parties") against any and all liabilities, claims, demands, damages, judgments and expenses of any nature, including without limitation legal expenses and reasonable attorneys' fees, under any theory of liability (including, without limitation, tort, warranty, or strict liability), arising out of the death, personal injury or illness of any person, or damage to any property, resulting from the production, manufacture, sale, use, lease or other disposition or consumption, promotion or advertisement of the LICENSED PRODUCTS or LICENSED METHODS by LICENSEE, its AFFILIATES, SUBLICENSEES; provided that LICENSEE shall have no obligation hereunder to Indemnified Parties with respect to liabilities, claims or demands ("Claims"), damages, judgments, losses and expenses to the extent that they arise out of the gross negligence or willful misconduct of any Indemnified Party.

14.2. YALE shall give LICENSEE prompt (and, in any event, within thirty (30) days after YALE's receipt of written notice of a Claim) written notice of any Claim asserted for which any Indemnified Party seeks to enforce Article 14.1, specifying in an amount of detail reasonable under the circumstances the nature of the Claim; provided that the failure to provide such notice on a timely basis shall not relieve LICENSEE of any obligation that it may have under Article 14.1, except to the extent that the defense of such Claim is materially prejudiced by such failure. LICENSEE shall have the opportunity to defend, negotiate and settle such claims using counsel of its choice; provided, however, that (i) any Indemnified Party shall be entitled to participate in the defense of such matter and to employ, at its expense, counsel to assist therein and (ii) LICENSEE shall not be responsible or bound by any settlement of any Claim without its prior written consent. YALE shall ensure that all Indemnified Parties seeking to enforce Article 14.1 provide LICENSEE with such information and assistance as LICENSEE may reasonably request, at the reasonable expense of LICENSEE.

14.3. LICENSEE shall purchase and maintain in effect during the TERM, and shall require its SUBLICENSEES (other than QUALIFIED SUBLICENSEES which may elect to self-insure and other than SUBLICENSEES with rights limited to *in vitro* and animal research) to purchase and maintain in effect during the TERM, a policy of general liability insurance. Such insurance shall:

(a) list "YALE, its trustees, directors, officers, employees and agents" as additional insureds under the policy and provide for thirty (30) days written notice prior to any cancellation or material change to the policy(ies); and

(b) be endorsed such that it provides contractual liability coverage for LICENSEE's indemnification under Article 14.1.

In addition, LICENSEE shall purchase and maintain in effect during the TERM a policy covering product liability in amounts no less than $[********]Dollars per incident and $[********]Dollars annual aggregate; provided that, by virtue of such minimum amount of coverage required, such insurance not be construed to create a limit of LICENSEE's liability with respect to its indemnification under Article 14.1.

14.4. By signing this Agreement, LICENSEE certifies that the requirements of Article 14.3 will be met on or before the earlier of (a) the date of FIRST SALE of any LICENSED PRODUCT or LICENSED METHOD or (b) the first date, after the EFFECTIVE DATE, any LICENSED PRODUCT or LICENSED METHOD is tested or used by LICENSEE, a SUBLICENSEE or an AFFILIATE on humans, and will continue to be met thereafter. Upon YALE's request during the TERM, LICENSEE shall furnish a Certificate of Insurance and a copy of the current insurance policy(ies) to YALE.

14.5. YALE represents and warrants to LICENSEE that (i) to YALE's knowledge, the INVENTORS are the only persons who contributed to either the conception or first reduction to practice of the INVENTION, (ii) each INVENTOR was an employee of YALE at the time the INVENTION was first disclosed to YALE's Office of Cooperative Research, (iii) YALE has secured a valid and binding written assignment to the INVENTION (including, without limitation, the LICENSED PATENTS) from each INVENTOR, (iv) YALE has made due inquiry of each INVENTOR and has no reason to believe that any such INVENTOR has granted, purported to grant or agreed to grant any right or license to the INVENTION or any of the LICENSED PATENTS to any third party, (v) to YALE's knowledge, YALE owns all right, title and interest in and to the LICENSED PATENTS, (vi)YALE has the lawful right to grant the LICENSE, (vii)YALE has not granted rights or licenses in derogation of this Agreement other than those rights granted or reserved to the U.S. Government, (viii) to YALE's knowledge, the LICENSED PATENTS are not invalid or unenforceable and (ix) in respect of the pending U.S. patent application included in the LICENSED PATENTS, YALE has presented all relevant prior art of which YALE and, to YALE's knowledge, the INVENTORS have knowledge to the relevant Patent Examiner at the United States Patent and Trademark Office. YALE agrees that, during the TERM, YALE shall not enter into any other agreements that conflict with the rights or obligations provided hereunder, including any rights and obligations that survive termination of this Agreement.

14.6. (a) EXCEPT AS OTHERWISE EXPRESSLY PROVIDED IN ARTICLE 14.5, YALE MAKES NO, AND EXPRESSLY DISCLAIMS ALL, REPRESENTATIONS OR WARRANTIES THAT ANY CLAIMS OF THE LICENSED PATENTS, ISSUED OR PENDING, ARE VALID, OR THAT THE MANUFACTURE, USE, SALE OR OTHER DISPOSAL OF THE LICENSED PRODUCTS, OR PRACTICE OF THE LICENSED METHODS DOES NOT OR WILL NOT INFRINGE UPON ANY PATENT OR OTHER RIGHTS NOT VESTED IN YALE.

(b) EXCEPT AS OTHERWISE EXPRESSLY PROVIDED IN ARTICLE 14.5, YALE MAKES NO, AND EXPRESSLY DISCLAIMS ALL, REPRESENTATIONS AND WARRANTIES WHATSOEVER WITH RESPECT TO THE LICENSED PATENTS, LICENSED PRODUCTS AND LICENSED METHODS, EITHER EXPRESS OR IMPLIED, INCLUDING, BUT NOT LIMITED TO, WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE. LICENSEE SHALL MAKE NO STATEMENTS, REPRESENTATION OR WARRANTIES WHATSOEVER TO ANY THIRD PARTIES WHICH ARE INCONSISTENT WITH SUCH DISCLAIMER BY YALE. IN NO EVENT SHALL YALE, OR ITS TRUSTEES, DIRECTORS, OFFICERS, EMPLOYEES AND AFFILIATES, BE LIABLE FOR SPECIAL, INCIDENTAL, CONSEQUENTIAL OR INDIRECT DAMAGES OF ANY KIND, INCLUDING ECONOMIC DAMAGE OR INJURY TO PROPERTY AND LOST PROFITS, REGARDLESS OF WHETHER YALE SHALL BE ADVISED, SHALL HAVE OTHER REASON TO KNOW, OR IN FACT SHALL KNOW OF THE POSSIBILITY OF THE FOREGOING.

ARTICLE 15 NOTICES

15.1. Any payment, notice or other communication required by this Agreement (a) shall be in writing, (b) may be delivered personally or sent by reputable overnight courier with written verification of receipt or by registered or certified first class United States Mail, postage prepaid, return receipt requested, (c) shall be sent to the following addresses or to such other address as such party shall designate by written notice to the other party, and (d) shall be effective upon receipt:

FOR YALE:

Managing Director
YALE UNIVERSITY
Office of Cooperative Research
433 Temple Street
New Haven, CT 06511

FOR LICENSEE:

TARGACEPT, INC.
200 East First Street, Suite 300
Winston-Salem, NC 27101
Attn: VP, Business and Commercial Development
Attn: General Counsel

ARTICLE 16 LAWS, FORUM AND REGULATIONS, DISPUTE RESOLUTION

16.1. Any matter arising out of or related to this Agreement shall be governed by and in accordance with the substantive laws of the State of Connecticut, without regard to its conflicts of law principles, except where the federal laws of the United States are applicable and have precedence. Any dispute arising out of or related to this Agreement shall be brought in a court of competent jurisdiction in the State of Connecticut.

16.2. LICENSEE shall comply, and shall cause its AFFILIATES to comply and contract with its SUBLICENSEES to comply, in all material respects with all foreign and United States federal, state, and local laws, regulations, rules and orders applicable to the testing, production, transportation, packaging, labeling, export, sale and use of the LICENSED PRODUCTS and practice of the LICENSED METHODS. In particular, LICENSEE shall be responsible for assuring compliance with all United States export laws and regulations applicable to this LICENSE and LICENSEE's activities under this Agreement

16.3. Neither party shall institute a proceeding in any court or administrative agency to resolve a dispute arising out of or relating to this Agreement before that party has sought to resolve such dispute through direct negotiation with the other party. Notwithstanding the foregoing, either party may seek, without waiving any right or remedy under this Agreement, from any court having jurisdiction injunctive or provisional relief to protect the rights or property of that party pending resolution of the dispute.

ARTICLE 17 MISCELLANEOUS

17.1. This Agreement shall be binding upon and inure to the benefit of the parties and their respective legal representatives, successors and permitted assigns.

17.2. This Agreement constitutes the entire agreement of the parties relating to the LICENSED PATENTS, LICENSED PRODUCTS and LICENSED METHODS, and all prior representations, agreements and understandings, written or oral (including, without limitation, the various draft term sheet proposals exchanged between the parties), are merged into it and superseded by this Agreement.

17.3. The provisions of this Agreement shall be deemed separable. If any part of this Agreement is rendered void, invalid, or unenforceable, such determination shall not affect the validity or enforceability of the remainder of this Agreement unless the part or parts which are void, invalid or unenforceable shall substantially impair the value of the entire Agreement as to either party.

17.4. Paragraph headings are inserted for convenience of reference only and do not form a part of this Agreement.

17.5. No person not a party to this Agreement, including any employee of either party to this Agreement, shall have or acquire any rights by reason of this Agreement. Nothing contained in this Agreement shall be deemed to constitute the parties partners with each other or any third party.

17.6. This Agreement may not be amended or modified except by written agreement executed by each of the parties. This Agreement is personal to LICENSEE and shall not be assigned by LICENSEE without the prior written consent of YALE, except no such consent shall be required in connection with any assignment by LICENSEE to an AFFILIATE or to a successor of all or substantially all of the business of LICENSEE to which this Agreement relates. Any attempted assignment in contravention of this Article 17.6 shall be null and void and shall constitute a material breach of this Agreement.

17.7. Neither LICENSEE nor any SUBLICENSEE or assignee will create, assume or permit to exist any lien, pledge, security interest or other encumbrance on this Agreement or any sublicense.

17.8. The failure of either party to enforce at any time, or for any period of time, any provision of this Agreement shall not be construed as a waiver of either such provision or of the right of such party thereafter to enforce each and every provision of this Agreement.

17.9. This Agreement may be executed in any number of counterparts and either party may execute any such counterpart, each of which when executed and delivered shall be deemed to be an original and all of which counterparts taken together shall constitute but one and the same instrument.

IN WITNESS to their Agreement, the parties have caused this Agreement to be executed in duplicate originals by their duly authorized representatives.

YALE UNIVERSITY

By: /s/ Jonathan Soderstrom

E. Jonathan Soderstrom, Ph.D.
Managing Director, Office of Cooperative Research

Date: 18 Jan 2007

TARGACEPT, INC.

By: /s/ Jeffrey C. Brennan

Name: Jeffrey C. Brennan
Title: Vice President, Business and Commercial Development

Date: January 22, 2007

Appendix A

LICENSED PATENTS

U.S. Patent Application 10/585,562 “Mecamylamine and Other Nicotinic Antagonists for Augmentation of SSRI, MAOIs, TCA and Other Antidepressants”.

U.S. provisional applications 60/534,532 and 60/627,250

PCT/US2005/000083 (Publication No. WO05067909A1)

AIA® Document B141™ – 1997 Part 1

Standard Form of Agreement Between Owner and Architect

with Standard Form of Architect's Services

This document has important legal consequences. Consultation with an attorney is encouraged with respect to its completion or modification.

TABLE OF ARTICLES

AGREEMENT made as of the 22nd day of January in the year Two Thousand Seven

(In words, indicate day, month and year)

BETWEEN the Architect's client identified as the Owner*:

(Name, address and other information)

Targacept, Inc.
200 East First Street, Suite 300
Winston-Salem, NC 27101-4165

* Targacept, Inc. leases the property which is the subject of this Agreement.

and the Architect:

(Name, address and other information)

O'Brien Atkins Associates, PA
P.O. Box 12037
Research Triangle Park, NC 27709

For the following Project:

(Include detailed description of Project)

Fit-Up of First Floor
200 East First Street
Winston-Salem, NC 27101-4165

Project Description: Targacept Animal Care Facility (+/- 5,400 GSF) (ACF), Associated Office Space (+/- 4,700 GSF) and Chemical Storage Room (+/- 360 GSF) as described in program documents prepared by Specialty Operations Solutions, Inc. for the Basis of Design (BOD) dated 7/13/06 and the Draft 3a Floor Plan dated 9/20/06 (see Exhibit A).

The Owner and Architect agree as follows:

ARTICLE 1.1 INITIAL INFORMATION

§ 1.1.1 This Agreement is based on the following information and assumptions.

(Note the disposition for the following items by inserting the requested information or a statement such as "not applicable," "unknown at time of execution" or "to be determined later by mutual agreement.")

§ 1.1.2 PROJECT PARAMETERS

§ 1.1.2.1 The objective or use is:

(Identify or describe, if appropriate, proposed use or goals.)

§ 1.1.2.2 The physical parameters are:

(Identify or describe, if appropriate, size, location, dimensions, or other pertinent information, such as geotechnical reports about the site.)

§ 1.1.2.3 The Owner's Program is:

(Identify documentation or state the manner in which the program will be developed.)

See program documents prepared by Specialty Operations Solutions, Inc. for the Basis of Design (BOD) dated 7/13/06 and the Draft 3a Floor Plan dated 9/20/06 (Exhibit A)

§ 1.1.2.4 The legal parameters are:

(Identify pertinent legal information, including, if appropriate, land surveys and legal descriptions and restrictions of the site.)

§ 1.1.2.5 The financial parameters are as follows.

.1 Amount of the Owner's overall budget for the Project, including the Architect's compensation, is: TBD.

.2 Amount of the Owner's budget for the Cost of the Work, excluding the Architect's compensation, is: TBD

§ 1.1.2.6 The time parameters are:

(Identify, if appropriate, milestone dates, durations or fast track scheduling.)

TBD

§ 1.1.2.7 The proposed procurement or delivery method for the Project is:

(Identify method such as competitive bid, negotiated contract, or construction management.)

Negotiated construction contract where the basis of payment is cost plus a fee with GMP.

§ 1.1.2.8 Other parameters are:

(Identify special characteristics or needs of the Project such as energy, environmental or historic preservation requirements.)

§ 1.1.3 PROJECT TEAM

§ 1.1.3.1 The Owner's Designated Representative is:

(List name, address and other information.)

Ms. Mauri K. Hodges
Targacept, Inc.
200 East First Street, Suite 300
Winston-Salem, NC 27101-4165

§ 1.1.3.2 The persons or entities, in addition to the Owner's Designated Representative, who are required to review the Architect's submittals to the Owner are:

(List name, address and other information.)

Special Operations Solutions, Inc.

§ 1.1.3.3 The Owner's other consultants and contractors are:

(List discipline and, if known, identify them by name and address.)

ACF Planning Consultant:

Specialty Operations Solutions, Inc.

§ 1.1.3.4 The Architect's Designated Representative is:

(List name, address and other information.)

Eric J. Erickson
O'Brien Atkins Associates, PA
P.O. Box 12037
Research Triangle Park, NC 27709

§ 1.1.3.5 The consultants retained at the Architect's expense are:

(List discipline and, if known, identify them by name and address.)

Mechanical Engineer (HVAC and Plumbing):

Name: Sterling Engineering Co., Inc.
Address: 79 Main Street
Sturbridge, MA 01566

Electrical Engineer:

Name: Sterling Engineering Co., Inc.
Address: 79 Main Street
Sturbridge, MA 01566

Fire Protection Engineering:

Name: Sterling Engineering Co., Inc.
Address: 79 Main Street
Sturbridge, MA 01566

Structural Engineer (if required):

Name: GKC Associates
Address: 510 Executive Park Drive
Durham, NC 27713

§ 1.1.4 Other important Architect requested initial information is:

§ 1.1.5 When the services under this Agreement include contract administration services, the General Conditions of the Contract for Construction shall be the 1997 edition of AIA Document A201 as modified by the Owner.

§ 1.1.6 The information contained in this Article 1.1 may be reasonably relied upon by the Owner and Architect in determining the Architect's compensation. Both parties, however, recognize that such information may change and, in that event, the Owner and the Architect shall negotiate appropriate adjustments in schedule, compensation and Change in Services in accordance with Section 1.3.3. The Architect represents, and the Owner reasonably relies on such representation, that the Architect has carefully reviewed the scope of Initial Information in Article 1.1 and, as of the date of this Agreement, has no actual knowledge of any additional Initial Information needed to perform the services described in this Agreement.

ARTICLE 1.2 RESPONSIBILITIES OF THE PARTIES

§ 1.2.1 The Owner and the Architect shall cooperate with one another to fulfill their respective obligations under this Agreement. Both parties shall endeavor to maintain good working relationships among all members of the Project team.

§ 1.2.2 OWNER

§ 1.2.2.1 Unless otherwise provided under this Agreement, the Owner shall provide full information in a timely manner regarding requirements for and limitations on the Project. The Owner shall furnish to the Architect, within 15 days after receipt of a written request, information necessary and relevant for the Architect to evaluate, give notice of or enforce lien rights.

§ 1.2.2.2 The Owner shall periodically update the budget for the Project, including that portion allocated for the Cost of the Work. The Owner shall not significantly increase or decrease the overall budget, the portion of the budget allocated for the Cost of the Work, or contingencies included in the overall budget or a portion of the budget, without the agreement of the Architect to a corresponding change in the Project scope and quality.

§ 1.2.2.3 The Owner's Designated Representative identified in Section 1.1.3 shall be authorized to act on the Owner's behalf with respect to the Project. The Owner or the Owner's Designated Representative shall render decisions in a timely manner pertaining to documents submitted by the Architect in order to avoid unreasonable delay in the orderly and sequential progress of the Architect's services.

§ 1.2.2.4 The Owner shall furnish the services of consultants other than those designated in Section 1.1.3 or authorize the Architect to furnish them as a Change in Services when such services are requested by the Architect and are reasonably required by the scope of the Project.

§ 1.2.2.5 Unless otherwise provided in this Agreement, the Owner shall furnish tests, inspections and reports required by law or the Contract Documents, such as structural, mechanical, and chemical tests, tests for air and water pollution, and tests for hazardous materials.

§ 1.2.2.6 The Owner shall furnish all legal, insurance and accounting services, including auditing services, that may be reasonably necessary at any time for the Project to meet the Owner's needs and interests.

§ 1.2.2.7 The Owner shall provide prompt written notice to the Architect if the Owner becomes aware of any fault or defect in the Project, including any errors, omissions or inconsistencies in the Architect's Instruments of Service; provided, however, that a failure of the Owner to give such notice shall not affect the duties and responsibilities of the Architect under this Agreement.

§ 1.2.3 ARCHITECT

§ 1.2.3.1 The services performed by the Architect, Architect's employees and Architect's consultants shall be as enumerated in Article 1.4.

§ 1.2.3.2 The Architect's services shall be performed as expeditiously as is consistent with professional skill and care and the orderly progress of the Project. The Architect shall submit for the Owner's approval a schedule for the performance of the Architect's services which initially shall be consistent with the time periods established in Section 1.1.2.6 and which shall be adjusted, if necessary, as the Project proceeds. This schedule shall include allowances for periods of time required for the Owner's review, for the performance of the Owner's consultants, and for approval of submissions by authorities having jurisdiction over the Project. Time limits established by this schedule approved by the Owner shall not, except for reasonable cause, be exceeded by the Architect or Owner.

§ 1.2.3.3 The Architect's Designated Representative identified in Section 1.1.3 shall be authorized to act on the Architect's behalf with respect to the Project.

§ 1.2.3.4 The Architect shall maintain the confidentiality of information specifically designated as confidential by the Owner, unless withholding such information would violate the law, create the risk of significant harm to the public or prevent the Architect from establishing a claim or defense in an adjudicatory proceeding. The Architect shall require of the Architect's consultants similar agreements to maintain the confidentiality of information specifically designated as confidential by the Owner.

§ 1.2.3.5 Except with the Owner's knowledge and consent, the Architect shall not engage in any activity, or accept any employment, interest or contribution that would reasonably appear to compromise the Architect's professional judgment with respect to this Project.

§ 1.2.3.6 The Architect shall review laws, codes, and regulations applicable to the Architect's services and shall perform its responsibilities under this Agreement in compliance with the applicable laws, codes and regulations. The Architect shall design the Project in accordance with the requirements imposed by governmental authorities having jurisdiction over the Project.

§ 1.2.3.7 The Architect shall be entitled to rely on the accuracy and completeness of services and information furnished by the Owner. The Architect shall provide prompt written notice to the Owner if the Architect becomes aware of any errors, omissions or inconsistencies in such services or information.

§ 1.2.3.8 The Architect hereby represents to the Owner that the Architect has visited the Project site and has thoroughly familiarized itself with the local conditions under which the services required hereunder are to be performed; and that the Architect possesses the requisite licenses, authority, experience, personnel and working capital to complete the services required hereunder.

ARTICLE 1.3 TERMS AND CONDITIONS

§ 1.3.1 COST OF THE WORK

§ 1.3.1.1 The Cost of the Work shall be the total cost or, to the extent the Project is not completed, the estimated cost to the Owner of all elements of the Project designed or specified by the Architect.

§ 1.3.1.2 The Cost of the Work shall include the cost at current market rates of labor and materials furnished by the Owner and equipment designed, specified, selected or specially provided for by the Architect, including the costs of management or supervision of construction or installation provided by a separate construction manager or contractor, plus a reasonable allowance for their overhead and profit. In addition, a reasonable allowance for contingencies shall be included for market conditions at the time of bidding and for changes in the Work.

§ 1.3.1.3 The Cost of the Work does not include the compensation of the Architect and the Architect's consultants, the costs of the land, rights-of-way and financing or other costs that are the responsibility of the Owner.

§ 1.3.2 INSTRUMENTS OF SERVICE

§ 1.3.2.1 Drawings, specifications and other documents, including those in electronic form, prepared by the Architect and the Architect's consultants are Instruments of Service for use solely with respect to this Project. The Architect and the Architect's consultants shall be deemed the authors and owners of their respective Instruments of Service and shall retain all common law, statutory and other reserved rights, including copyrights.

§ 1.3.2.2 The Architect shall provide the Owner with a complete copy of the original drawings and specifications, as well as the record drawings referenced in subparagraph 2.8.3.20. In addition, the Architect shall provide the Owner with a complete set of computer disks of the original drawings and record drawings referenced in subparagraph 2.8.3.20 for all such drawings that are produced by computer/CAD. These drawings and specifications and record drawings shall be the property of the Owner, who may use and reproduce them for reference without the Architect's permission for completion of or additions to the Project. Any use of the Architect's Instruments of Service on other projects without prior written permission by the Architect shall be at the Owner's sole risk and without liability to the Architect or the Architect's consultants.

§ 1.3.2.3

§ 1.3.2.4 Prior to the Architect providing to the Owner any Instruments of Service in electronic form or the Owner providing to the Architect any electronic data for incorporation into the Instruments of Service, the Owner and the Architect shall by separate written agreement set forth the specific conditions governing the format of such Instruments of Service or electronic data, including any special limitations or licenses not otherwise provided in this Agreement.

§ 1.3.3 CHANGE IN SERVICES

§ 1.3.3.1 Change in Services of the Architect, including services required of the Architect's consultants, may be accomplished after execution of this Agreement, without invalidating the Agreement, if mutually agreed in writing, if required by circumstances beyond the Architect's control, or if the Architect's services are affected as described in Section 1.3.3.2. In the absence of mutual agreement in writing, the Architect shall notify the Owner in writing prior to changing such services. If the Owner deems that all or a part of such Change in Services is not required, the Owner shall give prompt written notice to the Architect, and the Architect shall have no obligation to change those services. Except for a change due to the fault of the Architect, Change in Services of the Architect shall entitle the Architect to an adjustment in compensation pursuant to Section 1.5.2, and the Architect to any Reimbursable Expenses described in Section 1.3.9.2 and Section 1.5.5.

§ 1.3.3.2 If any of the following circumstances require the Architect to make material and substantial revisions to Instruments of Service or participation in subparagraph 1.3.3.2.6 activities below, the Architect or the Owner, as appropriate, shall be entitled to an appropriate adjustment in the Architect's schedule and compensation:

.1 change in the instructions or approvals given by the Owner that necessitate revisions in Instruments of Service;

.2 enactment or revision of codes, laws or regulations or official interpretations which necessitate changes to previously prepared Instruments of Service;

.3 changes due to decisions of the Owner, required by this Agreement, not rendered in a timely manner;

.4 significant change in the Project including, but not limited to, size, quality, complexity, the Owner's schedule or budget, or procurement method;

.5 failure of performance on the part of the Owner or the Owner's consultants or contractors;

.6 preparation for and attendance at a public hearing, a dispute resolution proceeding or a legal proceeding except where the Architect is party thereto or is alleged to have committed a wrongful act or omission which is a subject of such hearing or proceeding;

.7 change in the information contained in Article 1.1.

§ 1.3.4 MEDIATION

§ 1.3.4.1 Any claim, dispute or other matter in question between the Architect and the Owner arising out of or relating to this Agreement, the Project, the Work or the Contract Documents shall, upon demand by either party, be submitted to mediation under the auspices of and in accordance with the mediation rules of the American Arbitration Association, unless the parties mutually agree otherwise, before proceeding to any other form of dispute resolution, including litigation. The Owner, Architect and Contractor may participate in the mediation process, and any fees in connection therewith shall be borne equally by the parties. If a request for mediation is filed regarding a dispute between the Owner and the Contractor, which includes a claim involving the Architect, then upon written request by the Owner or Contractor, the Architect shall become a party to the mediation.

§ 1.3.4.2 Unless otherwise agreed in writing, the Architect shall carry on with the performance of its services and duties under this Agreement during the pendency of any proceeding to resolve any claim, dispute or other matter in question, and the Owner shall continue to make payments to the Architect in accordance with this Agreement, except that the Owner shall be under no obligation to make payments to the Architect on such claim, dispute or other matter in question during the pendency of any proceeding to resolve such claim, dispute or other matter in question.

§ 1.3.4.3

§ 1.3.5 ARBITRATION

§ 1.3.5.1 Any claim arising out of or relating to this Agreement, the Project, the Work or the Contract Documents that is not resolved through mediation shall be litigated unless, by mutual agreement, the parties agree to submit the dispute to binding arbitration under the auspices and rules of the American Arbitration Association or another organization mutually acceptable to the Owner and the Architect. The parties agree that all dispute resolution proceedings shall be in the county in which the Project is located. The Owner, Architect and Contractor may participate in the arbitration, and any fees in connection therewith shall be borne equally by the parties. Any award rendered shall be final and judgment may be entered upon it in accordance with applicable law by any court having jurisdiction. If any claim submitted to arbitration between the Owner and the Contractor involves the Architect, the Architect may be joined in the proceeding. If the Architect is found to have no liability, the Owner shall indemnify the Architect for all loss, cost, damage and expense (including reasonable attorneys' fees) incurred by the Architect as a result of being joined in the proceeding by the Owner; and the Owner shall make reasonable efforts to include a similar obligation on the Contractor in the contract with the Contractor.

§ 1.3.5.2

§ 1.3.5.3

§ 1.3.5.4

§ 1.3.5.5

§ 1.3.6 CLAIMS FOR CONSEQUENTIAL DAMAGES

§ 1.3.7 MISCELLANEOUS PROVISIONS

§ 1.3.7.1 This Agreement shall be governed by the law of the place of the Project.

§ 1.3.7.2 Terms in this Agreement shall have the same meaning as those in the 1997 edition of AIA Document A201, General Conditions of the Contract for Construction, as modified by the Owner.

§ 1.3.7.3 Causes of action between the parties to this Agreement pertaining to acts or failures to act shall be deemed to have accrued and the applicable statutes of limitations shall commence to run not later than either the date of Substantial Completion for acts or failures to act occurring prior to Substantial Completion or the date of issuance of the final Certificate for Payment for acts or failures to act occurring after Substantial Completion. In no event shall such statutes of limitations commence to run any later than the date when the Architect's services are substantially completed.

§ 1.3.7.4 To the extent damages are covered by property insurance during construction, the Owner and the Architect waive all rights against each other and against the contractors, consultants, agents and employees of the other for damages, except such rights as they may have to the proceeds of such insurance as set forth in the 1997 edition of AIA Document A201, General Conditions of the Contract for Construction, as modified by the Owner. The Owner or the Architect, as appropriate, shall require of the contractors, consultants, and agents of any of them similar waivers in favor of the other parties enumerated herein.

§ 1.3.7.5 Nothing contained in this Agreement shall create a contractual relationship with or a cause of action in favor of a third party against either the Owner or Architect.

§ 1.3.7.6 Unless otherwise provided in this Agreement, the Architect and Architect's consultants shall have no responsibility for the discovery, presence, handling, removal or disposal of or exposure of persons to hazardous materials or toxic substances in any form at the Project site. However, the Architect shall report to the Owner the presence and location of any hazardous material which it notices.

§ 1.3.7.7 Subject to the Owner's prior review and written approval thereof, the Architect shall have the right to include photographic or artistic representations of the design of the Project among the Architect's promotional and professional materials. The Architect shall be given reasonable access to the completed Project to make such representations. However, the Architect's materials shall not include the Owner's confidential or proprietary information if the Owner has previously advised the Architect in writing of the specific information considered by the Owner to be confidential or proprietary. The Owner may, in its sole discretion, provide professional credit for the Architect in the Owner's promotional materials for the Project.

§ 1.3.7.8 If the Owner requests the Architect to execute certificates, the proposed language of such certificates shall be submitted to the Architect for review at least 14 days prior to the requested dates of execution. The Architect shall not be required to execute certificates that would require knowledge, services or responsibilities beyond the scope of this Agreement, but the Owner may require and the Architect shall execute, as part of its scope of Services described under Article 1.4 or elsewhere herein any certificates or certifications customarily, commonly or reasonably required on projects of this type.

§ 1.3.7.9 The Owner and Architect, respectively, bind themselves, their partners, successors, assigns and legal representatives to the other party to this Agreement and to the partners, successors, assigns and legal representatives of such other party with respect to all covenants of this Agreement. The Architect shall not assign this Agreement without the prior written consent of the Owner, the Owner may assign this Agreement to an institutional lender providing financing for the Project. In such event, the lender shall assume the Owner's rights and obligations under this Agreement. The Architect shall execute all consents reasonably required to facilitate such assignment.

§ 1.3.8 TERMINATION OR SUSPENSION

§ 1.3.8.1 If the Owner fails to make payments to the Architect in accordance with this Agreement, the Architect having performed the Architect's obligation hereunder, such failure shall be considered substantial nonperformance and cause for termination or, at the Architect's option, cause for suspension of performance of services under this Agreement. If the Architect elects to suspend services, prior to suspension of services, the Architect shall give seven days' written notice to the Owner. In the event of a proper suspension of services, the Architect shall have no liability to the Owner for delay or damage caused the Owner because of such suspension of services. Before resuming services, the Architect shall be paid all sums due prior to suspension and any direct expenses reasonably incurred in the interruption and resumption of the Architect's services. The Architect's fees for the remaining services and the time schedules shall be equitably adjusted.

§ 1.3.8.2 If, through no fault of the Architect, the Project is suspended by the Owner for more than 30 consecutive days, the Architect shall be compensated for services performed prior to notice of such suspension. When the Project is resumed, the Architect shall be compensated for direct expenses reasonably incurred in the interruption and resumption of the Architect's services. The Architect's fees for the remaining services and the time schedules shall be equitably adjusted.

§ 1.3.8.3 If, through no fault of the Architect, the Project is suspended or the Architect's services are suspended for more than 180 consecutive days, the Architect may terminate this Agreement by giving not less than fourteen days' written notice.

§ 1.3.8.4 This Agreement may be terminated by either party upon not less than seven days' written notice should the other party fail substantially to perform in accordance with the terms of this Agreement through no fault of the party initiating the termination.

§ 1.3.8.5 This Agreement may be terminated by the Owner upon not less than seven days' written notice to the Architect for the Owner's convenience and without cause.

§ 1.3.8.6 In the event of termination not the fault of the Architect, the Architect shall be compensated for services performed prior to termination, together with Reimbursable Expenses then due.

§ 1.3.8.7 In the event of any termination under this Article, the Architect consents to the Owner's selection of another architect of the Owner's choice to assist the Owner in completing the Project. The Architect agrees to cooperate and provide any information requested by the Owner in connection with the completion of the Project and consents to and authorizes the making of any reasonable changes to the design of the Project as the Owner and such other architect may desire. Any services provided by the Architect that are requested by the Owner after date of termination shall be fairly compensated by the Owner pursuant to mutual agreement on the amount of compensation prior to the performance of such services. The Owner shall indemnify O'Brien Atkins for any damages or injuries that are proximately caused by such design modifications made by the follow on architect, unless O'Brien Atkins agreed to the design modifications.

§ 1.3.9 PAYMENTS TO THE ARCHITECT

§ 1.3.9.1 Payments on account of services rendered and for Reimbursable Expenses incurred shall be made monthly upon presentation of the Architect's properly submitted statement of services promptly after such services are performed. No deductions shall be made from the Architect's compensation on account of penalty, liquidated damages or other sums withheld from payments to contractors, or on account of the cost of changes in the Work other than those for which the Architect is responsible.

§ 1.3.9.2 Reimbursable Expenses are in addition to compensation for the Architect's services and include reasonable actual expenses incurred by the Architect and Architect's employees and consultants directly related to the Project, as identified in the following Clauses:

.1 transportation in connection with the Project, authorized out-of-town travel and subsistence, and electronic communications;

.2 fees paid for securing approval of authorities having jurisdiction over the Project;

.3 reproductions, plots, standard form documents, postage, handling and delivery of Instruments of Service;

.4 expense of overtime work requiring higher than regular rates if authorized in writing in advance by the Owner;

.5 renderings, models and mock-ups requested and authorized in writing in advance by the Owner;

.6 expense of professional liability insurance dedicated exclusively to this Project or the expense of additional insurance coverage or limits requested by the Owner in excess of that normally carried by the Architect and the Architect's consultants;

.7 reimbursable expenses as designated in Section 1.5.5;

.8 any other expense directly related to the Project and reasonably incurred after first receiving the written approval of the Owner.

§ 1.3.9.3 Records of Reimbursable Expenses, of expenses pertaining to a Change in Services, and of services performed on the basis of hourly rates or a multiple of Direct Personnel Expense shall be available to the Owner or the Owner's authorized representative at mutually convenient times. These records shall be preserved by the Architect for a period of four years after final payment.

§ 1.3.9.4 Direct Personnel Expense is defined as the direct salaries of the Architect's personnel engaged on the Project and the portion of the cost of their mandatory and customary contributions and benefits related thereto, such as employment taxes and other statutory employee benefits, insurance, sick leave, holidays, vacations, employee retirement plans and similar contributions.

ARTICLE 1.4 SCOPE OF SERVICES AND OTHER SPECIAL TERMS AND CONDITIONS

§ 1.4.1 Enumeration of Parts of the Agreement. This Agreement represents the entire and integrated agreement between the Owner and the Architect and supersedes all prior negotiations, representations or agreements, either written or oral. This Agreement may be amended only by written instrument signed by both Owner and Architect. This Agreement comprises the documents listed below.

§ 1.4.1.1 Standard Form of Agreement Between Owner and Architect, AIA Document B141-1997, as modified.

§ 1.4.1.2 Standard Form of Architect's Services: Design and Contract Administration, AIA Document B141-1997, as modified.

(List other documents, if any, delineating Architect's scope of services.)

§ 1.4.1.3 Other documents as follows:

(List other documents, if any, forming part of the Agreement.)

Exhibit A Program documents by Specialty Operations Solutions, Inc. (SOS) for the Basis of Design (BOD) dated 7/13/06 and the Draft 3a Floor Plan dated September 20, 2006

Exhibit B Fee Proposal from O'Brien Atkins, dated October 30, 2006

Exhibit C Proposal from subconsultant Sterling Engineering to O'Brien Atkins, dated October 24, 2006

NOTE: In the event of conflicts or discrepancies between the documents forming this contract, interpretations will be based on the following precedent priorities: (1) this modified B141 Owner/Architect Agreement; (2) Exhibit B; and then (3) Exhibit C.

§ 1.4.2 Special Terms and Conditions. Special terms and conditions that modify this Agreement are as follows:

§ 1.4.2.1 The Architect shall maintain throughout the period of the Project, and for a period of three years thereafter, standard errors and omissions insurance in an amount normally carried by the Architect and which is customary for similarly situated architects in the industry. The Architect shall maintain insurance coverage for commercial general liability, automobile liability and workers' compensation in form and amounts normally carried by the Architect which are customary for similarly situated architects in the industry. The Architect shall ensure that any and all consultants engaged or employed by the Architect carry similar insurance with reasonable prudent limits and coverages in light of the services to be rendered by such consultants. The Architect shall submit to the Owner proof of insurance in amounts satisfactory to the Owner and upon the Owner's request, shall promptly furnish copies of all insurance policies to the Owner. The insurance policies shall incorporate a provision for giving written notice to the Owner at least 30 days prior to any cancellation, non-renewal or material modification of the policies. Without limiting any other provision in this Agreement, failure of the Architect to comply with this paragraph 1.4.2.1 shall be cause for termination.

§ 1.4.2.2 To the fullest extent permitted by law, the Architect agrees to indemnify, hold harmless, protect and defend the Owner and the Owner's agents, representatives and affiliated entities against any and all claims, loss, liability, damage, costs and expenses including reasonable attorneys' fees, occurring as a result of or due to the negligence of the Architect, its agents, consultants, employees or representatives.

§ 1.4.2.3 The Architect shall be responsible for all services provided under this Agreement regardless of whether provided directly by the Architect or by any consultants directly employed by the Architect. The Architect will perform all duties and services and make all decisions called for hereunder promptly and without unreasonable delay and will give the Project such priority as is necessary to cause the Architect's services hereunder to be timely and properly performed.

§ 1.4.2.4 With respect to the Americans with Disabilities Act ("ADA"), the Owner acknowledges that the ADA is not a detailed building code and that its requirements are general in nature and open to differing interpretations. Consistent with the professional standard of care, the Architect will interpret applicable ADA requirements with respect to its design of the building. However, the Architect does not warrant or represent that services provided under this Agreement will result in full project compliance with the ADA or all interpretations of ADA requirements by regulatory bodies or court decisions. In addition, if the Owner requires that the construction of the project deviate from the Architect's reasonable judgment and understanding of the provisions of the ADA, the Owner shall hold the Architect harmless from any claim based upon such deviation. For clarity, this does not relieve the Architect of its duty to adhere to applicable state and local building codes.

ARTICLE 1.5 COMPENSATION

§ 1.5.1 For the Architect's services as described under Article 1.4 or elsewhere herein, compensation ("Basic Compensation") shall be computed as follows:

Review of SOS Documents/MEP Existing Cond	$ 26,080
Architectural Design Confirmation/MEP Schematic Design	25,564
Design Development	27,813
Construction Documents	67,648
Procurement & Permitting	9,492
Construction	46,330
Total	$202,927

The Architect shall submit to the Owner invoices on a monthly basis, the amount of each such invoice to be calculated based on the percentage of each Basic Compensation phase as set forth above.

§ 1.5.2 If the services of the Architect are changed as described in Section 1.3.3.1, the Architect's compensation shall be adjusted. Such adjustment shall be calculated as described below or, if no method of adjustment is indicated in this Section 1.5.2, in an equitable manner.

(Insert basis of compensation, including rates and multiples of Direct Personnel Expense for Principals and employees, and identify Principals and classify employees, if required. Identify specific services to which particular methods of compensation apply.)

See O'Brien Atkins Associates, P.A. Hourly Rates for 2006, attached and incorporated herein as **Exhibit B**.

§ 1.5.3 For a Change in Services of the Architect's consultants, compensation shall be computed as a multiple of One and one-tenth (1.10) times the amounts billed to the Architect for such services.

§ 1.5.4 For Reimbursable Expenses as described in Section 1.3.9.2, and any other items included in Section 1.5.5 as Reimbursable Expenses, the compensation shall be computed as a multiple of One and one-tenth (1.10) times the expenses incurred by the Architect, and the Architect's employees and consultants.

§ 1.5.5 Other Reimbursable Expenses, if any, are as follows:

§ 1.5.6 The rates and multiples for Changes in Services of the Architect and the Architect's consultants as set forth in this Agreement shall be adjusted in accordance with their normal salary review practices.

§ 1.5.7 Payments for services shall be made monthly, and where applicable, shall be in proportion to services performed on the basis set forth in this Agreement.

§ 1.5.8 Payments are due and payable Thirty (30) days from the date of the Architect's invoice. Amounts properly due and unpaid Sixty (60) days after the invoice date shall bear interest at the rate entered below, or in the absence thereof at the legal rate prevailing from time to time at the principal place of business of the Architect.

(Insert rate of interest agreed upon.)

Prime rate plus one percent per annum as published in the Wall Street Journal.

(Usury laws and requirements under the Federal Truth in Lending Act, similar state and local consumer credit laws and other regulations at the Owner's and Architect's principal places of business, the location of the Project and elsewhere may affect the validity of this provision. Specific legal advice should be obtained with respect to deletions or modifications, and also regarding requirements such as written disclosures or waivers.)

§ 1.5.9 If the services covered by this Agreement have not been completed within Eight (8) months of the date hereof, through no fault of the Architect, extension of the Architect's services beyond that time shall be equitably adjusted for any Change in Services required as a result of such time being exceeded or extended.

This Agreement entered into as of the day and year first written above.

OWNER – Targacept, Inc.

/s/ Alan A. Musso
(Signature)
Alan A. Musso, Vice President & CFO
(Printed name and title)

ARCHITECT – O'Brien Atkins Associates, P.A.

/s/ DBL
(Signature)
Dudley B. Lacy, AIA, President and COO
(Printed name and title)

AIA® Document B141™ – 1997 Part 2

Standard Form of Architect's Services:

Design and Contract Administration

This document has important legal consequences. Consultation with an attorney is encouraged with respect to its completion or modification.

TABLE OF ARTICLES

ARTICLE 2.1 PROJECT ADMINISTRATION SERVICES

§ 2.1.1 The Architect shall manage the Architect's services and administer the Project. The Architect shall consult with the Owner, research applicable design criteria, attend Project meetings, communicate with members of the Project team and issue progress reports. The Architect shall coordinate the services provided by the Architect and the Architect's consultants with those services provided by the Owner and the Owner's consultants.

§ 2.1.2 The Architect shall prepare, and periodically update for the Owner's approval within seven (7) days of the execution of this Agreement, a Project schedule that shall identify milestone dates for decisions required of the Owner, design services furnished by the Architect, completion of documentation provided by the Architect, commencement of construction and Substantial Completion of the Work.

§ 2.1.3 The Architect shall consider, and discuss with the Owner, the value of alternative materials, building systems and equipment, together with other considerations based on program, budget and aesthetics in developing the design for the Project.

§ 2.1.4 Upon request of the Owner, the Architect shall make a presentation to explain the design of the Project to representatives of the Owner.

§ 2.1.5 The Architect shall submit design documents to the Owner at intervals appropriate to the design process for purposes of evaluation and approval by the Owner. Subject to the provisions contained in the next sentence herein, the Architect shall be entitled to rely on approvals received from the Owner in the further development of the design. The Owner's approval of the Architect's design documents contemplated herein shall not be for the purpose of determining the accuracy, adequacy or completeness of such documents and shall not alter the Architect's responsibilities with respect to such documents.

§ 2.1.6 The Architect shall assist the Owner in connection with the Owner's responsibility for filing documents required for the approval of governmental authorities having jurisdiction over the Project.

§ 2.1.7 EVALUATION OF BUDGET AND COST OF THE WORK

§ 2.1.7.1 When the Project requirements have been sufficiently identified, the Architect shall prepare a preliminary estimate of the Cost of the Work. This estimate may be based on current area, volume or similar conceptual estimating techniques. As the design process progresses through the end of the preparation of the Construction Documents, the Architect shall update and refine the preliminary estimate of the Cost of the Work. The Architect shall advise the Owner of any adjustments to previous estimates of the Cost of the Work indicated by changes in Project requirements or general market conditions. If at any time the Architect's estimate of the Cost of the Work exceeds the Owner's budget, the Architect shall make appropriate recommendations to the Owner to adjust the Project's size, quality or budget, and the Owner shall cooperate with the Architect in making such adjustments.

§ 2.1.7.2 Evaluations of the Owner's budget for the Project, the preliminary estimate of the Cost of the Work and updated estimates of the Cost of the Work prepared by the Architect represent the Architect's judgment as a design professional familiar with the construction industry. It is recognized, however, that neither the Architect nor the Owner has control over the cost of labor, materials or equipment, over the Contractor's methods of determining bid prices, or over competitive bidding, market or negotiating conditions. Accordingly, the Architect cannot and does not warrant or represent that bids or negotiated prices will not vary from the Owner's budget for the Project or from any estimate of the Cost of the Work or evaluation prepared or agreed to by the Architect.

§ 2.1.7.3 In preparing estimates of the Cost of the Work, the Architect shall be permitted to include reasonable contingencies for design, bidding and price escalation; to determine what materials, equipment, component systems and types of construction acceptable to the Owner are to be included in the Contract Documents; to make reasonable adjustments in the scope of the Project acceptable to the Owner and to include in the Contract Documents alternate bids acceptable to the Owner as may be necessary to adjust the estimated Cost of the Work to meet the Owner's budget for the Cost of the Work. If an increase in the Contract Sum occurring after execution of the Contract between the Owner and the Contractor and not attributable to negligence of the Architect causes the budget for the Cost of the Work to be exceeded, that budget shall be increased accordingly.

§ 2.1.7.4 If bidding or negotiation has not commenced within 90 days after the Architect submits the Construction Documents to the Owner, the budget for the Cost of the Work shall be reviewed and, if necessary, adjusted to reflect changes, if any, in the general level of prices in the construction industry, between the date of submission of the Contract Documents to the Owner and the date on which proposals are sought.

§ 2.1.7.5 If the budget for the Cost of the Work is exceeded by the lowest bona fide bid or negotiated proposal, the Owner shall:

- **.1** give written approval of an increase in the budget for the Cost of the Work;
- **.2** authorize rebidding or renegotiating of the Project within a reasonable time;
- **.3** terminate in accordance with Section 1.3.8.5; or
- **.4** cooperate in revising the Project scope and quality as required to reduce the Cost of the Work.

§ 2.1.7.6 If the Owner chooses to proceed under Section 2.1.7.5.4, the Architect, without additional compensation, shall modify the documents for which the Architect is responsible under this Agreement as necessary to comply with the budget for the Cost of the Work. The modification of such documents shall be the limit of the Architect's responsibility under this Section 2.1.7. The Architect shall be entitled to compensation in accordance with this Agreement for all services performed whether or not construction is commenced.

ARTICLE 2.2 SUPPORTING SERVICES

§ 2.2.1 Unless provided by the Architect as specifically designated in Section 2.8.3, or reasonably inferable under paragraph 1.4 or elsewhere herein, the services in this Article 2.2 shall be provided by the Owner or the Owner's consultants and contractors.

§ 2.2.1.1 The Owner shall furnish a program setting forth the Owner's objectives, schedule, constraints and criteria, including space requirements and relationships, special equipment, systems and site requirements, unless such initial information has been included in Article 1.1 of this Agreement.

§ 2.2.1.2 The Owner shall furnish surveys to describe physical characteristics, legal limitations and utility locations for the site of the Project, and a written legal description of the site. The surveys and legal information shall include, as applicable, grades and lines of streets, alleys, pavements and adjoining property and structures; adjacent drainage; rights-of-way, restrictions, easements, encroachments, zoning, deed restrictions, boundaries and contours of the site; locations, dimensions and necessary data with respect to existing buildings, other improvements and trees; and information concerning available utility services and lines, both public and private, above and below grade, including inverts and depths. All the information on the survey shall be referenced to a Project benchmark, unless such initial information has been included in Article 1.1 of this Agreement.

§ 2.2.1.3 The Owner shall furnish services of geotechnical engineers which may include but are not limited to test borings, test pits, determinations of soil bearing values, percolation tests, evaluations of hazardous materials, ground corrosion tests and resistivity tests, including necessary operations for anticipating subsoil conditions, with reports and appropriate recommendations.

ARTICLE 2.3 EVALUATION AND PLANNING SERVICES

§ 2.3.1 The Architect shall provide a preliminary evaluation of the information furnished by the Owner under this Agreement, including the Owner's program and schedule requirements and budget for the Cost of the Work, each in terms of the other. The Architect shall review such information to ascertain that it is consistent with the requirements of the Project and shall notify the Owner in writing of any other information, tests, analyses, studies, reports or consultant services that may be reasonably needed for the Project.

§ 2.3.2 The Architect shall provide a preliminary evaluation of the Owner's site for the Project based on the information provided by the Owner and upon the Architect's observations of site conditions, and the Owner's program, schedule and budget for the Cost of the Work.

§ 2.3.3 The Architect shall review the Owner's proposed method of contracting for construction services and shall notify the Owner in writing of anticipated impacts that such method may have on the Owner's program, financial and time requirements, and the scope of the Project.

ARTICLE 2.3.4 ENGINEER PREDESIGN SERVICES

The Architect shall cause its engineering consultant, Sterling Engineering, to perform the following services for Targacept, Inc., located at 200 East First Street, Winston-Salem, NC 27101:

1. Review and confirmation of Specialty Operations Solutions, Inc. (SOS) Documents. To the extent unpaid, Architect to pay $8,000.00, including reimbursables to its consultant, Sterling Engineering, to perform the following pre-design services.
    a. Review of SOS documents to become familiar with the information and to meet with SOS to clarify questions concerning this information.
    b. Design confirmation code review of the SOS concept floor plan. Convert SOS plans to O'Brien/Atkins' CAD Standards, revise floor plans to confirm to code and make revisions accordingly.

ARTICLE 2.4 DESIGN SERVICES

§ 2.4.1 The Architect's design services shall include normal structural, mechanical and electrical engineering services.

§ 2.4.1.1 The Architect shall be responsible for the coordination of all drawings and design documents used on the Project which have been prepared by the Architect or the Architect's consultants. The Architect, subject to the professional standard of care, shall be responsible for the completeness and accuracy of all drawings and specifications submitted by or through the Architect and for their compliance with all applicable codes, ordinances, regulations, laws and statutes.

§ 2.4.1.2 The Owner shall have the right to disapprove any portion of the Architect's work on the Project (including, but not limited to, the Preliminary Planning and Conceptual Design Services, the Schematic Design Services, the Design Development Services, the Construction Documents Services, the Bidding or Negotiation Services or the Contract Administration Services) on any reasonable basis including, but not limited to, the Owner's opinion that the Cost of the Work is likely to render the Project infeasible. In the event that any non-construction phase of the Architect's work is not approved by the Owner, the Architect shall proceed, when requested by the Owner, to revise its work in good faith to attempt to satisfy the Owner's objections. These revisions will be made without adjustments to the compensation provided for hereunder, unless revisions are made to design work or documents previously approved by the Owner, in which case such revisions shall be paid for as Changes in Services pursuant to paragraph 1.3.3. Should there be substantial changes to the original program after the approval of schematic drawings, which changes substantially increase the scope of design services to be furnished hereunder, the Architect shall notify the Owner in writing of a Change in Services and receive approval from the Owner before proceeding with the revisions necessitated by such changes.

§ 2.4.1.3 See **Exhibit B**, Fee Proposal from O'Brien Atkins dated October 10, 2006, and **Exhibit C**, the subconsultant proposal from Sterling Engineering to O'Brien Atkins dated October 4, 2006.

§ 2.4.2 SCHEMATIC DESIGN DOCUMENTS

§ 2.4.2.1 The Architect shall provide Schematic Design Documents for the Owner's approval based on the mutually agreed-upon program, schedule, and budget for the Cost of the Work. The documents shall establish the conceptual design of the Project illustrating the scale and relationship of the Project components. The Schematic Design Documents shall include a conceptual site plan, if appropriate, and preliminary building plans, sections and elevations. At the Architect's option, the Schematic Design Documents may include study models, perspective sketches, electronic modeling or combinations of these media. Preliminary selections of major building systems and construction materials shall be noted on the drawings or described in writing.

§ 2.4.3 DESIGN DEVELOPMENT DOCUMENTS

§ 2.4.3.1 The Architect shall provide Design Development Documents for the Owner's approval based on the approved Schematic Design Documents and updated budget for the Cost of the Work. The Design Development Documents shall illustrate and describe the refinement of the design of the Project, establishing the scope, relationships, forms, size and appearance of the Project by means of plans, sections and elevations, typical construction details, and equipment layouts. The Design Development Documents shall include specifications that identify major materials and systems and establish in general their quality levels.

§ 2.4.4 CONSTRUCTION DOCUMENTS

§ 2.4.4.1 The Architect shall provide Construction Documents for the Owner's approval based on the approved Design Development Documents and updated budget for the Cost of the Work. The Construction Documents shall set forth in detail the requirements for construction of the Project. The Construction Documents shall include Drawings and Specifications that establish in detail the quality levels of materials and systems required for the Project.

§ 2.4.4.2 During the development of the Construction Documents and as requested by the Owner, the Architect shall assist the Owner in the development and preparation of: (1) bidding and procurement information which describes the time, place and conditions of bidding; bidding or proposal forms; and the form of agreement between the Owner and the Contractor; and (2) the Conditions of the Contract for Construction (General, Supplementary and other Conditions). The Architect also shall compile the Project Manual that includes the Conditions of the Contract for Construction and Specifications and may include bidding requirements and sample forms.

ARTICLE 2.5 CONSTRUCTION PROCUREMENT SERVICES

§ 2.5.1 The Architect shall assist the Owner in obtaining negotiated proposals and shall assist the Owner in awarding and preparing contracts for construction.

§ 2.5.2 The Architect shall assist the Owner in establishing a list of prospective bidders or contractors.

§ 2.5.3 The Architect shall assist the Owner in bid validation or proposal evaluation and determination of the successful bid or proposal, if any. If requested by the Owner, the Architect shall notify all prospective bidders or contractors of the bid or proposal results.

§ 2.5.4 COMPETITIVE BIDDING

§ 2.5.4.1 Bidding Documents shall consist of bidding requirements, proposed contract forms, General Conditions and Supplementary Conditions, Specifications and Drawings.

§ 2.5.4.2 If requested by the Owner, the Architect shall arrange for procuring the reproduction of Bidding Documents for distribution to prospective bidders. The Owner shall pay directly for the cost of reproduction or shall reimburse the Architect for such expenses.

§ 2.5.4.3 If requested by the Owner, the Architect shall distribute the Bidding Documents to prospective bidders and request their return upon completion of the bidding process. The Architect shall maintain a log of distribution and retrieval, and the amounts of deposits, if any, received from and returned to prospective bidders.

§ 2.5.4.4 The Architect shall consider requests for substitutions, if permitted by the Bidding Documents, and shall prepare and distribute addenda identifying approved substitutions to all prospective bidders.

§ 2.5.4.5 The Architect shall participate in or, at the Owner's direction, shall organize and conduct a pre-bid conference for prospective bidders.

§ 2.5.4.6 The Architect shall prepare responses to questions from prospective bidders and provide clarifications and interpretations of the Bidding Documents to all prospective bidders in the form of addenda.

§ 2.5.4.7 The Architect shall participate in or, at the Owner's direction, shall organize and conduct the opening of the bids. The Architect shall subsequently document and distribute the bidding results, as directed by the Owner.

§ 2.5.5 NEGOTIATED PROPOSALS

§ 2.5.5.1 Proposal Documents shall consist of proposal requirements, proposed contract forms, General Conditions and Supplementary Conditions, Specifications and Drawings.

§ 2.5.5.2 If requested by the Owner, the Architect shall arrange for procuring the reproduction of Proposal Documents for distribution to prospective contractors. The Owner shall pay directly for the cost of reproduction or shall reimburse the Architect for such expenses.

§ 2.5.5.3 If requested by the Owner, the Architect shall organize and participate in selection interviews with prospective contractors.

§ 2.5.5.4 As an additional service pursuant to Section 1.3.3, the Architect shall consider requests for substitutions, if permitted by the Proposal Documents, with the concurrence of the Owner, and shall prepare and distribute addenda identifying approved substitutions to all prospective contractors.

§ 2.5.5.5 If requested by the Owner, the Architect shall assist the Owner during negotiations with prospective contractors. The Architect shall subsequently prepare a summary report of the negotiation results, as directed by the Owner.

ARTICLE 2.6 CONTRACT ADMINISTRATION SERVICES

§ 2.6.1 GENERAL ADMINISTRATION

§ 2.6.1.1 The Architect shall provide administration of the Contract between the Owner and the Contractor(s) as set forth below and in the 1997 edition of AIA Document A201, General Conditions of the Contract for Construction, as modified by the Owner. Modifications made by the Owner to the General Conditions, when adopted as part of the Contract Documents, shall be enforceable under this Agreement only to the extent that they are consistent with this Agreement or approved in writing by the Architect.

§ 2.6.1.2 The Architect's responsibility to provide Contract Administration Services under this Agreement commences with the award of the Contract for Construction and, subject to subparagraphs 2.6.6.1 and 1.5.9, terminates at the later of 60 days after the final completion date set forth in the Contract Documents and any extensions of time granted pursuant thereto, or the date when all Work is complete as described in the Contract Documents.

§ 2.6.1.3 The Architect shall be a representative of and shall advise and consult with the Owner during the provision of the Contract Administration Services. The Architect shall have authority to act on behalf of the Owner only to the extent provided in this Agreement unless otherwise modified by written amendment.

§ 2.6.1.4 Duties, responsibilities and limitations of authority of the Architect under this Article 2.6 shall not be restricted, modified or extended without written agreement of the Owner and Architect with consent of the Contractor, which consent will not be unreasonably withheld.

§ 2.6.1.5 The Architect shall review properly prepared, timely requests by the Contractor for additional information about the Contract Documents. A properly prepared request for additional information about the Contract Documents shall be in a form prepared or approved by the Architect and shall include a detailed written statement that indicates the specific Drawings or Specifications in need of clarification and the nature of the clarification requested.

§ 2.6.1.6 If deemed appropriate by the Architect, the Architect shall on the Owner's behalf prepare, reproduce and distribute supplemental Drawings and Specifications in response to requests for information by the Contractor.

§ 2.6.1.7 The Architect shall interpret and decide matters concerning performance of the Owner and Contractor(s) under, and requirements of, the Contract Documents on written request of either the Owner or Contractor(s). The Architect's response to such requests shall be made in writing within any time limits agreed upon or otherwise with reasonable promptness.

§ 2.6.1.8 Interpretations and decisions of the Architect shall be consistent with the intent of and reasonably inferable from the Contract Documents and shall be in writing or in the form of drawings. When making such interpretations and initial decisions, the Architect shall endeavor to secure faithful performance by both Owner and Contractor, shall not show partiality to either, and shall not be liable for the results of interpretations or decisions so rendered in good faith.

§ 2.6.1.9 The Architect shall render initial decisions on claims, disputes or other matters in question between the Owner and Contractor as provided in the Contract Documents.

§ 2.6.2 EVALUATIONS OF THE WORK

§ 2.6.2.1 The Architect, as a representative of the Owner, shall visit the site at intervals appropriate to the stage of the Contractor's operations, or as otherwise agreed by the Owner and the Architect in Article 2.8, (1) to become generally familiar with and to keep the Owner informed about the progress and quality of the portion of the Work completed, (2) to use reasonable care to guard the Owner against defects and deficiencies in the Work, and (3) to determine in general if the Work is being performed in a manner indicating that the Work, when fully completed, will be in accordance with the Contract Documents. However, the Architect shall not be required to make exhaustive or continuous on-site inspections to check the quality or quantity of the Work. The Architect shall neither have control over or charge of, nor be responsible for, the construction means, methods, techniques, sequences or procedures, or for safety precautions and programs in connection with the Work, since these are solely the Contractor's rights and responsibilities under the Contract Documents.

§ 2.6.2.1.1 Although the Architect shall not be required to make exhaustive or continuous on-site inspections to check the quality or quantity of the Work, the Architect shall, review the quality and quantity of the Work on at least a bi-weekly basis as part of the Architect's Scope of Services under this Agreement, and shall issue written reports of such reviews, which reports shall inform the Owner of any material deviations from the Contract Documents observed during such reviews. The parties acknowledge that the basic services limit for site visits is nine (9) by the Architect and five (5) by the Architect's subconsultant, Sterling Engineering. The Architect shall conduct additional reviews if requested by the Owner; any such additional reviews shall constitute a Change in Services pursuant to paragraph 1.3.3.

§ 2.6.2.1.2 The Architect, as part of its scope of services under this Agreement, will attend and actively participate in bi-weekly progress meetings during construction of the Project which will be conducted by the Contractor.

§ 2.6.2.1.3 The Architect, as part of its scope of services under this Agreement, shall carefully review the Contractor's meeting minutes and prior to the next progress meeting issue amendments and corrections as necessary for an accurate record protecting the interests of the Owner. If the Architect determines that the Contractor has fallen substantially behind schedule, the Architect shall request from the Contractor a recovery plan to bring the Work back on schedule.

§ 2.6.2.2 The Architect shall report to the Owner and Contractor in writing known deviations from the Contract Documents and from the most recent construction schedule submitted by the Contractor. However, the Architect shall not be responsible for the Contractor's failure to perform the Work in accordance with the requirements of the Contract Documents. The Architect shall be responsible for the Architect's negligent acts or omissions, but shall not have control over or charge of and shall not be responsible for acts or omissions of the Contractor, Subcontractors, or their agents or employees, or of any other persons or entities performing portions of the Work.

§ 2.6.2.3 The Architect shall at all times have access to the Work wherever it is in preparation or progress.

§ 2.6.2.4 Except as otherwise provided in this Agreement or when direct communications have been specially authorized, the Owner shall endeavor to communicate with the Contractor through the Architect about matters arising out of or relating to the Contract Documents. Communications by and with the Architect's consultants shall be through the Architect.

§ 2.6.2.5 The Architect, in carrying out its responsibilities of observation and evaluation pursuant to this Agreement, shall have authority to reject Work that does not conform to the Contract Documents. With the approval of the Owner, whenever the Architect considers it necessary or advisable, the Architect will have authority to require inspection or testing of the Work in accordance with the provisions of the Contract Documents, whether or not such Work is fabricated, installed or completed. However, neither this authority of the Architect nor a decision made in good faith either to exercise or not to exercise such authority shall give rise to a duty or responsibility of the Architect or the Owner to the Contractor, Subcontractors, material and equipment suppliers, their agents or employees or other persons or entities performing portions of the Work.

§ 2.6.3 CERTIFICATION OF PAYMENTS TO CONTRACTOR

§ 2.6.3.1 The Architect shall review and certify the amounts due the Contractor and shall issue Certificates for Payment in such amounts, based on the Architect's observations and evaluations of the Contractor Applications for Payment. The Architect's certification for payment shall constitute a representation to the Owner, based on the Architect's evaluation of the Work as provided in Section 2.6.2 and on the data comprising the Contractor's Application for Payment, that the Work has progressed to the point indicated and that, to the best of the Architect's knowledge, information and belief, the quality of the Work is in accordance with the Contract Documents. The foregoing representations are subject (1) to an evaluation of the Work for conformance with the Contract Documents upon Substantial Completion, (2) to results of subsequent tests and inspections, (3) to correction of minor deviations from the Contract Documents prior to completion, and (4) to specific qualifications expressed by the Architect.

§ 2.6.3.2 The issuance of a Certificate for Payment shall not be a representation that the Architect has (1) made exhaustive or continuous on-site inspections to check the quality or quantity of the Work, (2) reviewed construction means, methods, techniques, sequences or procedures, (3) reviewed copies of requisitions received from Subcontractors and material suppliers and other data requested by the Owner to substantiate the Contractor's right to payment, or (4) ascertained how or for what purpose the Contractor has used money previously paid on account of the Contract Sum.

§ 2.6.3.3 The Architect shall maintain a record of the Contractor's Applications for Payment.

§ 2.6.4 SUBMITTALS

§ 2.6.4.1 The Architect shall review and approve or take other appropriate action upon the Contractor's submittals such as Shop Drawings, Product Data and Samples, but only for the limited purpose of checking for conformance with information given and the design concept expressed in the Contract Documents. The Architect's action shall be taken with such reasonable promptness as to cause no delay in the Work or in the activities of the Owner, Contractor or separate contractors, while allowing sufficient time in the Architect's professional judgment to permit adequate review. Review of such submittals is not conducted for the purpose of determining the accuracy and completeness of other details such as dimensions and quantities, or for substantiating instructions for installation or performance of equipment or systems, all of which remain the responsibility of the Contractor as required by the Contract Documents. The Architect's review shall not constitute approval of safety precautions or, unless otherwise specifically stated by the Architect, of any construction means, methods, techniques, sequences or procedures. The Architect's approval of a specific item shall not indicate approval of an assembly of which the item is a component.

§ 2.6.4.2 The Architect shall maintain a record of submittals and copies of submittals supplied by the Contractor in accordance with the requirements of the Contract Documents.

§ 2.6.4.3 If professional design services or certifications by a design professional related to systems, materials or equipment are specifically required of the Contractor(s) by the Contract Documents, the Architect shall specify appropriate performance and design criteria that such services must satisfy. Shop Drawings and other submittals related to the Work designed or certified by the design professional retained by the Contractor shall bear such professional's written approval when submitted to the Architect. The Architect shall be entitled to reasonably rely upon the adequacy, accuracy and completeness of the services, certifications or approvals performed by such design professionals.

§ 2.6.5 CHANGES IN THE WORK

§ 2.6.5.1 The Architect shall prepare Change Orders and Construction Change Directives, with supporting documentation and data, for the Owner's approval and execution in accordance with the Contract Documents. The Architect may, with the prior approval of the Owner, authorize minor changes in the Work not involving an adjustment in Contract Sum or an extension of the Contract Time which are consistent with the intent of the Contract Documents. If necessary, the Architect shall prepare, reproduce and distribute Drawings and Specifications to describe Work to be added, deleted or modified, as provided in Section 2.8.2.

§ 2.6.5.1.1 All changes in the Work potentially involving an adjustment in the Contract Sum or an extension of the Contract Time must be approved in writing in advance by the Owner.

§ 2.6.5.2 The Architect shall review and respond to reasonable requests by the Owner or Contractor for changes in the Work, including adjustments to the Contract Sum or Contract Time. If the Architect determines that requested changes in the Work are not materially different from the requirements of the Contract Documents, the Architect may issue an order for a minor change in the Work or recommend to the Owner that the requested change be denied. If a request for a change in the Work requires extensive investigation or preparation of additional drawings or specifications by the Architect, such Work shall be compensated as a Change in Service.

§ 2.6.5.3 If the Architect determines that implementation of the requested changes would result in a material change to the Contract that may cause an adjustment in the Contract Time or Contract Sum, the Architect shall make a recommendation to the Owner, who may authorize further investigation of such change. Upon such authorization, and based upon information furnished by the Contractor, if any, the Architect shall estimate the additional cost and time that might result from such change, including any additional costs attributable to a Change in Services of the Architect, providing such change is solely a result of some action or inaction on the part of a party other than the Architect. With the Owner's approval, the Architect shall incorporate those estimates into a Change Order or other appropriate documentation for the Owner's execution or negotiation with the Contractor.

§ 2.6.5.4 The Architect shall maintain records relative to changes in the Work.

§ 2.6.6 PROJECT COMPLETION

§ 2.6.6.1 The Architect shall conduct inspections to determine the date or dates of Substantial Completion and the date of final completion, shall receive from the Contractor and forward to the Owner, for the Owner's review and records, written warranties and related documents required by the Contract Documents and assembled by the Contractor, and shall issue a final Certificate for Payment based upon the Architect's final inspection indicating the Work complies with the requirements of the Contract Documents.

§ 2.6.6.1.1 If the Architect exceeds the number of inspections under basic services in this Agreement as a result of the fault of the Contractor, and if the Architect intends to charge the Owner for same as a Change in Services, then the Architect must recommend to the Owner that such amount be deducted from amounts due the Contractor on the subsequent or final Application for Payment.

§ 2.6.6.2 The Architect's inspection shall, at the option of the Owner, be conducted with the Owner's Designated Representative to check conformance of the Work with the requirements of the Contract Documents and to verify the accuracy and completeness of the list submitted by the Contractor of Work to be completed or corrected. The presence of the Owner's Designated Representative at such inspection shall not affect the duties and responsibilities of the Architect under this Agreement.

§ 2.6.6.3 When the Work is found to be substantially complete by the Architect, and the Owner is in agreement with same, the Architect shall inform the Owner about the balance of the Contract Sum remaining to be paid the Contractor(s), including any amounts needed to pay for final completion or correction of the Work.

§ 2.6.6.4 The Architect shall receive from the Contractor and forward to the Owner: (1) consent of surety or sureties, if any, to reduction in or partial release of retainage or the making of final payment and (2) affidavits, receipts, releases and waivers of liens or bonds indemnifying the Owner against liens and (3) warranties, guarantees and other Project closeout items required by the Contract Documents.

ARTICLE 2.7 FACILITY OPERATION SERVICES

§ 2.7.1 The Architect shall request of the Owner, and if the Owner decides to act on such request, the Architect shall meet with the Owner or the Owner's Designated Representative promptly after Substantial Completion to review the need for facility operation services.

§ 2.7.2 During the tenth month after Substantial Completion, the Architect shall arrange and conduct a meeting with the Owner and the Owner's Designated Representative, perform a thorough inspection of the Project and provide to the Owner a written report of deficiencies potentially constituting warranty issues of which the Contractor should be notified by the Owner.

ARTICLE 2.8 SCHEDULE OF SERVICES

§ 2.8.1 Design and Contract Administration Services beyond the following limits shall be provided by the Architect as a Change in Services in accordance with Section 1.3.3:

- **.1** up to two (2) reviews of each Shop Drawing, Product Data item, sample and similar submittal of the Contractor.
- **.2** one (1) bi-weekly visit to the site by the Architect over the duration of the Project during construction.
- **.3** up to one (1) inspection for any portion of the Work to determine whether such portion of the Work is substantially complete in accordance with the requirements of the Contract Documents.
- **.4** up to one (1) inspection for any portion of the Work to determine final completion.

NOTE: Under basic services, site visits are limited to nine (9) by the Architect and five (5) by the Architect's subconsultant, Sterling Engineering. Site visits exceeding these limits to which the Architect or its subconsultants bear no responsibility shall be subject to additional compensation as a Change in Services.

§ 2.8.2 The following Design and Contract Administration Services shall be provided by the Architect as a Change in Services in accordance with Section 1.3.3:

- **.1** review of a Contractor's submittal out of sequence from the submittal schedule agreed to by the Architect;
- **.2** responses to the Contractor's requests for information where such information is available to the Contractor from a careful study and comparison of the Contract Documents, field conditions, other Owner-provided information, Contractor-prepared coordination drawings, or prior Project correspondence or documentation;
- **.3** Change Orders and Construction Change Directives requiring evaluation of proposals, including the preparation or revision of Instruments of Service when such Change Orders and Construction Change Directives are issued solely as a result of some action or inaction on the part of a party other than the Architect;
- **.4** providing consultation concerning replacement of Work resulting from fire or other cause, not the fault of the Architect, during construction;
- **.5** evaluation of an extensive number of claims submitted by the Contractor or others in connection with the Work with such claims arising solely from some action or inaction on the part of a party other than the Architect;
- **.6** evaluation of substitutions proposed by the Owner's consultants or contractors and making subsequent revisions to Instruments of Service resulting therefrom;

.7 preparation of design and documentation for alternate bid or proposal requests proposed by the Owner; or

.8 providing services after the later of 60 days after the final completion date set forth in the Contract Documents and any extensions of time granted pursuant thereto, or the date when all Work is complete as described in the Contract Documents, but only to the extent that the Architect performs additional services that would otherwise not have had to have been performed if the Project was not delayed.

§ 2.8.3 The Architect shall furnish or provide the following services only if specifically designated or otherwise specified herein:

Services		Responsibility (Architect, Owner or Not Provided)	Location of Service Description
.1	Programming	Owner (SOS)	
.2	Land Survey Services	N/A	
.3	Geotechnical Services	N/A	
.4	Space Schematics/Flow Diagrams	Owner (SOS)	
.5	Existing Facilities Surveys	N/A	
.6	Economic Feasibility Studies	N/A	
.7	Site Analysis and Selection	N/A	
.8	Environmental Studies and Reports	N/A	
.9	Owner-Supplied Data Coordination	Owner/Architect	
.10	Schedule Development and Monitoring	N/A	
.11	Civil Design	N/A	
.12	Landscape Design	N/A	
.13	Interior Design	Architect	Selection of finishes
.14	Special Bidding or Negotiation	N/A	
.15	Value Analysis		
.16	Detailed Cost Estimating	N/A	
.17	On-Site Project Representation	N/A	
.18	Construction Management	N/A	
.19	Start-up Assistance	N/A	
.20	Record Drawings	Architect	para. 2.8.3.20.A
.21	Post-Contract Evaluation	N/A	
.22	Tenant-Related Services		
.23	Signage	Owner	If required
.24	Mechanical, Electrical and Plumbing Engineering	Architect	1.1.3.5
.25	Fire Protection Engineering	Architect	1.1.3.5
.26	Structural (if required)	Architect	1.1.3.5

§ 2.8.3.20.A No later than 120 days after final payment to the Contractor, and as part of Basic Services, the Architect shall provide the Owner with a complete set of reproducible record drawings, in hard copy and electronic form delivered to the Owner on CD. These files will show significant changes in the Work made during construction based on marked-up prints, drawings and other data furnished by the Contractor(s) to the Architect.

§ 2.8.4 Notwithstanding anything in this Agreement to the contrary, to the extent that architectural services are made necessary by any fault or omission of the Architect, such architectural services shall not be compensated as a Change in Service.

Description of Services.

(Insert descriptions of the services designated.)

ARTICLE 2.9 MODIFICATIONS

§ 2.9.1 Modifications to this Standard Form of Architect's Services: Design and Contract Administration, if any, are as follows:

By its execution, this Standard Form of Architect's Services: Design and Contract Administration and modifications hereto are incorporated into the Standard Form of Agreement Between the Owner and Architect, AIA Document B141-1997, as modified, that was entered into by the parties as of the date:

OWNER – Targacept, Inc.	**ARCHITECT – O'Brien Atkins Associates, P.A.**
/s/ Alan A. Musso	/s/ DBL
(Signature)	*(Signature)*
Alan A. Musso, VP & CFO	Dudley B. Lacy, AIA, President and COO
(Printed name and title)	*(Printed name and title)*

Exhibit A

Program Documents by Specialty Operations Solutions,
Inc. (SOS) for the Basis of Design (BOD) dated 7/13/06
and the Draft 3a Floor Plan dated 9/20/06

Targacept Tech One Expansion – Basis Of Design Document
REVISION # 0
July 13, 2006

GENERAL NOTES

- This facility will undergo a thorough commissioning of all installed systems. Because of the nature of the work being conducted (housing of non-regulated research animals) a detailed punchlist will be prepared following a thorough inspection. The facility cannot be used by the Tenant until all punchlist items are phased out.
- The scope items listed below apply only to animal housing and laboratory areas, and do not apply to office areas within the Tenant suite.
- All valves, dampers and other items requiring routine service should be located above accessible ceilings outside of the animal housing rooms, testing rooms and procedure rooms. No adjustable or serviceable devices of any kind should be mounted above the housing rooms, testing rooms and procedure rooms.

HVAC

- Constant volume throughout.
- Fully ducted. No plenum returns.
- Adjustable volume damper on each supply run and each exhaust run, accessible through access areas located in accessible ceilings.
- Stainless steel (304) grills and registers in two qualified animal housing rooms. Galvanized or aluminum ductwork permitted above the ceiling structure, with the exception of the cagewasher exhaust duct which must be stainless steel (304) to the mechanical penthouse. The cagewasher exhaust duct shall be appropriately formed and routed so that condensate will drain back to the cagewasher without leaking.
- 10 air changes per hour in two qualified housing rooms, cagewasher room, food & bedding storage room, behavior rooms and lab areas, **supplied by the existing base building HVAC systems.** The use of this space does not require a separate air handler, but will require additional constant volume boxes.
- Rodents shall be housed exclusively in powered, exhausted, individually isolated caging systems. The caging systems themselves shall be directly connected by flexible ductwork to the dedicated exhaust duct and fan serving the cagewasher, which is located in the mechanical penthouse. This fan and vertical riser duct will exhaust all caging systems and the cagewasher. This exhaust stream shall not be directed across a “heat wheel” heat recovery apparatus. Each caging system isolator typically exhausts 300CFM (adjustable) through a below-ceiling collar and blast gate damper. The cagewasher exhausts approximately 400 CFM.
- Ceiling mounted grilles with the exception of the exhaust collars in the primary housing room, and the steam collection hood in the cagewasher room.
- Control using system selected by the mechanical engineer to coordinate with the existing building system. Redundant control of spaces to be by stand-alone devices which will control emergency shutdown of the main supply and exhaust ducts, and emergency activation of the back-up heat/cool units located in the housing room.
- Each of the qualified housing rooms and behavior testing rooms shall be a separate reheat zone,
  fitted with its own thermostat.

- Reheat shall be effected by the use of electric coils, with devices mounted above accessible ceilings.
- No flexible ductwork.
- Balancing deviations shall be no greater than 5%. In no event shall the air change figure be allowed to drop below 10 ACH.
- The two qualified housing rooms and testing rooms 2 & 3 shall have a Mitsubishi Mr Slim DX heat pump (or approved equal) – appropriately sized - installed in the mounting location selected by SOS. This unit will be completely independent of the main control system and will be fitted with its own mechanical heat/cool thermostat. Mount condensing units at the direction of the architect.
- The central HVAC and control systems must be capable of maintaining the following environmental condition.
    1. 70 degrees F, -+ 4 degrees (8 degree F spread allowed)
    2. Relative humidity no lower than 30% and no higher than 70%. Set at 50%, +- 10%
    3. Humidification shall be central to the space, supplied by one humidifier located in the main supply trunk serving the entire Targacept suite.
    4. A redundant, mechanical control by Honeywell (T87F or approved equal) shall be used to prevent dangerous, wildly out of parameter temperatures in each of the two qualified housing rooms. In the event the ambient temperature of either room rises above 80 degrees F (adjustable to 90 F upper) or below *62* degrees F (adjustable to 55 degrees F lower), supply and exhaust control dampers shall positively close and the system will go into alarm. Supply dry contacts (NO or NC) for an alarm by others.
- In a power failure condition (or in the previously described out-of-parameter temperature condition) the control system shall be programmed so that the main control dampers for the housing room on the supply and exhaust ducts shall close and shall remain closed until the main power supply is restored.
- Each housing room shall be fitted with one Magnahelic gauge, mounted over the entrance door on the central ACF corridor side. This gauge is to determine the relative pressure of the housing room in comparison with the central ACF corridor.

ELECTRICAL

- All emergency systems shall be on stand-by power, served by a new stand-by load center, mounted in the new suite. Emergency systems consist of outlets powering the six ventilated caging systems; penthouse exhaust fan ventilating the caging systems; four emergency heat pump units (one in each qualified housing room); and two additional 120V 20A circuits.
- Lighting levels in the two qualified housing rooms and each behavior testing room shall be wired so that two separate light levels may be chosen by the user. The low light level shall be 25 FC measured at the floor and shall be controlled by a mechanical 24/7 timer, mounted in the corridor immediately outside the room being controlled. Use exterior-rated or marine application timers by Intermatic, Paragon, Hubbell or approved equal. Seal the timer housing to the wall with a smooth bead of GE silicone caulk.
- Provide Sylvania “full spectrum” lamps for housing room. Cool white for all other areas. The light fixture housings shall be sealed against the ceiling surface with a smooth bead of clear GE silicone caulk.
- All wall-mounted devices shall be exterior rated GFCI-type (or on GFCI breakers, at the discretion of the Electrical Engineer) with weatherproof covers. All wall-mounted switches shall be fitted with Hubbell clear plastic weatherproof covers.
- The electrical contractor shall install indicated conduits and boxes for telephone and data ports.
- Fire alarm devices shall be outdoor or marine rated. No claxon or horn shall be mounted in the two qualified housing rooms, with the approval of the Fire Marshal.
- Fire alarm pull stations shall be fitted with a clear plastic protective cover, Stopper II brand by Safety Technologies.

- All devices – switches for lights, and receptacles – fed by the stand-by power system shall be factory red in color. This applies to the device and the cover plate. If a factory red device or plate is not available (the weathertight covers or the ceiling mounted boxes for instance – the contractor shall paint the cover plate or box with red Rustoleum heavy duty enamel. The Hubbell clear flexible covers over light switches shall not be painted.
- The electrical contractor shall affix an engraved plastic indicator or professionally prepared label at each individual outlet and switch in the facility indicating feed panel and circuit number.

CONSTRUCTION

- Completely prepare the floor surface so that it is a smooth, defect free cement plane.
- Flooring shall be rolled on epoxy rated for severe & wet service.
- Materials shall be at the direction of SOS.
- Access panels shall be installed as needed to allow full and complete access.
- All wall and ceiling surfaces shall be coated with two coats (4.5 mils wet per coat) of Sherwin-Williams Poly-Lon 1900 polyester polyurethane epoxy, after appropriate surface preparation to make the surface perfectly smooth and free of gaps and defects.
- Hollow metal door frames in the two qualified housing rooms shall be “hospital rated” with welded joints
- All gaps at the joints of door frames and walls shall be filled with a smooth bead of GE clear silicone sealant
- Housing room doors shall have no view panels, or small view panels with light-tight inspection doors (Targacept option). Storage room doors shall have full upper view panel (Lexan or laminated safety glass).
- Fire corridor doors shall be existing or to match the building standard. No view panel
- The contractor shall affix engraved plastic labels (1/4” white letters on black background) on each access door installed in the ceiling of the central ACF corridor. The label shall list every electrical device, plumbing valve, damper and other device serviced through that access panel.
- All doors in the qualified housing rooms and behavior testing rooms shall be fitted with heavy duty LCN hydraulic closers, which are specifically designed to close slowly against an air pressure differential of .20”

SPECIALTIES

- All wall surfaces as indicated on the drawing shall be fitted with Acrovyn ECR-32 crash rails, manufactured by Construction Specialties.
- All swinging doors as indicated on the drawing shall be fitted with Acrovyn Latch Protectors, manufactured by Construction Specialties.
- All outside corner wall joints as indicated on the drawing shall be fitted with Acrovyn corner guards, manufactured by Construction Specialties.
- All hollow metal door frames as indicated on the drawing shall be fitted with Acrovyn DFP-B door frame protection sleeves, manufactured by Construction Specialties.
- Doors leading into or out of the ACF, on the two qualified housing rooms, on each testing room and on the food & bedding storage room shall be fitted with active door-bottom sealing mechanisms which will lower to the floor when the door is closed. A positive flexible seal at the floor is required. The frames of both doors shall be fitted with a positive sealing rubber gasket assembly. The performance specification here is to make as air-tight, and vermin-tight, a seal at both doors as is possible.
- Use extra heavy duty – Severe Service – hinge.
- Use stainless steel hardware and latches.

[Diagram of Floor Design]

Exhibit B

Fee Proposal from O'Brien Atkins dated October 30, 2006

O'Brien/Atkins Associates, PA
Architecture/Engineering
Landscape Architecture/Planning
Interior Design

Post Office Box 12037
Research Triangle Park, NC
27709

Durham 919/941-9000
Raleigh 919/755-1032
Chapel Hill 919/968-4571

OBrienAtkins

October 30, 2006

Ms. Mauri K. Hodges
200 E. 1st St.
Suite 300
Winston-Salem, NC 27101-4165

Re: Targacept ACF Fee Proposal

Dear Mauri:

Please find enclosed O'Brien/Atkins' revised fee proposal for providing architectural services for the partial fit-up of the first floor of One Technology Place. We are pleased to present this proposal for providing professional architecture for the design and construction documents of approximately 5400 GSF of animal care facility, 360 Sq. Ft of Chemical Storage Room and 4700 GSF of associated office space.

Scope of the Project

O'Brien/Atkins will provide architectural documents for the fit up of the spaces described above and as described in the program documents prepared by Specialty Operations Solutions for the Basis of Design (BOD) dated 7-13-06 and the Draft 3a Floor Plan dated 9-20-06.

Delivery of Services

Targacept will hold three contracts: One with Shelco the General Contractor, one with O'Brien/Atkins Associates for Architecture, MEP and Fire protection, and one with Specialty Operations Solutions. The contract of Sterling Engineering Company, Inc. for MEP and Fire protection has been assigned to O'Brien/Atkins. O'Brien Atkins will administer Sterling's contract and coordinate their services. Any required structural work (framing new roof/floor openings or support of roof mounted equipment) will be provided by GKC as a sub-consultant to O'Brien/Atkins. At this time it is not known if any structural modifications will be required. If such services are required we would provide a firm quote at the time the scope is determined.

Architecture and Engineering Team

O'Brien/Atkins will provide architectural design services and lead the design phase effort with the following team:

- *Architecture:* O'Brien/Atkins Associates, PA
- *Interior Design:* O'Brien/Atkins Associates, PA
- *Structural Engineering:* GKC if required
- *MEP Engineering:* Sterling Engineering Company, Inc. (assigned to O'Brien/Atkins)
- *Fire Protection Engineering:* Sterling Engineering Company, Inc. (assigned to O'Brien/Atkins)
- *ACF Planning:* by Owner's consultant, Specialty Operations Solutions (SOS)
- *Code Compliance:* O'Brien/Atkins Associates (Architecture), PA and Sterling Engineering Company Inc. (MEP and Fire Protection)
- *Civil Engineering:* Not Required
- *Landscape Architecture:* Not Required
- *Graphics & Signage:* Not included in basic services.
- *FF&E:* Not included in basic services.

Scope of Architecture Services

The scope of architectural services includes the customary design, documentation and construction phase services for the above scope of work.

Coordinated with the delivery of services, the project has been separated into the following phases of services:

- Review of SOS documents to become familiar with the information and to meet with SOS to clarify questions concerning this information
- Design confirmation code review of the SOS concept floor plan. Convert SOS plans to O'Brien/Atkins' CAD Standards, revise floor plans to confirm to code and make revisions accordingly.
- Design Development as per AIA Document B-141
- Construction Documents as per AIA Document B-141
- Bid/Negotiations as per AIA Document B-141
- Construction Administration as per AIA Document B-141

Scope of Engineering Services

The scope of the engineering services and associated fee is defined in Sterling Engineering Company's, Inc. Fee Proposal dated October 24, 2006 (copy attached).

Project Schedule

The schedule for the project is:

	Estimated Schedule	
	Start	Finish
Review of SOS Documents	**10/2/2006**	**10/6/2006**
Schematic Design	**10/6/2006**	**10/13/2006**
Design Development	**10/13/2006**	**10/20/2006**
Construction Documents	**10/20/2006**	**11/21/2006**
Procurement & Permitting	**11/22/2006**	**12/12/2006**
Construction	**12/12/2006**	**4/15/2007**
Commissioning	**4/15/2007**	**5/1/2007**

Note: The completion of Design Development Phase shall constitute Plan Lock. Any changes after that will constitute a change of scope and schedule, which in turn will require a negotiation of an adjustment to the fee and schedule. Design Development Phase approval is required prior to beginning the Construction Documents Phase.

Project Budget

The estimated construction budget for the project is approximately $2,000,000.

Services Not Included/clarifications

- Tabulation of existing and future Equipment and Cut sheets – by Owner's consultant, Specialty Operations Solutions
- Meetings limited to every two weeks during design
- Meetings every two weeks during construction (9 Meetings)
- Cost estimating services not included
- Scheduling services
- Laboratory casework programming and drawings by casework vendor
- Signage and Graphics not included
- O/A will rely on SOS for selection of Hardware, floor and wall finishes; Ceiling finishes within the perimeter of the ACF. SOS to furnish O'Brien/Atkins the appropriate cut sheets and product information for the specification process.
- Because of the short schedule any change in the BOD, equipment or floor plan may constitute an adjustment to the fee and schedule. Any changes after the plan lock will constitute will constitute a change of scope and schedule (see note above on the project schedule).
- O/A and Sterling has no scope during the Commissioning Phase

Receivables

O'Brien/Atkins needs the following documents:

- Signed Contract
- Authorization to proceed

Fee and Reimbursable Expenses

O'Brien/Atkins proposes to provide the services described above for Two Hundred Two Thousand Nine Hundred Twenty Seven Dollars ($202,927) plus the reasonable cost of its reimbursable expenses, submitted in a format acceptable to Targacept for travel, reproduction and express delivery times a 1.1 multiplier. For a breakout of the fee by tasks and associated hours please refer to the attached spreadsheets.

We appreciate this opportunity to work with Targacept again and are excited to work with you on this project.

Sincerely,
O'BRIEN/ATKINS ASSOCIATES, PA

/s/ Eric J. Erickson,
Eric J. Erickson, AIA
Principal, Director of Science & Technology

Attachments

cc: Graydon Pleasants
John L. Atkins, III, FAIA
Dudley B. Lacy, AIA

Part 1. Idealliance Biotechnology Research Facility
Recap of estimated fee & expenses by discipline by phase

Activity	Duration (Working Days)	Architecture & Project Mgmt. Est. hrs.	Architecture & Project Mgmt. Est. Fee	Mechanical Engineering Est. hrs.	Mechanical Engineering Est. Fee	Electrical Engineering Est. hrs.	Electrical Engineering Est. Fee	Total Hrs	Total $	Total Fee Structural GKC	Total Fee Sterling Engineering Company, INC	Total Fee O/A Coord/ Mgt	Total Fee	Total Fee O/A
Review of SOS Documents and MEP Existing Conditions	3	10	$ 1,610	0	$ 0	0	$ 0	10	$ 1,610		$ 22,245	$ 2,225	$ 26,080	$ 1,610
Architectural Design Confirmation/Schematic MEP	5	52	$ 4,780	0	$ 0	0	$ 0	52	$ 4,780	$ 0	$ 18,895	$ 1,890	$ 25,685	$ 4,780
Design Development	5	68	$ 7,380	0	$ 0	0	$ 0	68	$ 7,380	$ 0	$ 18,576	$ 1,856	$ 27,813	$ 7,380
Construction Documents Production	15	248	$ 28,480	0	$ 0	0	$ 0	248	$28,480	$ 0	$ 31,025	$ 3,103	$ 92,608	$28,480
Bld/Negotiation	20	36	$ 4,680	0	$ 0	0	$ 0	36	$ 4,680	$ 0	$ 4,375	$ 438	$ 9,493	$ 4,680
Construction Phase	110	200	$ 24,440	0	$ 0	0	$ 0	200	$24,440	$ 0	$ 19,900	$ 1,990	$ 46,330	$24,440
Interiors	1	72	$ 5,040					72	$ 5,040			$ 0	$ 5,040	$ 0
Estimated Total Hours		686		0		0		686						
Estimated Total Fee			$ 76,410		$ 0		$ 0		$76,410	$ 0	$ 116,015	$ 11,502	$202,927	$71,370
												$126,517		

Consultants:		
Sterling Engineering Co	$ 115,015	
Structural Fee: GKC	$ 0	
	$ 115,015	
Management/Coord. of consultants	$ 11,502	
Total for Basic Service Consultants	$ 126,517	
Basic Services		
Building		$ 76,410
Consultants		$ 126,517
Sub Total Basic Services		$ 202,927
Additional Services		
Marketing Support Materials	$ 0	
EDI- Telecom/Security	$ 0	
Management/Coord. of consultants	$ 0	
Total for Additional Service Consultants		$ 0
Total Fee (Excluding Reimbursable Expenses)		$ 202,927

	Estimated Construction Cost	A/E Fee	Total Est Const Cat + A/E Fee
Biotechnology Facility Cora & Shell Construction Budget	$2,000,000	$ 202,927	$ 2,202,927

Estimated Reimbursable Expenses
O'Brien/Atkins

Mileage	$1,346
Express Mail	$ 625
Reproduction	$3,570
Meals	$ 294
Sub-Total Expenses	$5,835
Time Multiplier of 1.1	$6,418

Consultants

Sterling Engineering	$4,480
	$ 0
	$ 0
	$ 0
Sub-Total Expenses	$4,480
Time Multiplier of 1.1	$4,928

Estimated Tot. Reimbursables = $10,898

Remarks:

1. Assumes 10,460 S.F. Build-out.
2. Construction Review limited to 18 weeks and 9 architectural site visits
3. Estimated Architectural 15 sheets
4. Estimated at 40 express mail packages at $25/package = $1000.

Part 1. Detailed Breakout of Fee & Expenses

Review of SOS Documents

3/1/05-3/15/05 **3 working days** **24 working hours**

		Architectural				Mechanical Engineering				Electrical Engineering			Landscape Architecture			
Activity	Remarks	Principal	Project Manager	Project Architect	Intern Architects	Mechanical Engineer	HVAC Designer	Plumbing Designer	Mechanical Drafters	Electrical Engineer	Electrical Designer	Electrical Drafters	Senior Landscape Architect	Landscape Architect	Total Hours	Total $
		2	8													
Estimated Hours		2	8	—	—		—	—	—	—	—	—	—	—	10	
Full-time Equivalents		0.08	0.33	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00				
Fee by Discipline					$ 1,610				$ —			$ —		$ —		$1,610
				10	$ 161			0	#DIV/01		0	#DlV/01	0	#DIV/01		

Design Confirmation

3/16/05 -3/30/05 **5 working days** **40 working hours**

		Architectural				Mechanical Engineering				Electrical Engineering			Landscape Architecture			
Activity	Remarks	Principal	Project Manager	Project Architect	Intern Architects	Mechanical Engineer	HVAC Designer	Plumbing Designer	Mechanical Drafters	Electrical Engineer	Electrical Designer	Electrical Drafters	Senior Landscape Architect	Landscape Architect	Total Hours	Total $
Schematic Design	1	4	8		40											
Estimated Hours		4	8	—	40	—	—	—	—	—	—	—	—	—	62	
Full-time Equivalents		0.10	0.20	0.00	1.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00				
Fee by Discipline					$ 4,780				$ —			$ —		$ —		$4,780
				52	$ 92			0	#DIV/01		0	#DIV/01	0	#DIV/01		

Design Development

3/31/05-4/14/05 **5 working days** **40 working hours**

		Architectural				Mechanical Engineering				Electrical Engineering			Landscape Architecture			
Activity	Remarks	Principal	Project Manager	Project Architect	Intern Architects	Mechanical Engineer	HVAC Designer	Plumbing Designer	Mechanical Drafters	Electrical Engineer	Electrical Designer	Electrical Drafters	Senior Landscape Architect	Landscape Architect	Total Hours	Total $
Design Development	1	8	20		40											
Estimated Hours		8	20		40	—	—	—	—	—	—	—	—	—	68	
Full-time Equivalents		0.20	0.50	0.00	1.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00		
Fee by Discipline					$ 7,380				$ —			$ —		$ —		$7,380
				68	$ 109			0	#DIV/01		0	#DIV/01	0	#DIV/01		

Construction Documents Production

4/15/05-5/19/5 **15 working days** **120 working hours**

		Architectural				Mechanical Engineering				Electrical Engineering			Landscape Architecture			
Activity	Remarks	Principal	Project Manager	Project Architect	Intern Architects	Mechanical Engineer	HVAC Designer	Plumbing Designer	Mechanical Drafters	Electrical Engineer	Electrical Designer	Electrical Drafters	Senior Landscape Architect	Landscape Architect	Total Hours	Total $
Construction Documents Production	1	8	40		120											
Specifications			80													
Estimated Hours		8	120	—	120	0.00	0.00	0.00	0.00	—	—	—	—	—	248	
Full-time Equivalents		0.07	1.00	0.00	1.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00		
Fee by Discipline					$28,480				$ —			$ —		$ —		$28.480
				248	$ 115			0	#DIV/01		0	#DIV/01	0	#DIV/01		

Bid/Negotiation

5/20/05-6/20/05 **160 working hours** **20 working days**

		Architectural				Mechanical Engineering				Electrical Engineering			Landscape Architecture			
Activity	Remarks	Principal	Project Manager	Project Architect	Intern Architects	Mechanical Engineer	HVAC Designer	Plumbing Designer	Mechanical Drafters	Electrical Engineer	Electrical Designer	Electrical Drafters	Senior Landscape Architect	Landscape Architect	Total Hours	Total $
Bid/Negotiation	1	4	20		12											
Hours		4	20	—	12	—	—	—	—	—	—	—	—	—	36	
Full-time Equivalents		0.03	0.13	0.00	0.08	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00		
Fee by Discipline					$ 4,680				$ —			$ —		$ —		$4,680
				36	$ 130			0	#DIV/01		0	#DIV/01	0	#DIV/01		

Construction Phase

6/20/06-12/11/06 **110 working days** **880 working hours**

		Architectural				Mechanical Engineering				Electrical Engineering			Landscape Architecture			
Activity	Remarks	Principal	Project Manager	Project Architect	Intern Architects	Mechanical Engineer	HVAC Designer	Plumbing Designer	Mechanical Drafters	Electrical Engineer	Electrical Designer	Electrical Drafters	Senior Landscape Architect	Landscape Architect	Total Hours	Total $
Construction Phase	1	8	40		60											
Construction Meetings			72													
Record Drawings					20											
Estimated Hours		8	112	—	80	—	—	—	—	—	—	—	—	—	200	
Full-time Equivalents		0.01		0.00	0.09	0.00	0.00	0.00	0.00	0.00	0.00	0.00	$ 120.00	$ 68.00		
Fee by Discipline					$ 24,440				$ —			$ —		$ —		$24,440
				200	$ 122			0	#DIV/01		0	#DIV/01	0	#DIV/01		

Interior Design

1 working days **8 working hours**

		Architectural				Mechanical Engineering				Electrical Engineering			Landscape Architecture			
Activity	Remarks	Principal	Project Manager	Sr Interior Designer	Interior Designer	Mechanical Engineer	HVAC Designer	Plumbing Designer	Mechanical Drafters	Electrical Engineer	Electrical Designer	Electrical Drafter	Senior Landscape Architect	Landscape Architect	Total Hours	Total $
Interior Design	1	0			72											
Coordination with FF&E Designer																
Estimated Hours		—		—	72	—	—	—	—	—	—	—	—	—	72	
Full-time Equivalents		0.00		0.00	9.00											
Fee by Person		$ —	$ —	$ —	$ 5,040	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —		
Fee by Discipline					$ 5,040				$ —			$ —		$ —		$5,040
				72	$ —			0			0	#DIV/01	0	#DIV/01		
	CDs	26	176	—	284	—	—	—	—	—	—	—	—	—	$ 486	
	CA	8	112	—	80	—	—	—	—	—	—	—	—	—	$ 200	
		34	288	—	364	—	—	—	—	—	—	—	—	—	$ 686	

Estimated Expenses

12/1/04 -12/31/06

Travel/Mileage	$1,346
Express Mail	$ 625
Reproduction	$3,570
Meals	$ 294
Total Estimated Expenses	$5,835

Remarks:

1. Assumes 10,480 S.F. Build-out.
2. Construction Review limited to 18 weeks and 9 architectural sits visits
3. Estimated Architectural 15 sheets
4. Estimated at 40 express mail packages at $25/package = $1000.

Estimated Reproduction	# Sheets	Cost Sheet	Cost/Set	Est. # of sets	Est. Cost
SD Deliverable Estimated at	2	$ 2.00	$ 4.00	15	$ 60.00
DD Deliverable Estimated at	16	$ 2.00	$32.00	15	$ 480.00
CD Deliverable Estimated at	15	$ 2.00	$30.00	20	$ 600.00
Bid Sets Estimated at	15	$ 2.00	$30.00	30	$ 900.00
DD Specifications	20	$ 0.10	$ 2,00	15	$ 30.00
CD Specifications	250	$ 0.10	$25.00	30	$ 750.00
Bid Specifications	250	$ 0.10	$25.00	30	$ 750.00
Total Reproduction					$3,570.00

		Rate	total per trip	# of trips	Total
Travel	178 miles/trip @	$0.36	$ 64.08	21	$1,345.88
Meals		$7.00	$ 7.00	42	$ 294.00

Exhibit C

Proposal from Subconsultant Sterling Engineering
to O'Brien Atkins dated October 4, 2006

STERLING engineering co., inc.
design & forensic engineers

79 Main Street

Sturbridge, MA 01566

www.sterling-eng.com

T Ÿ 508.347.9101

F Ÿ 508.347.7659

E Ÿ info@sterling-eng.com

October 24, 2006

Mr. Eric Erickson, AIA
O'Brien/Atkins Associates, PA
P.O. Box 12037
Research Triangle Park, NC 27709

Re: Targacept Tech One 1st Floor MEP Proposal - Rev 2

Dear Rick,

This letter of agreement outlines the details of the professional engineering services we will provide on a fixed fee basis. Please carefully review all items including the attached General Terms and Conditions, sign, date, and return this letter by fax or mail at your earliest convenience, and retain a copy for your records.

SCOPE OF WORK

We propose to perform the following services for O'Brien/Atkins Associates located at 5001 South Miami Blvd., Durham, NC 27703.

PHASE I- PREPURCHASE

1. We will generate a formal prepurchase equipment schedule for the purchase of the long lead items required for the fit-up of the Targacept Tech One 1st Floor ACF.
2. We will produce a specification for the equipment to support the prepurchase schedule information.
3. We will supply [3] sets each of 95% and 100% completion of the prepurchase specification and schedules.
4. Following the issuance of the 95% prepurchase set, (separate from the design drawing sets), we plan on [1] on-site review of the 95% prepurchase review set in conjunction with the 50% design drawing review meeting. We are planning on a number of phone calls with comments, but may require an additional trip(s) if comments and/or directives conflict in such a manner that the equipment will hamper the outcome of the intended design. The additional trip(s) are not covered by this proposal.

PHASE II- ACF/OFFICE DESIGN

1. We will survey the 1st floor and produce existing conditions drawings of the mechanical and electrical systems including HVAC, exhaust, electrical, drains, plumbing, fire protection, mechanical piping and gas (OFA/CA, natural gas and process vacuum). We will not include lab liquid or gases (Formalin, NoX, etc.) or other trades not expressly listed above. Other trade design can be incorporated for an additional cost, but is deemed outside of the scope of this proposal.

2. Mechanical design will follow the Sterling HVAC Assessment dated 9/28/06 and the Assessment Addendum #1 dated 10/4/06. Deviations from that will be recorded by Sterling and approved by OBA and Targacept prior to design incorporation. Included in the design will be the following design criteria outside of the Assessment's general scope:

   a) NC 55 for lab environments for the ACF and NC 45 for the office areas

   b) Coordination with North Carolina State Building, Fire Prevention, Mechanical, Plumbing and Energy Codes

   c) Normal power for outlets and lighting

   d) Emergency feeds for the necessary equipment

   e) Control power for devices and panels

   f) Specification of control instruments and panels

3. We will develop [3] sets each of 50%, 100% review and 100% complete drawings for the 1st floor and associated penthouse and ground floor equipment including transitions between floors. We will issue relevant specifications for mechanical and electrical trades. Other trade specifications will be handled by O'Brien/Atkins separately. Included with the sets will be the mechanical basis of design, and mechanical sequence of operations.

4. We will develop a permit set and include calculations for the plumbing, and HVAC loads if required.

5. We understand there is an existing building air system riser diagram. We intend on issuing a riser diagram with the 100% complete set and would like it to be as complete as possible. Therefore, we hope to receive an AutoCAD drawing of the print prior to the 50% review issue set. We do not intend on assessing the ductwork on the other floors, but again, would like it to be as complete and accurate as possible for the client.

6. We are planning on [3], on-site meetings prior to the 100% complete issue: kick-off, 50% review and 100% review. The 100% complete set will be issued via overnight courier – afternoon delivery the day prior to the due date. Teleconferences can be planned, as required.

7. We are planning on a monthly review meeting and construction observation trip until the projected, construction completion in February 2007 (3 trips total).

8. We will furnish [1] interim punch list at 95-100% complete construction by O'Brien/Atkins' direction or by the end of February 2007, whichever is later. In addition, we will issue [1] final mechanical/electrical punch list following or in conjunction with the commissioning process. This will allow the controls to be completed and tested. Also, we will verify the interim, punchlist items are rectified. [2] trips are planned during this process.

9. O'Brien/Atkins will furnish owner approved, AutoCAD room layout for our X-reference, as well as the program document, before the start of the MEP design process and a minimum of 10 business days prior to the 50% drawing issue date as determined by OBA/Sterling agreement.

10. We assume we will not require escorts for the 1st floor, penthouse or ground floor areas during our survey. We also have not planned for safety training or protocol training.

11. If possible, we desire the as-built set and the balance report information for the current 1st floor build-out. This will aid in the redesign of that floor.

12. Add Chemical Storage HVAC, Exhaust, Electrical, and Fire Protection as required for 1st floor and associated requirements up to roof.

    A. Coordinate with architect to route ductwork, install electrical lights and power, fire protection and exhaust to maintain Class I, Div I code compliance and maintain design schedule per the original proposal.

SCHEDULE

Below is a list of our current, projected dates for the design process:

Existing Conditions: October 6, 2006

Schematic Design: October 13, 2006

Design Development/ 50% Issued: October 20, 2006

Construction Documents/ 100% Design Issued: November 21, 2006

Permitting Complete/Construction Start: December 12, 2006

Construction Complete: April 15, 2007

Commissioning services are not included in this proposal.

The design schedule from October 11 to November 21 comprises a 7 business week schedule. This is the minimum duration based on the man-loading calculation that is achievable at the given price. If the schedule is compressed, the price should be reevaluated.

COST

The total cost of services, as outlined above, is a fixed fee of $ 119,495.00 including expenses.

Project Phase Breakout:

	LABOR	EXPENSES	NOTES on EXPENSE BRKDWN*
Phase 1- Existing Conditions:	$ 22,245.00	$ 1,625.00	3 ppl/2nights/drive 1600 miles total
Phase 2- Schematic Design:	$ 18,895.00	$ 0.00	
Phase 3- Design Development/ 50%:	$ 18,575.00	$ 1,575.00	2pp1/1 night/flv & car rental
Phase 4- Conceptual Design to 100%:	$ 31,025.00	$ 0.00	
Phase 5- Procurement, Permitting/Bidding:	$ 4,375.00	$ 0.00	
Phase 6- Construction Observation/Administration:	$ 19,900.00	$ 1,280.00	1 prsn/ 3 trips/1 night/fly or drive
TOTAL		**$ 119,495.00**	

* All values are approximate, per person and may vary: hotel-1 night ~ $120/night, fly ~ $550 pp/flight, drive ~$640 rnd trip, car rental ~ $110/day, meals ~ $35/day

Our billing rates for additional T&M work are as follows:

Principle Engineer/ P.E.:	$125.00
Project Manager	$115.00
Sr Engineer	$110.00
Sr. Designer:	$105.00
Engineer/Designer:	$ 95.00
Jr. Designer	$ 85.00
Drafter:	$ 65.00
Administrative Support:	$ 55.00

The price does not include remobilization for design or construction holds or delays. The billing rates are subject to change in 1 year from the issuance of this proposal.

EXECUTION

Please sign your name; print your name, title, and the date in the space provided. Having affixed their hands and seals below, Sterling Engineering, Co. Inc. and the Client indicate acceptance of the terms of this proposal and the attached General Terms and Conditions. Please return the signed original to us. We look forward to serving you on this project

CLIENT'S NAME

Signature: _____

Name and Title: _____

Date: _____

STERLING ENGINEERING CO., INC.

Signature: JVM (via email)
Name and Title: Jennifer V. Morrison, President
Date: October 24, 2006

Sterling Engineering
Job Budget

Client OBrien/Atkins
Address Durham, NC
Attention Eric Erickson, AIA

Proj. Mgr. Todd Somerset
Job # 06090
Job Title Targacept ACF

Phase	Description	Principal Eng.	Proj. Mgr.	Sr Eng	Sr. Designer	Engineer/ Designer	Jr Designer	Drafter	Admin. Support	
ES	Survey and Existing Site Conditions	41	40	43	40	6	16	24	2	
SC	Schematic Design	72	5	44		24	4	24	6	
DG	Design to 50%	36	10	29	50	20	25	8	1	
	Design to 100%	69	32	28	76	59	14	8	7	
SW	Bidding and RFI's	18	7	11			1		0.5	
CO	Construction Observation/Admin	71		42	58				4	
	Total Hours	307	94	197	224	109	60	64	20.5	
	Labor Cost	$38,375.00	$10,810.00	$21,670.00	$23,520.00	$10,355.00	$5,100.00	$4,160.00	$1,025.00	$0.00

Comments

Total Labor Cost	**$ 115,015.00**
Expenses	**$ 4,480.00**
Lab Charges	
Miscellaneous	
Total Contract	***$ 119,495.00***

Sterling Engineering Co., Inc
79 Main Street ..
Sturbridge, MA 01566
P: 508-347-9101
F: 508-347-7659

General Terms and Conditions

CONTRACT — The Contract consists of the proposal signed by the Client and Sterling Engineering Co., Inc., and these General Terms and Conditions. The unsigned proposal is valid for 90 days from the date on the front cover page of the proposal. The signed proposal is valid for 60 days form the date on the front cover page of the proposal unless a specific start of services date is identified within the proposal.

This Contract supersedes all written or oral agreements between Sterling Engineering Co., Inc. and the Client except those written documents specifically stated in the proposal as being a necessary document to the contractual arrangement of which the General Terms and Conditions is a part. No amendment of the signed proposal or General Terms and Conditions shall be of any force and effect unless mutually agreed to by Sterling Engineering Co., Inc. and the Client, and evidenced in writing by fully stating the nature and details of said amendment and signed by duly authorized representatives of Sterling Engineering Co., Inc. and the Client.

In the event that any clause or portion of a clause of this signed proposal or the General Terms and Conditions is finally determined by a court of competent jurisdiction, from which an appeal either cannot be taken or is not taken, to be in violation of any applicable federal, state, or local law, all other clauses or portions of a clause shall nevertheless remain in full force and effect to the maximum extent not clearly prohibited by applicable federal, state, or local law.

Wherever “Sterling Engineering Co., Inc.” is named in the General Terms and Conditions it shall also mean and include Sterling Engineering Co., Inc.’s officers, directors, owners, employees and subconsultants.

ABSENCE OF WARRANTY/STANDARD OF CARE — All services of Sterling Engineering Co., Inc. will be rendered in a reasonable and prudent manner in accordance with the generally accepted engineering practice at the time said services are rendered. All estimates, recommendations, opinions and decisions of Sterling Engineering Co., Inc. will be on the basis of the information available to Sterling Engineering Co., Inc. and Sterling Engineering Co., Inc.’s experience, technical qualifications, and professional judgement. There are no warranties of merchantability or fitness for a particular purpose or any other warranties or guarantees whatsoever, express or implied, with respect to any service rendered or materials provided under this Contract or any related agreement.

ADDITIONAL SERVICES — Additional services above the basic scope of work performed by Sterling Engineering Co., Inc. shall be compensated in accordance with our provided fee schedule plus reimbursable expenses. Additional services include, but are not limited to, site visits during construction in excess of those scheduled; any change causing mechanical or electrical redesign beyond the 80% complete phase; services required to comply with changes in criteria defined in the Basis of Design document and/or the Schematic Narrative received after Owner review and approval of Basis of Design document and Schematic Narrative documents; services required to verify the accuracy of drawings or other information furnished by the Client or owner; services required to prepare a set of record drawings showing changes in the work made during construction; project changes (including, but not limited to, size, system type, complexity, or schedule) required by the owner or Client following the date of completion of the schematic design phase; project revisions required due to codes, laws, or regulations enacted after completion of the schematic design phase; services or preparation of documents, review of Contractor’s proposals, or review of Contractor’s substitutions related to change orders; services related to defects or deficiencies in Contractor’s work; services related to damage from any source to the site, equipment, or materials associated with the project; preparation of alternate bids; performance of engineering feasibility studies, engineering economic studies, or surveys.

REIMBURSABLE EXPENSES — Reimbursable expenses include costs for travel fares (airfare, taxi, train, etc.), automobile rental or mileage at 44.5¢ per mile, tolls, parking, lodging, meals, photocopies and reproductions, plotting and scanning, postage, applicable codes and standards, reference material, subconsultants, rental equipment, laboratory services, and additional insurance coverage or

limits in excess of that normally carried (when requested by the Client in writing); expenses from required responses to subpoenas or court orders related to work under this Contract or any related agreement. All reimbursable expenses from work by subconsultants and from laboratory services may be marked up 15% for administrative cost; all other reimbursable expenses will be billed at cost.

INFORMATION FURNISHED BY CLIENT — The Client will assist Sterling Engineering Co., Inc. by placing at Sterling Engineering Co., Inc.'s disposal all available information pertinent to the project including previous reports and any other data relative to design or construction of the project or Sterling Engineering Co., Inc.'s provision of services. Sterling Engineering Co., Inc. shall have no liability for any claims attributable to Sterling Engineering Co., Inc.'s reliance upon or use of data, design criteria, drawings, specifications or other information furnished by the Client and the Client agrees to indemnify and hold harmless Sterling Engineering Co., Inc. from any and all liability, claims, demands, judgments, damages, losses, costs and expenses, including consequential or indirect damages, whatsoever, including reasonable attorney's fees, therefrom. Sterling Engineering Co., Inc. shall disclose to the Client prior to use thereof, defects or omissions in the data, design criteria, drawings, specifications or other information furnished by the Client to Sterling Engineering Co., Inc. that Sterling Engineering Co., Inc. discovers in its review and inspection thereof.

SCHEDULE — The Client agrees to submit any project requirements to Sterling Engineering Co., Inc. before the end of the schematic design phase unless Sterling Engineering Co., Inc. is not required to comply with the project schedule. The Client agrees to submit any project changes or changes in the scope of work no later than the date indicated for Client review comments of our 60% or greater complete submission phase unless Sterling Engineering Co., Inc. is not required to comply with the project schedule. Time limits established by the project schedule shall not, except for reasonable cause, be adjusted by Sterling Engineering Co., Inc. or the Client.

CONSTRUCTION OBSERVATION — Construction observation, when performed, is to verify general conformance with the construction documents. The Contractor is solely responsible for means, methods, accuracy, adequacy, schedule, and supervision of construction. The Contractor is solely responsible for delivery and installation of materials and equipment. The Contractor is solely responsible for all measurements, dimensions, and fit of materials and equipment. The Contractor is solely responsible for supervision of personnel, materials, equipment, and machinery. The Contractor is solely responsible for safety regarding all work. The Client agrees to indemnify and hold harmless Sterling Engineering Co., Inc. from all liability, claims, demands, judgments, damages, losses, costs and expenses, including consequential or indirect damages, whatsoever, including reasonable attorney's fees, arising out of or resulting from the Contractor's means, methods, and safety practices, and for the acts or omissions of any person (except Sterling Engineering Co., Inc.'s own employees or agent) at the project site or otherwise performing any of the work of the project.

DOCUMENTS — Documents prepared by Sterling Engineering Co., Inc. including but not limited to drawings, specifications, reports, calculations, data, notes, sketches, photographs, renderings, and electronic media are instruments of service and remain the copyrighted property of Sterling Engineering Co., Inc. The Client agrees not to use any instruments of service for any purpose other than for the project for which the instruments of service were prepared, without express written permission from and verification or adaptation by Sterling Engineering Co., Inc. Any such unauthorized use by the Client will be at the Client's sole risk and without liability or legal exposure to Sterling Engineering Co., Inc., and the Client shall indemnify and hold harmless Sterling Engineering Co., Inc. from any and all liability, claims, demands, judgments, damages, losses, costs and expenses, whatsoever, including consequential or indirect damages, whatsoever, including reasonable attorney's fees, arising out of or resulting therefrom. Sterling Engineering Co., Inc. reserves the right to remove its professional stamp and title block from documents turned over to the Client. The hard copies or printed original documents provided by Sterling Engineering Co., Inc. shall remain the controlling version of the instruments of service. If it is necessary to disseminate any documents to an unrelated third party, both the third party and the Client agree: 1) the third party is bound by all of the conditions and limitations of this Contract and related documents; 2) the third party is bound by all limitations of liability or indemnity provisions hereof; and 3) the limitation of liability set forth in section "Liability"

below is an aggregate limit and the client does not have the right or duty to apportion the limitation amount between itself and the third party. Sterling Engineering Co., Inc. shall have the right to use any documents in promotional materials or professional articles unless the Client expressly prohibits such use in writing.

CODE COMPLIANCE — Sterling Engineering Co., Inc. shall exercise usual and standard professional care and judgement to design in compliance with applicable laws, regulations, codes, and standards in effect as of the date of the services rendered.

ABANDONMENT OR SUSPENSION OF WORK — Abandonment or suspension of work by the Client with or without written notice does not reduce the Client's liability to promptly pay Sterling Engineering Co., Inc. for all services rendered to date of written notification of abandonment or suspension. The Client agrees to promptly pay commitments to consultants of Sterling Engineering Co., Inc. made in association with work of this Contract, or any related agreement, to date of written notification of abandonment or suspension of work. Sterling Engineering Co., Inc. may, upon seven days written notice to the Client, suspend any and all work associated with this Contract, or any related agreement, when the Client does not pay the full balance of any invoice when due. Sterling Engineering Co., Inc. reserves the right to abandon any and all work associated with this Contract, or any related agreement, when the Client does not pay the full balance of any invoice within 120 days of the date of invoice. The Client agrees to indemnify, defend and hold harmless Sterling Engineering Co., Inc. from all liability, claims, demands, judgments, damages, losses, costs and expenses, whatsoever, including reasonable attorney's fees, arising out of or resulting from such suspension or abandonment.

ACCESS AND RIGHT OF ENTRY — When access or right of entry to property is required by work, the Client agrees to obtain legal right-of-entry on the property.

LIABILITY — The Client agrees that Sterling Engineering Co., Inc.'s total liability for any and all claims, demands, judgments, damages, losses, costs and expenses, whatsoever, including reasonable attorney's fees, arising out of or in any way related to the project or this Contract or any related agreement, from any insurable cause including its negligent acts, errors or omissions, breach of contract, or strict liability, shall not exceed the total amount recoverable from Sterling Engineering Co., Inc.'s general liability insurance and professional liability insurance at the time of determination of liability. The Client hereby releases Sterling Engineering Co., Inc. from any liability above such amount and such amount shall be the *sole and exclusive remedy* available to the Client. The Client agrees to indemnify and hold harmless Sterling Engineering Co., Inc. from any and all consequential or indirect damages arising out of or in any way related to the project or this contract. Appropriate insurance certificates will be furnished upon request.

INDEMNIFICATION — Sterling Engineering Co., Inc. shall, subject to the limitation of liability contained in "Liability" above, indemnify and hold harmless the Client for claims, demands, judgments, damages, losses, costs and expenses, whatsoever, including reasonable attorney's fees, caused by Sterling Engineering Co., Inc.'s negligent acts, errors or omissions in rendering the services under this Contract or any related agreement to the extent and in proportion to Sterling Engineering Co., Inc.'s comparative degree of fault. The Client shall indemnify and hold harmless Sterling Engineering Co., Inc. for any and all claims, demands, judgments, damages, losses, costs and expenses, whatsoever, including reasonable attorney's fees, caused by the Client's professional negligence to the extent and in proportion to the Client's comparative degree of fault.

HAZARDS — The Client agrees that Sterling Engineering Co., Inc. and their consultants have no responsibility for the discovery, presence, handling, removal, disposal, or treatment of, or exposure of persons to, hazardous or toxic substances related to the project or at the project site. Client agrees that Sterling Engineering Co., Inc. and their subconsultants have no responsibility for discovery or remediation of, or exposure of persons to, hazardous or dangerous circumstances. The Client agrees to indemnify, defend and hold harmless Sterling Engineering Co., Inc. from all liability, claims, demands, judgments, damages, losses, costs and expenses, whatsoever, including reasonable attorney's fees, arising out of or resulting from such hazardous or toxic conditions.

FORCE MAJEURE — The Client agrees that Sterling Engineering Co., Inc. may not be held responsible for delay or failure of performance of any commitment or agreement beyond our control including, without limiting the generality thereof, act of god, governmental regulations, priorities, embargoes, blockade, sabotage, fire, strike, lockouts and other industrial disturbances, explosions, hurricanes, windstorm, flood, accident, epidemic, interruption of transportation facilities, appropriation of plant or produce by any government or public authority, inability to obtain necessary materials, supplies, or permits due to existing or future rules, regulations, orders, laws or proclamations of governmental authorities either civil or military, and any other cause whether of the kind herein enumerated or otherwise, that are not reasonably within our control. Any Force Majeure shall be remedied with all reasonable dispatch.

PAYMENT TERMS — The Client agrees to pay Sterling Engineering Co., Inc. within thirty days from the date of the invoice. An interest charge of 1-1/2% per month of the invoice will be added for late payments. All payments received shall be applied to the oldest invoices first. The Client agrees to reimburse Sterling Engineering Co., Inc. for all attorney's fees and collection costs related to collection of late payments. When the fee is based on a percentage of construction cost and any portion of the project is abandoned, not constructed, or constructed for less than current market rates, services performed by Sterling Engineering Co., Inc. shall be compensated based on the Contractor bid price, if prepared, otherwise on the latest cost estimate by Sterling Engineering Co., Inc.

PROPRIETARY DATA — The technical and pricing information contained in the accompanying proposal or related agreement is to be considered confidential and proprietary and is not to be disclosed or otherwise made available to third parties without the express written consent of Sterling Engineering Co., Inc.

SUCCESSORS AND ASSIGNMENTS — Sterling Engineering Co., Inc. and the Client, and each of their respective partners, successors, executors, administrators, and legal representatives, are hereby bound to the other party to this Contract and any related agreement and to the partners, successors, executors, administrators, and legal representatives (and said assigns) of such other party with respect to all covenants, agreements and obligations of this Contract or any related agreement. Neither Sterling Engineering Co., Inc. nor the Client shall assign, sublet or transfer any rights under or interest in this Contract or any related agreement (including but without limitation, moneys that may become due or moneys that are due) without the express written consent of the other, except to the extent that any assignment, subletting or transfer is mandated by law. Unless specifically stated to the contrary in any written consent to an assignment, no assignment will release or discharge the assignor from any duty or responsibility under this Contract or any related agreement. Nothing contained in this paragraph shall prevent Sterling Engineering Co., Inc. from employing such independent associates and subconsultants as Sterling Engineering Co., Inc. may deem appropriate to assist in the rendering of services hereunder.

PRECEDENCE — These General Terms and Conditions shall take precedence over any inconsistency or contradictory provisions contained in any proposal, contract, purchase order, requisition, notice to proceed, or any other document related to this Contract, excepting direct amendments to these provisions that are stated as such in writing. It is understood and agreed that the services performed under the accompanying proposal or any related agreement are not subject to any provision of the Uniform Commercial Code. Any terms and conditions set forth in the Client's purchase order, requisition, or other notice or authorization to proceed are inapplicable to the services under the proposal or any related agreement, except when specifically provided for in full on the face of such purchase order, requisition, or notice or authorization, and specifically accepted in writing by Sterling Engineering Co., Inc. Sterling Engineering Co., Inc.'s acknowledgement of receipt of any purchase order, requisition, notice or authorization, or Sterling Engineering Co., Inc.'s rendering of services subsequent to receipt thereof, does not constitute acceptance of any terms or conditions other than those set forth herein.

GOVERNING LAW — The validity and interpretation of this Contract and any related agreement shall be governed by the laws of the Commonwealth of Massachusetts.

AIA® Document A111™ – 1997

Standard Form of Agreement Between Owner and Contractor
where the basis for payment is the COST OF THE WORK PLUS A FEE with a negotiated Guaranteed Maximum Price

This document has important legal consequences. Consultation with an attorney is encouraged with respect to its completion or modification.

This document is not intended for use in competitive bidding.

AIA Document A201-1997, General Conditions of the Contract for Construction, is adopted in this document by reference. Do not use with other general conditions unless this document is modified.

This document has been approved and endorsed by the Associated General Contractors of America.

AGREEMENT made as of the 22nd day of January in the year Two Thousand and Seven

(In words, indicate day, month and year)

BETWEEN the Owner*:

(Name, address and other information)

Targacept, Inc.
200 East First Street, Suite 300
Winston-Salem, NC 27101-4165

* Targacept, Inc. leases the property which is the subject of this Agreement.

and the Contractor:

(Name, address and other information)

Shelco, Inc.
1381 Old Mill Circle, Suite 300
Winston-Salem, NC 27103
Telephone: 336-760-5005
Fax: 336-760-5001

The Project is:

(Name and location)

Fit-Up of First Floor
200 East First Street
Winston-Salem, NC 27101-4165

Project Description: Targacept Animal Care Facility (+/- 5,400 GSF) (ACF), Associated Office Space (+/- 4,700 GSF) and Chemical Storage Room (+/- 360 GSF)

The Architect is:

(Name, address and other information)

O'Brien Atkins Associates, PA
P.O. Box 12037
Research Triangle Park, NC 27709
Telephone: 919-941-9000
Fax: 919-941-9006

The Owner and Contractor agree as follows.

ARTICLE 1 THE CONTRACT DOCUMENTS

The Contract Documents consist of this Agreement, Conditions of the Contract (General, Supplementary and other Conditions), Drawings, Specifications, Addenda issued prior to execution of this Agreement, other documents listed in this Agreement and Modifications issued after execution of this Agreement; these form the Contract, and are as fully a part of the Contract as if attached to this Agreement or repeated herein. The Contract represents the entire and integrated agreement between the parties hereto and supersedes prior negotiations, representations or agreements, either written or oral. An enumeration of the Contract Documents, other than Modifications, appears in Article 15. If anything in the other Contract Documents is inconsistent with this Agreement, this Agreement shall govern. All references herein to AIA Document A201-1997 shall mean that document as modified by the Owner.

ARTICLE 2 THE WORK OF THIS CONTRACT

The Contractor shall fully execute the Work described in the Contract Documents, except to the extent specifically indicated in the Contract Documents to be the responsibility of others.

ARTICLE 3 RELATIONSHIP OF THE PARTIES

The Contractor accepts the relationship of trust and confidence established by this Agreement and covenants with the Owner to cooperate with the Architect and exercise the Contractor's skill and judgment in furthering the interests of the Owner; to furnish efficient business administration and supervision; to furnish at all times an adequate supply of workers and materials; and to perform the Work in an expeditious and economical manner consistent with the Owner's interests. The Owner agrees to furnish and approve, in a timely manner, information required by the Contractor and to make payments to the Contractor in accordance with the requirements of the Contract Documents.

ARTICLE A PRE-CONSTRUCTION SERVICES

A.1 PRELIMINARY EVALUATION

The Contractor shall provide a preliminary evaluation of the Owner's program and Project budget requirements, each in terms of the other.

A.2 CONSULTATION

The Contractor with the Architect shall jointly schedule and attend regular meetings with the Owner and Architect. The Contractor shall consult with the Owner and Architect regarding site use and improvements, and the selection of materials, building systems and equipment. The Contractor shall provide recommendations on construction feasibility; actions designed to minimize adverse effects of labor or material shortages; time requirements for procurement, installation and construction completion; and factors related to construction cost including estimates of alternative designs or materials, preliminary budgets and possible economies.

A.3 PRELIMINARY CONSTRUCTION SCHEDULE

When Project requirements have been sufficiently identified, the Contractor shall prepare, and periodically update, a preliminary Construction schedule for the Architect's review and the Owner's approval. The Contractor shall obtain the Architect's approval of the portion of the preliminary Project Schedule relating to the performance of the Architect's services. The Contractor shall coordinate and integrate the preliminary Project schedule with the services and activities of the Owner, Architect and Contractor. As design proceeds, the preliminary Project schedule shall be updated to indicate proposed activity sequences and durations, milestone dates for: receipt and approval of pertinent information, submittal of a Guaranteed Maximum Price proposal, preparation and processing of shop drawings and samples, delivery of materials or equipment requiring long-lead time procurement, Owner's occupancy requirements showing portions of the Project having occupancy priority, and proposed date of Substantial Completion. If preliminary Project schedule updates indicate that previously approved schedules may not be met, the Contractor shall make appropriate recommendations to the Owner and Architect.

A.4 PHASED CONSTRUCTION

The Contractor shall make recommendations to the Owner and Architect regarding the phased issuance of Drawings and Specifications to facilitate phased construction of the Work, if such phased construction is appropriate for the Project, taking into consideration such factors as economies, time of performance, availability of labor and materials, and provisions for temporary facilities.

A.5 PRELIMINARY COST ESTIMATES

A.5.1 When the Owner has sufficiently identified the Project requirements and the Architect has prepared other basic design criteria, the Contractor shall prepare, for the review of the Architect and approval of the Owner, a preliminary cost estimate utilizing area, volume or similar conceptual estimating techniques.

A.5.2 When Schematic Design Documents have been prepared by the Architect and approved by the Owner, the Contractor shall prepare for the review of the Architect and approval of the Owner, a more detailed estimate with supporting data. During the preparation of the Design Development Documents, the Contractor shall update and refine this estimate at appropriate intervals agreed to by the Owner, Architect and Contractor.

A.5.3 When Design Development Documents have been prepared by the Architect and approved by the Owner, the Contractor shall prepare a detailed estimate with supporting data for review by the Architect and approval by the Owner. During the preparation of the Construction Documents, the Contractor shall update and refine this estimate at appropriate intervals agreed to by the Owner, Architect and Contractor.

A.5.4 If any estimate submitted to the Owner exceeds previously approved estimates or the Owner's budget for the same scope of work as previously estimated, the Contractor shall make appropriate recommendations to the Owner and Architect.

A.6 SUBCONTRACTORS AND SUPPLIERS

The Contractor shall seek to develop subcontractor interest in the Project and shall furnish to the Owner and Architect for their information a list of possible subcontractors, including suppliers who are to furnish materials or equipment fabricated to a special design, from whom proposals will be requested for each principal portion of the Work. The Architect will promptly reply in writing to the Contractor if the Architect or Owner knows of any objection to such subcontractor or supplier. The receipt of such list shall not require the Owner or Architect to investigate the qualifications of proposed subcontractors or suppliers, nor shall it waive the right of the Owner or Architect later to object to or reject any proposed subcontractor or supplier.

A.7 LONG-LEAD TIME ITEMS

The Contractor shall recommend to the Owner and Architect a schedule for procurement of long-lead time items which will constitute part of the Work as required to meet the Project schedule. If such long-lead time items are procured by the Owner, they shall be procured on terms and conditions acceptable to the Owner and the Contractor, and in accordance with subparagraph 6.1.5 of AIA A201, 1997 edition. Upon the Owner's acceptance of the Contractor's Guaranteed Maximum Price proposal, all contracts for such items shall be assigned by the Owner to the Contractor, who shall accept responsibility for such items as if procured by the Contractor. The Contractor shall expedite the delivery of long-lead time items.

A.8 COMPENSATION FOR PRECONSTRUCTION SERVICES

Preconstruction Services are included in the Contractor's Fee.

ARTICLEB GUARANTEED MAXIMUM PRICE PROPOSAL

B.1 When the Drawings and Specifications are sufficiently complete, the Contractor shall propose a Guaranteed Maximum Price, which shall be the sum of the estimated Cost of the Work and the Contractor's Fee. The proposed Guaranteed Maximum Price shall be based on the Project Cost Elements as described in **Exhibit B**, attached and incorporated herein. At the Owner's discretion, a Guaranteed Maximum Price proposal may be requested of and shall be provided by the Contractor for a portion or portions of the Project for which Drawings and Specifications are sufficiently complete.

B.2 The Contractor shall include with the Guaranteed Maximum Price proposal a written statement of its basis, which shall include:

.1 A list of the Drawings and Specifications, including all addenda thereto and the Conditions of the Contract, which were used in preparation of the Guaranteed Maximum Price proposal.

.2 A list of allowances and a statement of their basis.

.3 A list of the clarifications and assumptions made by the Contractor in the preparation of the Guaranteed Maximum Price proposal to supplement the information contained in the Drawings and Specifications.

.4 The proposed Guaranteed Maximum Price, including a statement of the estimated cost organized by trade categories, allowances, contingency, and other items and the fee that comprise the Guaranteed Maximum Price.

.5 The date of Substantial Completion upon which the proposed Guaranteed Maximum Price is based, and a schedule of the Construction Documents issuance dates upon which the date of Substantial Completion is based.

B.3 The Contractor shall meet with the Owner and Architect to review the Guaranteed Maximum Price proposal and the written statement of its basis. In the event that the Owner or Architect discovers any inconsistencies or inaccuracies in the information presented, they shall promptly notify the Contractor, who shall make appropriate adjustments to the Guaranteed Maximum Price proposal, its basis or both.

B.4 The Owner shall authorize and cause the Architect to revise the Drawings and Specifications to the extent necessary to reflect the agreed-upon assumptions and clarifications upon which the Guaranteed Maximum Price is based. Such revised Drawings and Specifications shall be furnished to the Contractor in accordance with schedules agreed to by the Owner, Architect and Contractor. The Contractor shall promptly notify the Architect and Owner if such revised Drawings and Specifications are inconsistent with the agreed-upon assumptions and clarifications.

B.5 The Guaranteed Maximum Price proposal will become effective upon written acceptance by the Owner and the Contractor.

B.6 Upon acceptance by the Owner of the Guaranteed Maximum Price proposal, the Guaranteed Maximum Price and its basis shall be established by Change Order as set forth in paragraph 5.2 of this Agreement.

B.7 The Guaranteed Maximum Price shall include taxes in the Cost of the Work.

B.8 Prior to the Owner’s acceptance of the Contractor’s Guaranteed Maximum Price proposal and issuance of a Notice to Proceed, the Contractor shall not incur any cost to be reimbursed as part of the Cost of the Work, except as the Owner specifically authorizes in writing.

ARTICLE 4 DATE OF COMMENCEMENT AND SUBSTANTIAL COMPLETION

§ 4.1 The date of commencement of the Work shall be the date of this Agreement unless a different date is stated below or provision is made for the date to be fixed in a notice to proceed issued by the Owner.

(Insert the date of commencement, if it differs from the date of this Agreement or, if applicable, state that the date will be fixed in a notice to proceed.)

The date of commencement shall be November 15, 2006 (Demo); December 12, 2006 (New Construction). See paragraph 4.2 below.

If, prior to commencement of the Work, the Owner requires time to file mortgages, mechanic’s liens and other security interests, the Owner’s time requirement shall be as follows:

§ 4.2 The Contract Time shall be measured from the date of commencement of the Construction Phase.

§ 4.2.1 The Construction Phase shall commence on the earlier of:

(1) the Owner's acceptance of the Contractor's Guaranteed Maximum Price proposal and issuance of a Notice to Proceed, or

(2) the Owner's first authorization to the Contractor to:

(a) award a subcontract, or

(b) undertake construction Work with the Contractor's own forces, or

(c) issue a purchase order for materials or equipment required for the Work.

§ 4.3 Assuming permits are obtained by January 16, 2007, the Contractor shall achieve Substantial Completion of the entire Work not later than June 1, 2007 :

(Insert number of calendar days. Alternatively, a calendar date may be used when coordinated with the date of commencement. Unless stated elsewhere in the Contract Documents, insert any requirements for earlier Substantial Completion of certain portions of the Work.)

* The Contract Time will be included in the Change Order(s) referenced in subparagraph 5.2.1.

Portion of Work	**Substantial Completion date**

, subject to adjustments of this Contract Time as provided in the Contract Documents.

(Insert provisions, if any, for liquidated damages relating to failure to complete on time, or for bonus payments for early completion of the Work.)

ARTICLE 5 BASIS FOR PAYMENT

§ 5.1 CONTRACT SUM

§ 5.1.1 The Owner shall pay the Contractor the Contract Sum in current funds for the Contractor's performance of the Contract. The Contract Sum is the Cost of the Work as defined in Article 7 plus the Contractor's Fee.

§ 5.1.2 The Contractor's Fee is:

(State a lump sum, percentage of Cost of the Work or other provision for determining the Contractor's Fee, and describe the method of adjustment of the Contractor's Fee for changes in the Work.)

Four and one-half percent (4.5%) of the Cost of the Work. The Contractor's Fee for Changes in the Work shall be Five percent (5%).

§ 5.2 GUARANTEED MAXIMUM PRICE

§ 5.2.1 The sum of the Cost of the Work and the Contractor's Fee is guaranteed by the Contractor not to exceed ($ *), subject to additions and deductions by Change Order as provided in the Contract Documents. Such maximum sum is referred to in the Contract Documents as the Guaranteed Maximum Price. Costs which would cause the Guaranteed Maximum Price to be exceeded shall be paid by the Contractor without reimbursement by the Owner.

(Insert specific provisions if the Contractor is to participate in any savings.)

* The Guaranteed Maximum Price will be established by Change Order in accordance with ARTICLE B above. If a Guaranteed Maximum Price has been proposed and accepted for a portion of the Project only, then at the Owner's discretion, subsequent Guaranteed Maximum Price proposals may be requested of and shall be provided by the Contractor in accordance with ARTICLE B. If the Owner accepts such subsequent proposals, the Guaranteed Maximum Price shall be increased by subsequent Change Orders in accordance with ARTICLE B above and this subparagraph 5.2.1.

In the event that the actual Cost of the Work plus the Contractor's fees is less than the Guaranteed Maximum Price, the savings shall be split 70% Owner and 30% General Contractor. (GMP amount will be authorized via a Change Order to this contract.)

§ 5.2.2 The Guaranteed Maximum Price is based on the following alternates, if any, which are described in the Contract Documents and are hereby accepted by the Owner:

(State the numbers or other identification of accepted alternates. If decisions on other alternates are to be made by the Owner subsequent to the execution of this Agreement, attach a schedule of such other alternates showing the amount for each and the date when the amount expires.)

§ 5.2.3 Unit prices, if any, are as follows:

Description	Units	Price ($ 0.00)
Project Executive		$82.66/HR
Project Manager		$67.07/HR
Estimator		$67.07/HR
Safety Officer & Field Officer		$58.87/HR
Project Superintendent		$58.87/HR
Project Engineer		$42.27/HR
Clerk (on site)		$17.68/HR
Carpenter*		$22.96/HR
Laborer*		$12.87/HR
Labor Burden		39.5%
Superintendent Truck		$325/WK
Copy Machine (on site)		$150/MO**
Computer (on site)		$250/MO**
Office Trailer		$300/MO**
General Liability Insurance		.00133 of Subcontract Amount

* Overtime rate of 1.5 for over 40 hours per week.

** Pursuant to Subparagraph 7.5.2.

§ 5.2.4 Allowances, if any, are as follows

(Identify and state the amounts of any allowances, and state whether they include labor, materials, or both.)

Allowance	Amount ($ 0.00)	Included items
TBD		

§ 5.2.5 Assumptions, if any, on which the Guaranteed Maximum Price is based are as follows:

§ 5.2.6 To the extent that the Drawings and Specifications are anticipated to require further development by the Architect, the Contractor has provided in the Guaranteed Maximum Price for such further development consistent with the Contract Documents and reasonably inferable therefrom. Such further development does not include such things as changes in scope, systems, kinds and quality of materials, finishes or equipment, all of which, if required, shall be incorporated by Change Order.

ARTICLE 6 CHANGES IN THE WORK

§ 6.1 Adjustments to the Guaranteed Maximum Price on account of changes in the Work may be determined by any of the methods listed in Section 7.3.3 of AIA Document A201-1997.

§ 6.2 In calculating adjustments to subcontracts (except those awarded with the Owner's prior consent on the basis of cost plus a fee), the terms "cost" and "fee" as used in Section 7.3.3.3 of AIA Document A201-1997 and the terms "costs" and "a reasonable allowance for overhead and profit" as used in Section 7.3.6 of AIA Document A201-1997 shall have the meanings assigned to them in AIA Document A201-1997 and shall not be modified by Articles 5, 7 and 8 of this Agreement. Adjustments to subcontracts awarded with the Owner's prior consent on the basis of cost plus a fee shall be calculated in accordance with the terms of those subcontracts.

§ 6.3 In calculating adjustments to the Guaranteed Maximum Price, the terms "cost" and "costs" as used in the above-referenced provisions of AIA Document A201-1997 shall mean the Cost of the Work as defined in Article 7 of this Agreement and the terms "fee" and "a reasonable allowance for overhead and profit" shall mean the Contractor's Fee as defined in Section 5.1.2 of this Agreement.

§ 6.4 If no specific provision is made in Section 5.1 for adjustment of the Contractor's Fee in the case of changes in the Work, or if the extent of such changes is such, in the aggregate, that application of the adjustment provisions of Section 5.1 will cause substantial inequity to the Owner or Contractor, the Contractor's Fee shall be equitably adjusted on the basis of the Fee established for the original Work, and the Guaranteed Maximum Price shall be adjusted accordingly.

ARTICLE 7 COSTS TO BE REIMBURSED

§ 7.1 COST OF THE WORK

The term Cost of the Work shall mean costs necessarily incurred by the Contractor in the proper performance of the Work. Such costs shall be at rates not higher than the standard paid at the place of the Project except with prior consent of the Owner. The Cost of the Work shall include only the items set forth in this Article 7.

§ 7.2 LABOR COSTS

§ 7.2.1 Wages of construction workers directly employed by the Contractor to perform the construction of the Work at the site or, with the Owner's approval, at off-site workshops.

§ 7.2.2 Wages or salaries approved in advance by the Owner in writing of the Contractor's supervisory and administrative personnel when stationed at the site with the Owner's approval.

(If it is intended that the wages or salaries of certain personnel stationed at the Contractor's principal or other offices shall be included in the Cost of the Work, identify in Article 14 the personnel to be included and whether for all or only part of their time, and the rates at which their time will be charged to the Work.)

See subparagraph 5.2.3.

§ 7.2.3 Wages and salaries of the Contractor's supervisory or administrative personnel engaged, at factories, workshops or on the road, in expediting the production or transportation of materials or equipment required for the Work, but only for that portion of their time required for the Work.

§ 7.2.4 Costs paid or incurred by the Contractor for taxes, insurance, contributions, assessments and benefits required by law or collective bargaining agreements and, for personnel not covered by such agreements, customary benefits such as sick leave, medical and health benefits, holidays, vacations and pensions, but not bonuses, provided such costs are based on wages and salaries included in the Cost of the Work under Sections 7.2.1 through 7.2.3.

§ 7.3 SUBCONTRACT COSTS

§ 7.3.1 Payments made by the Contractor to Subcontractors in accordance with the requirements of the subcontracts.

§ 7.4 COSTS OF MATERIALS AND EQUIPMENT INCORPORATED IN THE COMPLETED CONSTRUCTION

§ 7.4.1 Costs, including transportation and storage, of materials and equipment incorporated or to be incorporated in the completed construction.

§ 7.4.2 Costs of materials described in the preceding Section 7.4.1 in excess of those actually installed to allow for reasonable waste and spoilage. Unused excess materials, if any, shall become the Owner's property at the completion of the Work or, at the Owner's option, shall be sold by the Contractor. Any amounts realized from such sales shall be credited to the Owner as a deduction from the Cost of the Work.

§ 7.5 COSTS OF OTHER MATERIALS AND EQUIPMENT, TEMPORARY FACILITIES AND RELATED ITEMS

§ 7.5.1 Costs, including transportation and storage, installation, maintenance, dismantling and removal of materials, supplies, temporary facilities, machinery, equipment, and hand tools not customarily owned by construction workers, that are provided by the Contractor at the site and fully consumed in the performance of the Work; and cost (less salvage value) of such items if not fully consumed, whether sold to others or retained by the Contractor. Cost for items previously used by the Contractor shall mean fair market value.

§ 7.5.2 Rental charges for temporary facilities, machinery, equipment, and hand tools not customarily owned by construction workers that are provided by the Contractor at the site, whether rented from the Contractor or others, and costs of transportation, installation, minor repairs and replacements, dismantling and removal thereof. Rates and quantities of equipment rented shall be subject to the Owner's prior written approval.

§ 7.5.3 Costs of removal of debris from the site.

§ 7.5.4 Costs of document reproductions, facsimile transmissions and long-distance telephone calls, postage and parcel delivery charges, telephone service at the site and reasonable petty cash expenses of the site office.

§ 7.5.5 That portion of the reasonable expenses of the Contractor's personnel incurred while traveling in discharge of duties connected with the Work.

§ 7.5.6 Costs of materials and equipment suitably stored off the site at a mutually acceptable location, if approved in advance by the Owner.

§ 7.6 MISCELLANEOUS COSTS

§ 7.6.1 That portion of insurance and bond premiums that can be directly attributed to this Contract:

§ 7.6.2 Sales, use or similar taxes imposed by a governmental authority that are related to the Work.

§ 7.6.3 Fees and assessments for the building permit and for other permits, licenses and inspections for which the Contractor is required by the Contract Documents to pay.

§ 7.6.4 Fees of laboratories for tests required by the Contract Documents, except those related to defective or nonconforming Work for which reimbursement is excluded by Section 13.5.3 of AIA Document A201-1997 or other provisions of the Contract Documents, and which do not fall within the scope of Section 7.7.3.

§ 7.6.5 Royalties and license fees paid for the use of a particular design, process or product required by the Contract Documents; the cost of defending suits or claims for infringement of patent rights arising from such requirement of the Contract Documents; and payments made in accordance with legal judgments against the Contractor resulting from such suits or claims and payments of settlements made with the Owner's consent. However, such costs of legal defenses, judgments and settlements shall not be included in the calculation of the Contractor's Fee or subject to the Guaranteed Maximum Price. If such royalties, fees and costs are excluded by the last sentence of Section 3.17.1 of AIA Document A201-1997 or other provisions of the Contract Documents, then they shall not be included in the Cost of the Work.

§ 7.6.6 Data processing costs related to the Work.

§ 7.6.7 Deposits lost for causes other than the Contractor's negligence or failure to fulfill a specific responsibility to the Owner as set forth in the Contract Documents.

§ 7.6.8 Legal, mediation and arbitration costs, including attorneys' fees, other than those arising from disputes between the Owner and Contractor, reasonably incurred by the Contractor in the performance of the Work and with the Owner's prior written approval; which approval shall not be unreasonably withheld.

§ 7.6.9 Expenses incurred in accordance with the Contractor's standard personnel policy for relocation and temporary living allowances of personnel required for the Work, if approved by the Owner.

§ 7.7 OTHER COSTS AND EMERGENCIES

§ 7.7.1 Other costs incurred in the performance of the Work if and to the extent approved in advance in writing by the Owner.

§ 7.7.2 Costs due to emergencies incurred in taking action to prevent threatened damage, injury or loss in case of an emergency affecting the safety of persons and property, as provided in Section 10.6 of AIA Document A201-1997.

§ 7.7.3 Costs of repairing or correcting damaged or nonconforming Work executed by the Contractor, Subcontractors or suppliers, provided that such damaged or nonconforming Work was not caused by negligence or failure to fulfill a specific responsibility of the Contractor and only to the extent that the cost of repair or correction is not recoverable by the Contractor from insurance, sureties, Subcontractors or suppliers.

ARTICLE 8 COSTS NOT TO BE REIMBURSED

§ 8.1 The Cost of the Work shall not include:

§ 8.1.1 Salaries and other compensation of the Contractor's personnel stationed at the Contractor's principal office or offices other than the site office, except as specifically provided in Sections 7.2.2 and 7.2.3 or as may be provided in Article 14.

§ 8.1.2 Expenses of the Contractor's principal office and offices other than the site office.

§ 8.1.3 Overhead and general expenses, except as may be expressly included in Article 7.

§ 8.1.4 The Contractor's capital expenses, including interest on the Contractor's capital employed for the Work.

§ 8.1.5 Rental costs of machinery and equipment, except as specifically provided in Section 7.5.2.

§ 8.1.6 Except as provided in Section 7.7.3 of this Agreement, costs due to the negligence or failure to fulfill a specific responsibility of the Contractor, Subcontractors and suppliers or anyone directly or indirectly employed by any of them or for whose acts any of them may be liable.

§ 8.1.7 Any cost not specifically and expressly described in Article 7.

§ 8.1.8 Costs, other than costs included in Change Orders approved by the Owner, that would cause the Guaranteed Maximum Price to be exceeded.

§ 8.1.9 Bonuses, incentives compensation, contributions, gratuities and entertainment expense. No secretarial or administrative costs or salaries shall be reimbursed except as provided in Paragraph 7.2.2.

§ 8.1.10 Costs for transportation and subsistence incurred by the Contractor's employees stationed at the home office, except those employees involved in the direct execution of the Work.

§ 8.1.11 Expenses for travel, including Contractor-supplied vehicles used for personal use, incurred by the Contractor's employees while traveling for purposes other than the direct execution of the Work.

§ 8.1.12 Fines other than those due to the acts or omissions of the Owner.

§ 8.1.13 Costs incurred due to labor disharmony, unrest, or strikes, including, but not limited to, delays, security, legal expenses, fines and work stoppages or slowdowns, except where such costs are due to circumstances wholly beyond the control of the Contractor.

§ 8.1.14 Corporate accounting, check and accounting processing costs.

§ 8.1.15 Other costs, damages, or expenses specifically excluded elsewhere in the Contract Documents.

ARTICLE 9 DISCOUNTS, REBATES AND REFUNDS

§ 9.1 Cash discounts obtained on payments made by the Contractor shall accrue to the Owner if (1) before making the payment, the Contractor included them in an Application for Payment and received payment therefor from the Owner, or (2) the Owner has deposited funds with the Contractor with which to make payments; otherwise, cash discounts shall accrue to the Contractor. Trade discounts, rebates, refunds and amounts received from sales of surplus materials and equipment shall accrue to the Owner, and the Contractor shall make provisions so that they can be secured.

§ 9.2 Amounts that accrue to the Owner in accordance with the provisions of Section 9.1 shall be credited to the Owner as a deduction from the Cost of the Work.

ARTICLE 10 SUBCONTRACTS AND OTHER AGREEMENTS

§ 10.1 Those portions of the Work that the Contractor does not customarily perform with the Contractor's own personnel shall be performed under subcontracts or by other appropriate agreements with the Contractor. The Owner may designate specific persons or entities from whom the Contractor shall obtain bids. The Contractor shall obtain bids from Subcontractors and from suppliers of materials or equipment fabricated especially for the Work and shall deliver such bids to the Architect. The Owner shall then determine, with the advice of the Contractor and the Architect, which bids will be accepted. The Contractor shall not be required to contract with anyone to whom the Contractor has reasonable objection.

§ 10.2 If a specific bidder among those whose bids are delivered by the Contractor to the Architect (1) is recommended to the Owner by the Contractor; (2) is qualified to perform that portion of the Work; and (3) has submitted a bid that conforms to the requirements of the Contract Documents without reservations or exceptions, but the Owner requires that another bid be accepted, then the Contractor may require that a Change Order be issued to adjust the Guaranteed Maximum Price by the difference between the bid of the person or entity recommended to the Owner by the Contractor and the amount of the subcontract or other agreement actually signed with the person or entity designated by the Owner.

§ 10.3 Subcontracts or other agreements shall conform to the applicable payment provisions of this Agreement, and shall not be awarded on the basis of cost plus a fee without the prior consent of the Owner.

ARTICLE 11 ACCOUNTING RECORDS

The Contractor shall keep full and detailed accounts and exercise such controls as may be necessary for proper financial management under this Contract, and the accounting and control systems shall be satisfactory to the Owner. The Owner and the Owner's accountants shall be afforded access to, and shall be permitted to audit and copy, the Contractor's records, books, correspondence, instructions, drawings, receipts, subcontracts, purchase orders, vouchers, memoranda and other data relating to this Contract, and the Contractor shall preserve these for a period of seven (7) years after final payment, or for such longer period as may be required by law.

ARTICLE 12 PAYMENTS

§ 12.1 PROGRESS PAYMENTS

§ 12.1.1 Based upon Applications for Payment submitted to the Architect by the Contractor and Certificates for Payment issued by the Architect, the Owner shall make progress payments on account of the Contract Sum to the Contractor as provided below and elsewhere in the Contract Documents.

§ 12.1.2 The period covered by each Application for Payment shall be one calendar month ending on the last day of the month, or as follows:

§ 12.1.3 The Contractor shall submit Applications for Payment to the Architect on the fifth (5th) day of each month. Within ten (10) business days after receiving an Application for Payment, supported as required by the Contract Documents, the Architect will deliver the Application to the Owner with a Certificate for Payment in the amount due the Contractor based on the Architect's observations, inspections and evaluations of the Work represented by the Contractor's Application. The Owner shall pay the Contractor the amount certified by the Architect within thirty (30) calendar days after receiving an Application and Certificate for Payment from the Architect, provided that the cost data supplied by the Contractor with the Application pursuant to subparagraph 12.1.4 supports the amount certified. In the event the Owner determines that the cost data supplied by the Contractor does not support the amount certified, or if the Owner determines to withhold any part of the Contractor's payment pursuant to subparagraph 9.4.3 of AIA A201, the Owner shall pay the Contractor the portion of the amount certified that the Owner determines is properly due the Contractor, and along with the payment shall provide the Contractor with a detailed explanation for any reductions or amounts withheld and the actions required of the Contractor to entitle the Contractor to payment of the full amount certified by the Architect.

§ 12.1.4 With each Application for Payment, the Contractor shall submit payrolls, petty cash accounts, receipted invoices or invoices with check vouchers attached, and any other evidence required by the Owner or Architect to demonstrate that cash disbursements already made by the Contractor on account of the Cost of the Work equal or exceed (1) progress payments already received by the Contractor; less (2) that portion of those payments attributable to the Contractor's Fee; plus (3) payrolls for the period covered by the present Application for Payment.

§ 12.1.5 Each Application for Payment shall be based on the most recent schedule of values submitted by the Contractor in accordance with the Contract Documents. The schedule of values shall allocate the entire Guaranteed Maximum Price among the various portions of the Work, except that the Contractor's Fee shall be shown as a single separate item. The schedule of values shall be prepared in such form and supported by such data to substantiate its accuracy as the Architect may require. This schedule, unless objected to by the Architect, shall be used as a basis for reviewing the Contractor's Applications for Payment.

§ 12.1.6 Applications for Payment shall show the percentage of completion of each portion of the Work as of the end of the period covered by the Application for Payment. The percentage of completion shall be the lesser of (1) the percentage of that portion of the Work which has actually been completed; or (2) the percentage obtained by dividing (a) the expense that has actually been incurred by the Contractor on account of that portion of the Work for which the Contractor has made or intends to make actual payment prior to the next Application for Payment by (b) the share of the Guaranteed Maximum Price allocated to that portion of the Work in the schedule of values.

§ 12.1.7 Subject to other provisions of the Contract Documents, the amount of each progress payment shall be computed as follows:

.1 take that portion of the Guaranteed Maximum Price properly allocable to completed Work as determined by multiplying the percentage of completion of each portion of the Work by the share of the Guaranteed Maximum Price allocated to that portion of the Work in the schedule of values. Pending final determination of cost to the Owner of changes in the Work, amounts not in dispute shall be included as provided in Section 7.3.8 of AIA Document A201-1997;

.2 add that portion of the Guaranteed Maximum Price properly allocable to materials and equipment delivered and suitably stored at the site for subsequent incorporation in the Work, or if approved in advance by the Owner, suitably stored off the site at a location agreed upon in writing;

.3 add the Contractor's Fee, less retainage of ten percent (10%).The Contractor's Fee shall be computed upon the Cost of the Work described in the two preceding Clauses at the rate stated in Section 5.1.2 or, if the Contractor's Fee is stated as a fixed sum in that Subparagraph, shall be an amount that bears the same ratio to that fixed-sum fee as the Cost of the Work in the two preceding Clauses bears to a reasonable estimate of the probable Cost of the Work upon its completion;

.4 subtract the aggregate of previous payments made by the Owner;

.5 subtract the shortfall, if any, indicated by the Contractor in the documentation required by Section 12.1.4 to substantiate prior Applications for Payment, or resulting from errors subsequently discovered by the Owner's accountants in such documentation; and

.6 subtract amounts, if any, for which the Architect has withheld or nullified a Certificate for Payment as provided in Section 9.5 of AIA Document A201-1997.

§ 12.1.8 Except with the Owner's prior approval, payments to the Contractor for self-performed Work and to Subcontractors shall be subject to retainage of not less than ten percent (10%). The Owner and the Contractor shall agree upon a mutually acceptable procedure for review and approval of payments and retention for Subcontractors.

§ 12.1.9 In taking action on the Contractor's Applications for Payment, the Architect shall be entitled to rely on the accuracy and completeness of the information furnished by the Contractor and shall not be deemed to represent that the Architect has made a detailed examination, audit or arithmetic verification of the documentation submitted in accordance with Section 12.1.4 or other supporting data; that the Architect has made exhaustive or continuous on-site inspections or that the Architect has made examinations to ascertain how or for what purposes the Contractor has used amounts previously paid on account of the Contract. Such examinations, audits and verifications, if required by the Owner, will be performed by the Owner's accountants acting in the sole interest of the Owner.

§ 12.1.10 At the discretion of the Owner, and upon written approval of the Contractor's surety (if applicable), the retainage described in sub-subparagraph 12.1.7.3 above may be reduced to five percent (5%) when the Project is fifty percent (50%) complete.

§ 12.2 FINAL PAYMENT

§ 12.2.1 Final payment, constituting the entire unpaid balance of the Contract Sum, shall be made by the Owner to the Contractor when:

.1 the Contractor has fully performed the Contract except for the Contractor's responsibility to correct Work as provided in Section 12.2.2 of AIA Document A201-1997, and to satisfy other requirements, if any, which extend beyond final payment; and

.2 a final Certificate for Payment has been issued by the Architect.

§ 12.2.2 The Owner's final payment to the Contractor shall be made no later than 30 days after the issuance of the Architect's final Certificate for Payment, or as follows:

§ 12.2.3 The Owner's accountants will review and report in writing on the Contractor's final accounting within 30 days after delivery of the final accounting to the Architect by the Contractor. Based upon such Cost of the Work as the Owner's accountants report to be substantiated by the Contractor's final accounting, and provided the other conditions of Section 12.2.1 have been met, the Architect will, within seven days after receipt of the written report of the Owner's accountants, either issue to the Owner a final Certificate for Payment with a copy to the Contractor, or notify the Contractor and Owner in writing of the Architect's reasons for withholding a certificate as provided in Section 9.5.1 of the AIA Document A201-1997. The time periods stated in this Section 12.2.3 supersede those stated in Section 9.4.1 of the AIA Document A201-1997.

§ 12.2.4 If the Owner's accountants report the Cost of the Work as substantiated by the Contractor's final accounting to be less than claimed by the Contractor, the Contractor shall be entitled to demand resolution of the disputed amount under paragraphs 4.5 and 4.6 of AIA A201, without a further decision of the Architect. Such demand shall be made by the Contractor within 30 days after the Contractor's receipt of a copy of the Architect's final Certificate for Payment; failure to demand resolution within this 30-day period shall result in the substantiated amount reported by the Owner's accountants becoming binding on the Contractor. Pending a final resolution, the Owner shall pay the Contractor the amount certified in the Architect's final Certificate for Payment.

§ 12.2.5 If, subsequent to final payment and at the Owner's request, the Contractor incurs costs described in Article 7 and not excluded by Article 8 to correct defective or nonconforming Work, the Owner shall reimburse the Contractor such costs and the Contractor's Fee applicable thereto on the same basis as if such costs had been incurred prior to final payment, but not in excess of the Guaranteed Maximum Price. If the Contractor has participated in savings as provided in Section 5.2, the amount of such savings shall be recalculated and appropriate credit given to the Owner in determining the net amount to be paid by the Owner to the Contractor.

ARTICLE 13 TERMINATION OR SUSPENSION

§ 13.1 The Contract may be terminated by the Contractor, or by the Owner for convenience, as provided in Article 14 of AIA Document A201-1997. However, the amount to be paid to the Contractor under Section 14.1.3 of AIA Document A201-1997 shall not exceed the amount the Contractor would be entitled to receive under Section 13.2 below, except that the Contractor's Fee shall be calculated as if the Work had been fully completed by the Contractor, including a reasonable estimate of the Cost of the Work for Work not actually completed.

§ 13.2 The Contract may be terminated by the Owner for cause as provided in Article 14 of AIA Document A201-1997. The amount, if any, to be paid to the Contractor under Section 14.2.4 of AIA Document A201-1997 shall not cause the Guaranteed Maximum Price to be exceeded, nor shall it exceed an amount calculated as follows:

§ 13.2.1 Take the Cost of the Work incurred by the Contractor to the date of termination;

§ 13.2.2 Add the Contractor's Fee computed upon the Cost of the Work to the date of termination at the rate stated in Section 5.1.2 or, if the Contractor's Fee is stated as a fixed sum in that Section, an amount that bears the same ratio to that fixed-sum Fee as the Cost of the Work at the time of termination bears to a reasonable estimate of the probable Cost of the Work upon its completion; and

§ 13.2.3 Subtract the aggregate of previous payments made by the Owner.

§ 13.3 The Owner shall also pay the Contractor fair compensation, either by purchase or rental at the election of the Owner, for any equipment owned by the Contractor that the Owner elects to retain and that is not otherwise included in the Cost of the Work under Section 13.2.1. To the extent that the Owner elects to take legal assignment of subcontracts and purchase orders (including rental agreements), the Contractor shall, as a condition of receiving the payments referred to in this Article 13, execute and deliver all such papers and take all such steps, including the legal assignment of such subcontracts and other contractual rights of the Contractor, as the Owner may require for the purpose of fully vesting in the Owner the rights and benefits of the Contractor under such subcontracts or purchase orders.

§ 13.4 The Work may be suspended by the Owner as provided in Article 14 of AIA Document A201-1997; in such case, the Guaranteed Maximum Price and Contract Time shall be increased as provided in Section 14.3.2 of AIA Document A201-1997 except that the term "profit" shall be understood to mean the Contractor's Fee as described in Sections 5.1.2 and Section 6.4 of this Agreement.

ARTICLE 14 MISCELLANEOUS PROVISIONS

§ 14.1 Where reference is made in this Agreement to a provision of AIA Document A201-1997 or another Contract Document, the reference refers to that provision as amended or supplemented by other provisions of the Contract Documents.

§ 14.2 Payments due and unpaid under the Contract shall bear interest from the date payment is due at the rate stated below, or in the absence thereof, at the legal rate prevailing from time to time at the place where the Project is located.

(Insert rate of interest agreed upon, if any.)

2.00% per annum above prime rate (as established by Bank of America) on the date payment is due

(Usury laws and requirements under the Federal Truth in Lending Act, similar state and local consumer credit laws and other regulations at the Owner's and Contractor's principal places of business, the location of the Project and elsewhere may affect the validity of this provision. Legal advice should be obtained with respect to deletions or modifications, and also regarding requirements such as written disclosures or waivers.)

§ 14.3 The Owner's representative is:

(Name, address and other information.)

Ms. Mauri Hodges
Targacept, Inc.
200 East First Street, Suite 300
Winston-Salem, NC 27101-4165

§ 14.4 The Contractor's representative is:

(Name, address and other information.)

Mr. Richard D. Sanders
Shelco, Inc.
1381 Old Mill Circle, Suite 300
Winston-Salem, NC 27103
Telephone: 336-760-5017
Fax: 336-760-5001

§ 14.5 Neither the Owner's nor the Contractor's representative shall be changed without ten days' written notice to the other party.

§ 14.6 Other provisions:

§ 14.6.1 The Owner agrees to make payment to the Contractor's lock box at the following address:

By United States Mail: Shelco, Inc.
P.O. Box 890706
Charlotte, NC 28289-0706

§ 14.6.2 Order of Precedence of Contract Documents:

1. Agreement (this modified A111 Owner/Contractor Agreement)
2. Exhibits (as set out in paragraph 15.1.7 herein)
3. General Conditions (modified A201 General Conditions, **Exhibit A**)

§ 14.6.3 Contractor's personnel stationed at the Contractor's offices, working directly on this Project, shall be included in the cost of the Work at rates identified in Article 5.2.3.

ARTICLE 15 ENUMERATION OF CONTRACT DOCUMENTS

§ 15.1 The Contract Documents, except for Modifications issued after execution of this Agreement, are enumerated as follows:

§ 15.1.1 The Agreement is this executed 1997 edition of the Standard Form of Agreement Between Owner and Contractor, AIA Document A111-1997, as modified herein.

§ 15.1.2 The General Conditions are the 1997 edition of the General Conditions of the Contract for Construction, AIA Document A201-1997. The General Conditions are attached and incorporated herein as Exhibit A.

§ 15.1.3 The Supplementary and other Conditions of the Contract are those contained in the Project Manual dated * , and are as follows:

Document	Title	Pages

* To be incorporated by Change Order.

§ 15.1.4 The Specifications are those contained in the Project Manual dated as in Section 15.1.3, and are as follows:

(Either list the Specifications here or refer to an exhibit attached to this Agreement.)

To be incorporated by Change Order.

§ 15.1.5 The Drawings are as follows, and are dated * unless a different date is shown below:

(Either list the Drawings here or refer to an exhibit attached to this Agreement.)

* To be incorporated by Change Order.

§ 15.1.6 The Addenda, if any, are as follows:

Number	Date	Pages

Portions of Addenda relating to bidding requirements are not part of the Contract Documents unless the bidding requirements are also enumerated in this Article 15.

§ 15.1.7 Other Documents, if any, forming part of the Contract Documents are as follows:

(List here any additional documents, such as a list of alternates that are intended to form part of the Contract Documents. AIA Document A201-1997 provides that bidding requirements such as advertisement or invitation to bid, Instructions to Bidders, sample forms and the Contractor's bid are not part of the Contract Documents unless enumerated in this Agreement. They should be listed here only if intended to be part of the Contract Documents.)

Exhibit A	General Conditions of the Contract for Construction (AIA Document A201), as modified by the Owner, is attached and incorporated herein.
Exhibit B	Identification of Project Cost Elements approved by the Owner is attached and incorporated herein.
Exhibit C	Contractor's Form of Release and Waiver of Liens (on Partial Payment), as approved by the Owner, is attached and incorporated herein.
Exhibit D	Contractor's Form of Release and Waiver of Liens on Final Payment, as approved by the Owner, is attached and incorporated herein.
Exhibit E	Subcontractor's Form of Release and Waiver of Liens on Final Payment, as approved by the Owner, is attached and incorporated herein.

ARTICLE 16 INSURANCE AND BONDS

(List required limits of liability for insurance and bonds. AIA Document A201-1997 gives other specific requirements for insurance and bonds.)

Type of insurance	**Limit of liability ($ 0.00)**
See Subparagraph 11.1.4 of AIA A201.	

This Agreement is entered into as of the day and year first written above and is executed in at least three original copies, of which one is to be delivered to the Contractor, one to the Architect for use in the administration of the Contract, and the remainder to the Owner.

Targacept, Inc.	**Shelco, Inc.**
/s/ Alan A. Musso	/s/ Richard D. Sanders
OWNER *(Signature)*	**CONTRACTOR** *(Signature)*
Alan A. Musso, Vice President and CFO	Richard D. Sanders, Senior Vice President
(Printed name and title)	*(Printed name and title)*

List of Exhibits

Exhibit A	A201 General Conditions of the Contract for Construction (1997 edition) as modified by the Owner
Exhibit B	Project Cost Elements
Exhibit C	Contractor’s Release and Waiver of Liens (Partial)
Exhibit D	Contractor’s Release and Waiver of Liens on Final Payment
Exhibit E	Subcontractor’s Release and Waiver of Liens on Final Payment

EXHIBIT A

AIA A201 GENERAL CONDITIONS OF THE CONTRACT FOR CONSTRUCTION (1997 EDITION) as modified by the Owner

[Attached Pages]

AIA® Document A201™ – 1997

General Conditions of the Contract for Construction

This document has important legal consequences. Consultation with an attorney is encouraged with respect to its completion or modification.

This document has been approved and endorsed by The Associated General Contractors of America

for the following PROJECT:

(Name and location or address):
Fit-Up of First Floor
200 East First Street
Winston-Salem, NC 27101-4165

Project Description: Targacept Animal Care Facility (+/- 5,400 GSF) (ACF), Associated Office Space (+/- 4,700 GSF) and Chemical Storage Room (+/- 360 GSF)

THE OWNER*:

(Name and address):

Targacept, Inc.
200 East First Street, Suite 300
Winston-Salem, NC 27101-4165

* Targacept, Inc. leases the property which is the subject of this Agreement.

THE ARCHITECT:

(Name and address):

O'Brien Atkins Associates, PA
P.O. Box 12037
Research Triangle Park, NC 27709
Telephone: 919-941-9000
Fax: 919-941-9006

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ARTICLE 1 GENERAL PROVISIONS

§ 1.1 BASIC DEFINITIONS

§ 1.1.1 THE CONTRACT DOCUMENTS

The Contract Documents consist of the Agreement between Owner and Contractor (hereinafter the Agreement), Conditions of the Contract (General, Supplementary and other Conditions), Drawings, Schedules, Specifications, Addenda issued prior to execution of the Contract, other documents listed in the Agreement and Modifications issued after execution of the Contract. A Modification is (1) a written amendment to the Contract signed by both parties, (2) a Change Order, (3) a Construction Change Directive or (4) a written order for a minor change in the Work issued by the Architect. Unless specifically enumerated in the Agreement, the Contract Documents do not include other documents such as bidding requirements (advertisement or invitation to bid, Instructions to Bidders, sample forms, the Contractor's bid or portions of Addenda relating to bidding requirements).

§ 1.1.2 THE CONTRACT

The Contract Documents form the Contract for Construction. The Contract represents the entire and integrated agreement between the parties hereto and supersedes prior negotiations, representations or agreements, either written or oral. The Contract may be amended or modified only by a Modification. The Contract Documents shall not be construed to create a contractual relationship of any kind (1) between the Architect and Contractor, (2) between the Owner and a Subcontractor or Sub-subcontractor, (3) between the Owner and Architect or (4) between any persons or entities other than the Owner and Contractor. The Architect shall, however, be entitled to performance and enforcement of obligations under the Contract intended to facilitate performance of the Architect's duties.

§ 1.1.3 THE WORK

The term "Work" means the construction and services required by the Contract Documents, whether completed or partially completed, and includes all other labor, materials, equipment and services provided or to be provided by the Contractor to fulfill the Contractor's obligations. The Work may constitute the whole or a part of the Project. Work includes coordination of work of other trades. Although not indicated, work includes providing supplementary or miscellaneous items, appurtenances and devices incidental to or necessary for a sound, secure and complete installation.

§ 1.1.4 THE PROJECT

The Project is the total construction of which the Work performed under the Contract Documents may be the whole or a part and which may include construction by the Owner or by separate contractors.

§ 1.1.5 THE DRAWINGS

The Drawings are the graphic and pictorial portions of the Contract Documents showing the design, location and dimensions of the Work, generally including plans, elevations, sections, details, schedules and diagrams.

§ 1.1.6 THE SPECIFICATIONS

The Specifications are that portion of the Contract Documents consisting of the written requirements for materials, equipment, systems, standards and workmanship for the Work, and performance of related services.

§ 1.1.7 THE PROJECT MANUAL

The Project Manual is a volume assembled for the Work which may include the bidding requirements, sample forms, Conditions of the Contract and Specifications.

§ 1.2 CORRELATION AND INTENT OF THE CONTRACT DOCUMENTS

§ 1.2.1 The intent of the Contract Documents is to include all items necessary for the proper execution and completion of the Work by the Contractor. The Contract Documents are complementary, and what is required by one shall be as binding as if required by all; performance by the Contractor shall be required only to the extent consistent with the Contract Documents and reasonably inferable from them as being necessary to produce the indicated results. In the event of discrepancies between or within Contract Documents, the Contractor shall provide the better quality or greater quantity and shall comply with the more stringent requirements.

§ 1.2.2 Organization of the Specifications into divisions, sections and articles, and arrangement of Drawings shall not control the Contractor in dividing the Work among Subcontractors or in establishing the extent of Work to be performed by any trade.

§ 1.2.3 Unless otherwise stated in the Contract Documents, words which have well-known technical or construction industry meanings are used in the Contract Documents in accordance with such recognized meanings.

§ 1.3 CAPITALIZATION

§ 1.3.1 Terms capitalized in these General Conditions include those which are (1) specifically defined, (2) the titles of numbered articles or (3) the titles of other documents published by the American Institute of Architects.

§ 1.4 INTERPRETATION

§ 1.4.1 In the interest of brevity the Contract Documents frequently omit modifying words such as “all” and “any” and articles such as “the” and “an,” but the fact that a modifier or an article is absent from one statement and appears in another is not intended to affect the interpretation of either statement.

§ 1.5 EXECUTION OF CONTRACT DOCUMENTS

§ 1.5.1 The Contract Documents shall be signed by the Owner and Contractor. If either the Owner or Contractor or both do not sign all the Contract Documents, the Architect shall identify such unsigned Documents upon request.

§ 1.5.2 Execution of the Contract by the Contractor is a representation that the Contractor has visited the site, become generally familiar with local conditions under which the Work is to be performed and correlated personal observations with requirements of the Contract Documents.

§ 1.6 OWNERSHIP AND USE OF DRAWINGS, SPECIFICATIONS AND OTHER INSTRUMENTS OF SERVICE

§ 1.6.1 The Drawings, Specifications and other documents, including those in electronic form, prepared by the Architect and the Architect’s consultants are Instruments of Service through which the Work to be executed by the Contractor is described. The Contractor may retain one record set. Neither the Contractor nor any Subcontractor, Sub-subcontractor or material or equipment supplier shall own or claim a copyright in the Drawings, Specifications and other documents prepared by the Architect or the Architect’s consultants, and unless otherwise indicated the Architect and the Architect’s consultants shall be deemed the authors of them and will retain all common law, statutory and other reserved rights, in addition to the copyrights. All copies of Instruments of Service, except the Contractor’s record set, shall be returned or suitably accounted for to the Architect, on request, upon completion of the Work. The Drawings, Specifications and other documents prepared by the Architect and the Architect’s consultants, and copies thereof furnished to the Contractor, are for use solely with respect to this Project. They are not to be used by the Contractor or any Subcontractor, Sub-subcontractor or material or equipment supplier on other projects or for additions to this Project outside the scope of the Work without the specific written consent of the Owner, Architect and the Architect’s consultants. The Contractor, Subcontractors, Sub-subcontractors and material or equipment suppliers are authorized to use and reproduce applicable portions of the Drawings, Specifications and other documents prepared by the Architect and the Architect’s consultants appropriate to and for use in the execution of their Work under the Contract Documents. All copies made under this authorization shall bear the statutory copyright notice, if any, shown on the Drawings, Specifications and other documents prepared by the Architect and the Architect’s consultants. Submittal or distribution to meet official regulatory requirements or for other purposes in connection with this Project is not to be construed as publication in derogation of the Architect’s or Architect’s consultants’ copyrights or other reserved rights.

ARTICLE 2 OWNER

§ 2.1 GENERAL

§ 2.1.1 The Owner is the person or entity identified as such in the Agreement and is referred to throughout the Contract Documents as if singular in number. The Owner shall designate in writing a representative who shall have express authority to bind the Owner with respect to all matters requiring the Owner’s approval or authorization. Except as otherwise provided in Section 4.2.1, the Architect does not have such authority. The term “Owner” means the Owner or the Owner’s authorized representative.

§ 2.1.2 The Owner shall furnish to the Contractor within fifteen days after receipt of a written request, information necessary and relevant for the Contractor to evaluate, give notice of or enforce mechanic’s lien rights. Such information shall include a correct statement of the record legal title to the property on which the Project is located, usually referred to as the site, and the Owner’s interest therein.

§ 2.2 INFORMATION AND SERVICES REQUIRED OF THE OWNER

§ 2.2.1 The Owner shall, at the written request of the Contractor, prior to commencement of the Work and thereafter, furnish to the Contractor reasonable evidence that financial arrangements have been made to fulfill the Owner's obligations under the Contract. Furnishing of such evidence shall be a condition precedent to commencement or continuation of the Work. After such evidence has been furnished, the Owner shall not materially vary such financial arrangements without prior notice to the Contractor.

§ 2.2.2 Except for permits and fees, including those required under Section 3.7.1, which are the responsibility of the Contractor under the Contract Documents, the Owner shall secure and pay for necessary approvals, easements, assessments and charges required for construction, use or occupancy of permanent structures or for permanent changes in existing facilities.

§ 2.2.3 The Owner shall furnish surveys describing physical characteristics, legal limitations and utility locations for the site of the Project, and a legal description of the site. The Contractor shall be entitled to rely on the accuracy of information furnished by the Owner provided that the Contractor has diligently reviewed the information and has informed the Owner in writing if it has actual knowledge of incorrect information. The Contractor shall exercise proper precautions relating to the safe performance of the Work.

§ 2.2.4 Information or services required of the Owner by the Contract Documents shall be furnished by the Owner with reasonable promptness. Any other information or services relevant to the Contractor's performance of the Work under the Owner's control shall be furnished by the Owner after receipt from the Contractor of a written request for such information or services.

§ 2.2.5 Unless otherwise provided in the Contract Documents, the Contractor will be furnished, free of charge, such copies of Drawings and Project Manuals as are reasonably necessary for execution of the Work.

§ 2.3 OWNER'S RIGHT TO STOP THE WORK

§ 2.3.1 If the Contractor fails to correct Work which is not in accordance with the requirements of the Contract Documents as required by Section 12.2 or persistently fails to carry out Work in accordance with the Contract Documents, the Owner may issue a written order to the Contractor to stop the Work, or any portion thereof, until the cause for such order has been eliminated; however, the right of the Owner to stop the Work shall not give rise to a duty on the part of the Owner to exercise this right for the benefit of the Contractor or any other person or entity, except to the extent required by Section 6.1.3.

§ 2.4 OWNER'S RIGHT TO CARRY OUT THE WORK

§ 2.4.1 If the Contractor defaults or neglects to carry out the Work in accordance with the Contract Documents and fails within a seven-day period after receipt of written notice from the Owner to commence and continue correction of such default or neglect with diligence and promptness, the Owner may after such seven-day period give the Contractor a second written notice to correct such deficiencies within a three-day period. If the Contractor within such three-day period after receipt of such second notice fails to commence and continue to correct any deficiencies, the Owner may, without prejudice to other remedies the Owner may have, correct such deficiencies. In such case an appropriate Change Order shall be issued deducting from payments then or thereafter due the Contractor the reasonable cost of correcting such deficiencies, including Owner's expenses and compensation for the Architect's additional services made necessary by such default, neglect or failure. Such action by the Owner and amounts charged to the Contractor are both subject to prior approval of the Architect. If payments then or thereafter due the Contractor are not sufficient to cover such amounts, the Contractor shall pay the difference to the Owner.

§ 2.5 EXTENT OF OWNER'S RIGHTS

§ 2.5.1 In no event shall the Owner have control over, charge of, or any responsibility for construction means, methods, techniques, sequences or procedures or for safety precautions and programs in connection with the Work, which are the sole responsibility of the Contractor, notwithstanding any of the rights and authority granted the Owner in the Contract Documents.

ARTICLE 3 CONTRACTOR

§ 3.1 GENERAL

§ 3.1.1 The Contractor is the person or entity identified as such in the Agreement and is referred to throughout the Contract Documents as if singular in number. The term "Contractor" means the Contractor or the Contractor's authorized representative.

§ 3.1.2 The Contractor shall perform the Work in accordance with the Contract Documents.

§ 3.1.3 The Contractor shall not be relieved of obligations to perform the Work in accordance with the Contract Documents either by activities or duties of the Architect in the Architect's administration of the Contract, or by tests, inspections or approvals required or performed by persons other than the Contractor.

§ 3.2 REVIEW OF CONTRACT DOCUMENTS AND FIELD CONDITIONS BY CONTRACTOR

§ 3.2.1 Since the Contract Documents are complementary, before starting each portion of the Work, the Contractor shall carefully study and compare the various Drawings and other Contract Documents relative to that portion of the Work, as well as the information furnished by the Owner pursuant to Section 2.2.3, shall take field measurements of any existing conditions related to that portion of the Work and shall observe any conditions at the site affecting it. These obligations are for the purpose of facilitating construction by the Contractor and are not for the purpose of discovering errors, omissions, or inconsistencies in the Contract Documents; however, any errors, inconsistencies or omissions discovered by the Contractor shall be reported promptly to the Architect as a request for information in such form as the Architect may require.

§ 3.2.2 Any design errors or omissions noted by the Contractor during this review shall be reported promptly to the Architect, but it is recognized that the Contractor's review is made in the Contractor's capacity as a contractor and not as a licensed design professional unless otherwise specifically provided in the Contract Documents. The Contractor is not required to ascertain that the Contract Documents are in accordance with applicable laws, statutes, ordinances, building codes, and rules and regulations, but any nonconformity discovered by or made known to the Contractor shall be reported promptly to the Architect.

§ 3.2.3 If the Contractor believes that additional cost or time is involved because of clarifications or instructions issued by the Architect in response to the Contractor's notices or requests for information pursuant to Sections 3.2.1 and 3.2.2, the Contractor shall make Claims as provided in Sections 4.3.6 and 4.3.7. If the Contractor fails to perform the obligations of Sections 3.2.1 and 3.2.2, the Contractor shall pay such costs and damages to the Owner as would have been avoided if the Contractor had performed such obligations. The Contractor shall not be liable to the Owner or Architect for damages resulting from errors, inconsistencies or omissions in the Contract Documents or for differences between field measurements or conditions and the Contract Documents unless the Contractor recognized such error, inconsistency, omission or difference and knowingly failed to report it to the Architect.

§ 3.3 SUPERVISION AND CONSTRUCTION PROCEDURES

§ 3.3.1 The Contractor shall supervise and direct the Work, using the Contractor's best skill and attention. The Contractor shall be solely responsible for and have control over construction means, methods, techniques, sequences and procedures and for coordinating all portions of the Work under the Contract, unless the Contract Documents give other specific instructions concerning these matters. If the Contract Documents give specific instructions concerning construction means, methods, techniques, sequences or procedures, the Contractor shall evaluate the jobsite safety thereof and, except as stated below, shall be fully and solely responsible for the jobsite safety of such means, methods, techniques, sequences or procedures. If the Contractor determines that such means, methods, techniques, sequences or procedures may not be safe, the Contractor shall give timely written notice to the Owner and Architect and shall not proceed with that portion of the Work without further written instructions from the Architect. If the Contractor is then instructed to proceed with the required means, methods, techniques, sequences or procedures without acceptance of changes proposed by the Contractor, the Owner shall be solely responsible for any resulting loss or damage.

§ 3.3.2 The Contractor shall be responsible to the Owner for acts and omissions of the Contractor's employees, Subcontractors and their agents and employees, and other persons or entities performing portions of the Work for or on behalf of the Contractor or any of its Subcontractors.

§ 3.3.3 The Contractor shall be responsible for inspection of portions of Work already performed to determine that such portions are in proper condition to receive subsequent Work.

§ 3.4 LABOR AND MATERIALS

§ 3.4.1 Unless otherwise provided in the Contract Documents, the Contractor shall provide and pay for labor, materials, equipment, tools, construction equipment and machinery, water, heat, utilities, transportation, and other facilities and services necessary for proper execution and completion of the Work, whether temporary or permanent and whether or not incorporated or to be incorporated in the Work.

§ 3.4.2 The Contractor may make substitutions only with the consent of the Owner, after evaluation by the Architect and in accordance with a Change Order.

§ 3.4.3 The Contractor shall enforce strict discipline and good order among the Contractor's employees and other persons carrying out the Contract. The Contractor shall not permit employment of unfit persons or persons not skilled in tasks assigned to them.

§ 3.5 WARRANTY

§ 3.5.1 The Contractor warrants to the Owner and Architect that materials and equipment furnished under the Contract will be of good quality and new unless otherwise required or permitted by the Contract Documents, that the Work will be free from defects not inherent in the quality required or permitted, and that the Work will conform to the requirements of the Contract Documents. Work not conforming to these requirements, including substitutions not properly approved and authorized, may be considered defective. The Contractor's warranty excludes remedy for damage or defect caused by abuse, modifications not executed by the Contractor, improper or insufficient maintenance, improper operation, or normal wear and tear and normal usage. If required by the Architect, the Contractor shall furnish satisfactory evidence as to the kind and quality of materials and equipment.

§ 3.6 TAXES

§ 3.6.1 The Contractor shall pay sales, consumer, use and similar taxes for the Work provided by the Contractor which are legally enacted when bids are received or negotiations concluded, whether or not yet effective or merely scheduled to go into effect.

§ 3.7 PERMITS, FEES AND NOTICES

§ 3.7.1 Unless otherwise provided in the Contract Documents, the Contractor shall secure and pay for the building permit and other permits and governmental fees, licenses and inspections necessary for proper execution and completion of the Work which are customarily secured after execution of the Contract and which are legally required when bids are received or negotiations concluded.

§ 3.7.2 The Contractor shall comply with and give notices required by laws, ordinances, rules, regulations and lawful orders of public authorities applicable to performance of the Work.

§ 3.7.3 It is not the Contractor's responsibility to ascertain that the Contract Documents are in accordance with applicable laws, statutes, ordinances, building codes, and rules and regulations. However, if the Contractor observes that portions of the Contract Documents are at variance therewith, the Contractor shall promptly notify the Architect and Owner in writing, and necessary changes shall be accomplished by appropriate Modification.

§ 3.7.4 If the Contractor performs Work knowing it to be contrary to laws, statutes, ordinances, building codes, and rules and regulations without such notice to the Architect and Owner, the Contractor shall assume appropriate responsibility for such Work and shall bear the costs attributable to correction.

§ 3.8 ALLOWANCES

§ 3.8.1 The Contractor shall include in the Contract Sum all allowances stated in the Contract Documents. Items covered by allowances shall be supplied for such amounts and by such persons or entities as the Owner may direct, but the Contractor shall not be required to employ persons or entities to whom the Contractor has reasonable objection.

§ 3.8.2 Unless otherwise provided in the Contract Documents:

.1 allowances shall cover the cost to the Contractor of materials and equipment delivered at the site and all required taxes, less applicable trade discounts;

.2 Contractor's costs for unloading and handling at the site, labor, installation costs, overhead, profit and other expenses contemplated for stated allowance amounts shall be included in the Contract Sum but not in the allowances;

.3 whenever costs are more than or less than allowances, the Contract Sum shall be adjusted accordingly by Change Order. The amount of the Change Order shall reflect (1) the difference between actual costs and the allowances under Section 3.8.2.1 and (2) changes in Contractor's costs under Section 3.8.2.2.

§ 3.8.3 Materials and equipment under an allowance shall be selected by the Owner in sufficient time to avoid delay in the Work.

§ 3.9 SUPERINTENDENT

§ 3.9.1 The Contractor shall employ a competent superintendent and necessary assistants who shall be in attendance at the Project site during performance of the Work. The superintendent shall represent the Contractor, and communications given to the superintendent shall be as binding as if given to the Contractor. Important communications shall be confirmed in writing. Other communications shall be similarly confirmed on written request in each case.

§ 3.9.2 The Contractor's project manager and the Contractor's superintendent shall be full-time employees of the Contractor. The project manager and the superintendent shall each have a minimum of five years' experience constructing projects similar to the Project. The project manager's and the superintendent's previous work performances must, respectively, be acceptable to the Owner as to quality of workmanship and time of performance. Resumes of the project manager and the superintendent shall be submitted by the Contractor to the Owner at the time the Contract is signed. If either person is or becomes unacceptable to the Owner, the Contractor, upon written demand by the Owner, shall promptly remove the unacceptable person and shall appoint a replacement satisfactory to the Owner.

§ 3.10 CONTRACTOR'S CONSTRUCTION SCHEDULES

§ 3.10.1 The Contractor, promptly after being awarded the Contract, shall prepare and submit for the Owner's and Architect's information a Contractor's construction schedule for the Work. The schedule shall not exceed time limits current under the Contract Documents, shall be revised at appropriate intervals as required by the conditions of the Work and Project, shall be related to the entire Project to the extent required by the Contract Documents, and shall provide for expeditious and practicable execution of the Work.

§ 3.10.2 The Contractor shall prepare and keep current, for the Architect's approval, a schedule of submittals which is coordinated with the Contractor's construction schedule and allows the Architect reasonable time to review submittals.

§ 3.10.3 The Contractor shall perform the Work in general accordance with the most recent schedules submitted to the Owner and Architect.

§ 3.11 DOCUMENTS AND SAMPLES AT THE SITE

§ 3.11.1 The Contractor shall maintain at the site for the Owner one record copy of the Drawings, Specifications, Addenda, Change Orders and other Modifications, in good order and marked currently to record field changes and selections made during construction, and one record copy of approved Shop Drawings, Product Data, Samples and similar required submittals. These shall be available to the Architect and shall be delivered to the Architect for submittal to the Owner upon completion of the Work.

§ 3.12 SHOP DRAWINGS, PRODUCT DATA AND SAMPLES

§ 3.12.1 Shop Drawings are drawings, diagrams, schedules and other data specially prepared for the Work by the Contractor or a Subcontractor, Sub-subcontractor, manufacturer, supplier or distributor to illustrate some portion of the Work.

§ 3.12.2 Product Data are illustrations, standard schedules, performance charts, instructions, brochures, diagrams and other information furnished by the Contractor to illustrate materials or equipment for some portion of the Work.

§ 3.12.3 Samples are physical examples which illustrate materials, equipment or workmanship and establish standards by which the Work will be judged.

§ 3.12.4 Shop Drawings, Product Data, Samples and similar submittals are not Contract Documents. The purpose of their submittal is to demonstrate for those portions of the Work for which submittals are required by the Contract Documents the way by which the Contractor proposes to conform to the information given and the design concept expressed in the Contract Documents. Review by the Architect is subject to the limitations of Section 4.2.7. Informational submittals upon which the Architect is not expected to take responsive action may be so identified in the Contract Documents. Submittals which are not required by the Contract Documents may be returned by the Architect without action.

§ 3.12.5 The Contractor shall review for compliance with the Contract Documents, approve and submit to the Architect Shop Drawings, Product Data, Samples and similar submittals required by the Contract Documents with reasonable promptness and in such sequence as to cause no delay in the Work or in the activities of the Owner or of separate contractors. Submittals which are not marked as reviewed for compliance with the Contract Documents and approved by the Contractor may be returned by the Architect without action.

§ 3.12.6 By approving and submitting Shop Drawings, Product Data, Samples and similar submittals, the Contractor represents that the Contractor has determined and verified materials, field measurements and field construction criteria related thereto, or will do so, and has checked and coordinated the information contained within such submittals with the requirements of the Work and of the Contract Documents.

§ 3.12.7 The Contractor shall perform no portion of the Work for which the Contract Documents require submittal and review of Shop Drawings, Product Data, Samples or similar submittals until the respective submittal has been approved by the Architect.

§ 3.12.8 The Work shall be in accordance with approved submittals except that the Contractor shall not be relieved of responsibility for deviations from requirements of the Contract Documents by the Architect's approval of Shop Drawings, Product Data, Samples or similar submittals unless the Contractor has specifically informed the Architect in writing of such deviation at the time of submittal and (1) the Architect has given written approval to the specific deviation as a minor change in the Work, or (2) a Change Order or Construction Change Directive has been issued authorizing the deviation. The Contractor shall not be relieved of responsibility for errors or omissions in Shop Drawings, Product Data, Samples or similar submittals by the Architect's approval thereof.

§ 3.12.9 The Contractor shall direct specific attention, in writing or on resubmitted Shop Drawings, Product Data, Samples or similar submittals, to revisions other than those requested by the Architect on previous submittals. In the absence of such written notice the Architect's approval of a resubmission shall not apply to such revisions.

§ 3.12.10 The Contractor shall not be required to provide professional services which constitute the practice of architecture or engineering unless such services are specifically required by the Contract Documents for a portion of the Work or unless the Contractor needs to provide such services in order to carry out the Contractor's responsibilities for construction means, methods, techniques, sequences and procedures. The Contractor shall not be required to provide professional services in violation of applicable law. If professional design services or certifications by a design professional related to systems, materials or equipment are specifically required of the Contractor by the Contract Documents, the Owner and the Architect will specify all performance and design criteria that such services must satisfy. The Contractor shall cause such services or certifications to be provided by a properly licensed design professional, whose signature and seal shall appear on all drawings, calculations, specifications, certifications, Shop Drawings and other submittals prepared by such professional. Shop Drawings and other submittals related to the Work designed or certified by such professional, if prepared by others, shall bear such professional's written approval when submitted to the Architect. The Owner and the Architect shall be entitled to rely upon the adequacy, accuracy and completeness of the services, certifications or approvals performed by such design professionals, provided the Owner and Architect have specified to the Contractor all performance and design criteria that such services must satisfy. Pursuant to this Section 3.12.10, the Architect will review, approve or take other appropriate action on submittals only for the limited purpose of checking for conformance with information given and the design concept expressed in the Contract Documents. The Contractor shall not be responsible for the adequacy of the performance or design criteria required by the Contract Documents.

§ 3.12.11 The Contractor will reimburse the Owner for costs of the Architect's reviewing more than two submittals on a single item in the shop drawings, product data, samples and the like, provided the additional submittals are not due to the fault or omission of the Architect.

§ 3.13 USE OF SITE

§ 3.13.1 The Contractor shall confine operations at the site to areas permitted by law, ordinances, permits and the Contract Documents and shall not unreasonably encumber the site with materials or equipment.

§ 3.14 CUTTING AND PATCHING

§ 3.14.1 The Contractor shall be responsible for cutting, fitting or patching required to complete the Work or to make its parts fit together properly.

§ 3.14.2 The Contractor shall not damage or endanger a portion of the Work or fully or partially completed construction of the Owner or separate contractors by cutting, patching or otherwise altering such construction, or by excavation. The Contractor shall not cut or otherwise alter such construction by the Owner or a separate contractor except with written consent of the Owner and of such separate contractor; such consent shall not be unreasonably withheld. The Contractor shall not unreasonably withhold from the Owner or a separate contractor the Contractor's consent to cutting or otherwise altering the Work.

§ 3.15 CLEANING UP

§ 3.15.1 The Contractor shall keep the premises and surrounding area free from accumulation of waste materials or rubbish caused by operations under the Contract. At completion of the Work, the Contractor shall remove from and about the Project waste materials, rubbish, the Contractor's tools, construction equipment, machinery and surplus materials.

§ 3.15.2 If the Contractor fails to clean up as provided in the Contract Documents, the Owner may do so and the cost thereof shall be charged to the Contractor.

§ 3.16 ACCESS TO WORK

§ 3.16.1 The Contractor shall provide the Owner and Architect access to the Work in preparation and progress wherever located.

§ 3.17 ROYALTIES, PATENTS AND COPYRIGHTS

§ 3.17.1 The Contractor shall pay all royalties and license fees. The Contractor shall defend suits or claims for infringement of copyrights and patent rights and shall hold the Owner and Architect harmless from loss on account thereof, but shall not be responsible for such defense or loss when a particular design, process or product of a particular manufacturer or manufacturers is required by the Contract Documents or where the copyright violations are contained in Drawings, Specifications or other documents prepared by the Owner or Architect. However, if the Contractor has reason to believe that the required design, process or product is an infringement of a copyright or a patent, the Contractor shall be responsible for such loss unless such information is promptly furnished to the Architect.

§ 3.18 INDEMNIFICATION

§ 3.18.1 To the fullest extent permitted by law and to the extent claims, damages, losses or expenses are not covered by Project Management Protective Liability insurance purchased by the Contractor in accordance with Section 11.3, the Contractor shall indemnify and hold harmless the Owner, Architect, Architect's consultants, and agents and employees of any of them from and against claims, damages, losses and expenses, including but not limited to attorneys' fees, arising out of or resulting from performance of the Work, provided that such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself), including loss of use therefrom, but only to the extent caused by the negligent acts or omissions of the Contractor, a Subcontractor, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, regardless of whether or not such claim, damage, loss or expense is caused in part by a party indemnified hereunder. Such obligation shall not be construed to negate, abridge, or reduce other rights or obligations of indemnity which would otherwise exist as to a party or person described in this Section 3.18.

§ 3.18.2 In claims against any person or entity indemnified under this Section 3.18 by an employee of the Contractor, a Subcontractor, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, the indemnification obligation under Section 3.18.1 shall not be limited by a limitation on amount or type of damages, compensation or benefits payable by or for the Contractor or a Subcontractor under workers' compensation acts, disability benefit acts or other employee benefit acts.

ARTICLE 4 ADMINISTRATION OF THE CONTRACT

§ 4.1 ARCHITECT

§ 4.1.1 The Architect is the person lawfully licensed to practice architecture or an entity lawfully practicing architecture identified as such in the Agreement and is referred to throughout the Contract Documents as if singular in number. The term "Architect" means the Architect or the Architect's authorized representative.

§ 4.1.2 Duties, responsibilities and limitations of authority of the Architect as set forth in the Contract Documents shall not be restricted, modified or extended without written consent of the Owner, Contractor and Architect. Consent shall not be unreasonably withheld.

§ 4.1.3 If the employment of the Architect is terminated, the Owner shall employ a new Architect against whom the Contractor has no reasonable objection and whose status under the Contract Documents shall be that of the former Architect.

§ 4.2 ARCHITECT'S ADMINISTRATION OF THE CONTRACT

§ 4.2.1 The Architect will provide administration of the Contract as described in the Contract Documents, and will be an Owner's representative (1) during construction, (2) until final payment is due and (3) with the Owner's concurrence, from time to time during the one-year period for correction of Work described in Section 12.2. The Architect will have authority to act on behalf of the Owner only to the extent provided in the Contract Documents, unless otherwise modified in writing in accordance with other provisions of the Contract.

§ 4.2.2 The Architect, as a representative of the Owner, will visit the site at intervals appropriate to the stage of the Contractor's operations (1) to become generally familiar with and to keep the Owner informed about the progress and quality of the portion of the Work completed, (2) to use reasonable care to guard the Owner against defects and deficiencies in the Work, and (3) to determine in general if the Work is being performed in a manner indicating that the Work, when fully completed, will be in accordance with the Contract Documents. However, the Architect will not be required to make exhaustive or continuous on-site inspections to check the quality or quantity of the Work. The Architect will neither have control over or charge of, nor be responsible for, the construction means, methods, techniques, sequences or procedures, or for the safety precautions and programs in connection with the Work, since these are solely the Contractor's rights and responsibilities under the Contract Documents, except as provided in Section 3.3.1.

§ 4.2.3 The Architect will not be responsible for the Contractor's failure to perform the Work in accordance with the requirements of the Contract Documents. The Architect will not have control over or charge of and will not be responsible for acts or omissions of the Contractor, Subcontractors, or their agents or employees, or any other persons or entities performing portions of the Work.

§ 4.2.4 Communications Facilitating Contract Administration. Except as otherwise provided in the Contract Documents or when direct communications have been specially authorized, the Owner and Contractor shall endeavor to communicate with each other through the Architect about matters arising out of or relating to the Contract. Communications by and with the Architect's consultants shall be through the Architect. Communications by and with Subcontractors and material suppliers shall be through the Contractor. Communications by and with separate contractors shall be through the Owner.

§ 4.2.5 Based on the Architect's evaluations of the Contractor's Applications for Payment, the Architect will review and certify the amounts due the Contractor and will issue Certificates for Payment in such amounts.

§ 4.2.6 The Architect will have authority to reject Work that does not conform to the Contract Documents. Whenever the Architect considers it necessary or advisable, the Architect will have authority to require inspection or testing of the Work in accordance with Sections 13.5.2 and 13.5.3, whether or not such Work is fabricated, installed or completed. However, neither this authority of the Architect nor a decision made in good faith either to exercise or not to exercise such authority shall give rise to a duty or responsibility of the Architect to the Contractor, Subcontractors, material and equipment suppliers, their agents or employees, or other persons or entities performing portions of the Work.

§ 4.2.7 The Architect will review and approve or take other appropriate action upon the Contractor's submittals such as Shop Drawings, Product Data and Samples, but only for the limited purpose of checking for conformance with information given and the design concept expressed in the Contract Documents. The Architect's action will be taken with such reasonable promptness as to cause no delay in the Work or in the activities of the Owner, Contractor or separate contractors, while allowing sufficient time in the Architect's professional judgment to permit adequate review. Review of such submittals is not conducted for the purpose of determining the accuracy and completeness of other details such as dimensions and quantities, or for substantiating instructions for installation or performance of equipment or systems, all of which remain the responsibility of the Contractor as required by the Contract Documents. The Architect's review of the Contractor's submittals shall not relieve the Contractor of the obligations under Sections 3.3, 3.5 and 3.12. The Architect's review shall not constitute approval of safety precautions or, unless otherwise specifically stated by the Architect, of any construction means, methods, techniques, sequences or procedures. The Architect's approval of a specific item shall not indicate approval of an assembly of which the item is a component.

§ 4.2.8 The Architect will prepare Change Orders and Construction Change Directives, and may authorize minor changes in the Work as provided in Section 7.4.

§ 4.2.9 The Architect will conduct inspections to determine the date or dates of Substantial Completion and the date of final completion, will receive and forward to the Owner, for the Owner's review and records, written warranties and related documents required by the Contract and assembled by the Contractor, and will issue a final Certificate for Payment upon compliance with the requirements of the Contract Documents.

§ 4.2.10 If the Owner and Architect agree, the Architect will provide one or more project representatives to assist in carrying out the Architect's responsibilities at the site. The duties, responsibilities and limitations of authority of such project representatives shall be as set forth in an exhibit to be incorporated in the Contract Documents.

§ 4.2.11 The Architect will interpret and decide matters concerning performance under and requirements of, the Contract Documents on written request of either the Owner or Contractor. The Architect's response to such requests will be made in writing within any time limits agreed upon or otherwise with reasonable promptness. If no agreement is made concerning the time within which interpretations required of the Architect shall be furnished in compliance with this Section 4.2, then delay shall not be recognized on account of failure by the Architect to furnish such interpretations until 15 days after written request is made for them.

§ 4.2.12 Interpretations and decisions of the Architect will be consistent with the intent of and reasonably inferable from the Contract Documents and will be in writing or in the form of drawings. When making such interpretations and initial decisions, the Architect will endeavor to secure faithful performance by both Owner and Contractor, will not show partiality to either and will not be liable for results of interpretations or decisions so rendered in good faith.

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§ 4.3 CLAIMS AND DISPUTES

§ 4.3.1 Definition. A Claim is a demand or assertion by one of the parties seeking, as a matter of right, adjustment or interpretation of Contract terms, payment of money, extension of time or other relief with respect to the terms of the Contract. The term "Claim" also includes other disputes and matters in question between the Owner and Contractor arising out of or relating to the Contract. Claims must be initiated by written notice. The responsibility to substantiate Claims shall rest with the party making the Claim. All Claims must be supported by (a) a detailed chronology of the events comprising the Claim, and (b) copies of all documents supporting the Claim including, but not limited to, applicable provisions of the Contract Documents, submittals, Requests for Information, Bulletin Drawings, correspondence, Construction Change Directives and other documents. The Architect shall have no obligation to review a Claim that is not supported as required by this subparagraph 4.3.1 or to take any of the actions specified in subparagraphs 4.4.1, 4.4.2, 4.4.5 and 4.5.1, and the time periods set forth in those subparagraphs shall not apply until the Architect determines that the Claim has been supported as required by this subparagraph 4.3.1. The Architect's determination of such compliance is a condition precedent to the claimant's entitlement to mediation, arbitration or the institution of legal or equitable proceedings to resolve a Claim.

§ 4.3.2 Time Limits on Claims. Claims by either party must be initiated within 21 days after occurrence of the event giving rise to such Claim or within 21 days after the claimant first recognizes the condition giving rise to the Claim, whichever is later; providing, however, that the claimant shall use its best efforts to furnish the Architect, as expeditiously as possible, with notice of any Claim once such Claim is recognized, and shall use its best effort to mitigate the alleged or potential damages, delay or other adverse consequences arising out of the condition which is the cause of any such claim. Claims must be initiated by written notice to the Architect and the other party.

§ 4.3.3 Continuing Contract Performance. Pending final resolution of a Claim except as otherwise agreed in writing or as provided in Section 9.7.1 and Article 14, the Contractor shall proceed diligently with performance of the Contract and the Owner shall continue to make payments in accordance with the Contract Documents.

§ 4.3.4 Claims for Concealed or Unknown Conditions. If conditions are encountered at the site which are (1) subsurface or otherwise concealed physical conditions which differ materially from those indicated in the Contract Documents or (2) unknown physical conditions of an unusual nature, which differ materially from those ordinarily found to exist and generally recognized as inherent in construction activities of the character provided for in the Contract Documents, then notice by the observing party shall be given to the other party promptly before conditions are disturbed and in no event later than 21 days after first observance of the conditions. The Architect will promptly investigate such conditions and, if they differ materially and cause an increase or decrease in the Contractor's cost of, or time required for, performance of any part of the Work, will recommend an equitable adjustment in the Contract Sum or Contract Time, or both. If the Architect determines that the conditions at the site are not materially different from those indicated in the Contract Documents and that no change in the terms of the Contract is justified, the Architect shall so notify the Owner and Contractor in writing, stating the reasons. Claims by either party in opposition to such determination must be made within 21 days after the Architect has given notice of the decision. If the conditions encountered are materially different, the Contract Sum and Contract Time shall be equitably adjusted, but if the Owner and Contractor cannot agree on an adjustment in the Contract Sum or Contract Time, the adjustment shall be referred to the Architect for initial determination, subject to further proceedings pursuant to Section 4.4.

§ 4.3.5 Claims for Additional Cost. If the Contractor wishes to make Claim for an increase in the Contract Sum, written notice as provided herein shall be given before proceeding to execute the Work. Prior notice is not required for Claims relating to an emergency endangering life or property arising under Section 10.6.

§ 4.3.6 If the Contractor believes additional cost is involved for reasons including but not limited to (1) a written interpretation from the Architect, (2) an order by the Owner to stop the Work where the Contractor was not at fault, (3) a written order for a minor change in the Work issued by the Architect, (4) failure of payment by the Owner, (5) termination of the Contract by the Owner, (6) Owner's suspension or (7) other reasonable grounds, Claim shall be filed in accordance with this Section 4.3.

§ 4.3.7 Claims for Additional Time

§ 4.3.7.1 If the Contractor wishes to make Claim for an increase in the Contract Time, written notice as provided herein shall be given. The Contractor's Claim shall include an estimate of cost and of probable effect of delay on progress of the Work. In the case of a continuing delay only one Claim is necessary.

§ 4.3.7.2 If adverse weather conditions are the basis for a Claim for additional time, such Claim shall be documented by data substantiating that weather conditions were abnormal for the period of time, could not have been reasonably anticipated and had an adverse effect on the scheduled construction. Only delay impacting the critical path of the Work shall be considered in determining whether the Contractor is entitled to additional time.

§ 4.3.7.3 Acceptable data for substantiating a claim for additional time due to abnormal weather conditions will be the records of the National Oceanographic and Atmospheric Administration (NOAA) for the prior 5 years. In the absence of NOAA records for the Project site, local official records will be acceptable.

§ 4.3.8 Injury or Damage to Person or Property. If either party to the Contract suffers injury or damage to person or property because of an act or omission of the other party, or of others for whose acts such party is legally responsible, written notice of such injury or damage, whether or not insured, shall be given to the other party within a reasonable time not exceeding 21 days after discovery. The notice shall provide sufficient detail to enable the other party to investigate the matter.

§ 4.3.9 If unit prices are stated in the Contract Documents or subsequently agreed upon, and if quantities originally contemplated are materially changed in a proposed Change Order or Construction Change Directive so that application of such unit prices to quantities of Work proposed will cause substantial inequity to the Owner or Contractor, the applicable unit prices shall be equitably adjusted.

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§ 4.4 RESOLUTION OF CLAIMS AND DISPUTES

§ 4.4.1 Decision of Architect. Claims, including those alleging an error or omission by the Architect but excluding those arising under Sections 10.3 through 10.5, shall be referred initially to the Architect for decision. A written decision by the Architect shall be required as a condition precedent to mediation, arbitration or litigation of all Claims between the Contractor and Owner arising prior to the date final payment is due, unless 30 days have passed after the Claim has been referred to the Architect with no decision having been rendered by the Architect. The Architect will not decide disputes between the Contractor and persons or entities other than the Owner.

§ 4.4.2 The Architect will review Claims and within twenty-one (21) days of the receipt of the Claim take one or more of the following actions: (1) request additional supporting data from the claimant or a response with supporting data from the other party, (2) reject the Claim in whole or in part, (3) approve the Claim, (4) suggest a compromise, or (5) advise the parties that the Architect is unable to resolve the Claim if the Architect lacks sufficient information to evaluate the merits of the Claim or if the Architect concludes that, in the Architect's sole discretion, it would be inappropriate for the Architect to resolve the Claim.

§ 4.4.3 In evaluating Claims, the Architect may, but shall not be obligated to, consult with or seek information from either party or from persons with special knowledge or expertise who may assist the Architect in rendering a decision. The Architect may request the Owner to authorize retention of such persons at the Owner's expense.

§ 4.4.4 If the Architect requests a party to provide a response to a Claim or to furnish additional supporting data, such party shall respond, within ten days after receipt of such request, and shall either provide a response on the requested supporting data, advise the Architect when the response or supporting data will be furnished or advise the Architect that no supporting data will be furnished. Upon receipt of the response or supporting data, if any, the Architect will either reject or approve the Claim in whole or in part.

§ 4.4.5 The Architect will approve or reject Claims by written decision, which shall state the reasons therefor and which shall notify the parties of any change in the Contract Sum or Contract Time or both. The approval or rejection of a Claim by the Architect shall be final and binding on the parties but subject to paragraphs 4.5 and 4.6. If a written request for dispute resolution is not filed within 30 days after the Architect's written decision in accordance with paragraph 4.5.1, the Architect's decision shall become final and binding upon the Owner and Contractor.

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§ 4.4.7 Upon receipt of a Claim against the Contractor or at any time thereafter, the Architect or the Owner may, but is not obligated to, notify the surety, if any, of the nature and amount of the Claim. If the Claim relates to a possibility of a Contractor's default, the Architect or the Owner may, but is not obligated to, notify the surety and request the surety's assistance in resolving the controversy.

§ 4.4.8 If a Claim relates to or is the subject of a mechanic's lien, the party asserting such Claim may proceed in accordance with applicable law to comply with the lien notice or filing deadlines prior to resolution of the Claim by the Architect, by mediation or by arbitration.

§ 4.5 MEDIATION

§ 4.5.1 Any Claim arising out of or related to the Contract, except Claims relating to aesthetic effect and except those waived as provided for in Sections 4.3.10, 9.10.4 and 9.10.5 shall, after written decision by the Architect or 30 days after submission of the Claim to the Architect in accordance with subparagraph 4.3.1, be subject to mediation as a condition precedent to arbitration or the institution of legal or equitable proceedings by either party.

§ 4.5.2 If a Claim involves the Architect, then upon written request of the Owner or Contractor, the Architect shall become a party to the dispute resolution.

§ 4.5.2.1 Any mediation conducted pursuant to this sub-subparagraph 4.5.2.1 shall be held in accordance with the Construction Industry Mediation Rules of the American Arbitration Association currently in effect, unless the parties mutually agree otherwise. Demand for mediation shall be filed in writing with the other party to this Agreement and with the American Arbitration Association, or another dispute resolution organization as agreed by the parties. In no event shall the demand for mediation be made after the date when institution of legal or equitable proceedings based upon such Claim would be barred by the applicable statute of limitations.

§ 4.5.3 In any mediation, the parties shall share the mediator's fee and any filing fees equally. The mediation shall be held in the place where the Project is located, unless another location is mutually agreed upon. Agreements reached in mediation shall be enforceable as settlement agreements in any court having jurisdiction thereof.

§ 4.6 ARBITRATION

§ 4.6.1 Any claim arising out of or relating to this Contract, the Project, the Work or the Contract Documents that is not resolved through mediation shall be litigated unless by mutual agreement, the Parties agree to submit the dispute to binding arbitration under the auspices and rules of the American Arbitration Association or another dispute resolution organization as agreed by the parties. All fees in connection therewith shall be borne equally by the parties. Any award rendered shall be final and judgment may be entered upon it in accordance with applicable law by any court having jurisdiction. If any Claim submitted to arbitration involves the Architect, the Architect may be joined in the proceeding. If the Architect is found to have no liability, the party joining the Architect agrees to indemnify the Architect for all loss, cost, damage and expense (including reasonable attorneys' fees) incurred by the Architect as a result of being joined in the proceeding.

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§ 4.6.3

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§ 4.6.6

ARTICLE 5 SUBCONTRACTORS

§ 5.1 DEFINITIONS

§ 5.1.1 A Subcontractor is a person or entity who has a direct contract with the Contractor to perform a portion of the Work at the site. The term "Subcontractor" is referred to throughout the Contract Documents as if singular in number and means a Subcontractor or an authorized representative of the Subcontractor. The term "Subcontractor" does not include a separate contractor or subcontractors of a separate contractor.

§ 5.1.2 A Sub-subcontractor is a person or entity who has a direct or indirect contract with a Subcontractor to perform a portion of the Work at the site. The term "Sub-subcontractor" is referred to throughout the Contract Documents as if singular in number and means a Sub-subcontractor or an authorized representative of the Sub-subcontractor.

§ 5.2 AWARD OF SUBCONTRACTS AND OTHER CONTRACTS FOR PORTIONS OF THE WORK

§ 5.2.1 Unless otherwise stated in the Contract Documents or the bidding requirements, the Contractor, as soon as practicable after award of the Contract, shall furnish in writing to the Owner through the Architect the names of persons or entities (including those who are to furnish materials or equipment fabricated to a special design) proposed for each principal portion of the Work. The Architect will promptly reply to the Contractor in writing stating whether or not the Owner or the Architect, after due investigation, has reasonable objection to any such proposed person or entity. Failure of the Owner or Architect to reply promptly shall constitute notice of no reasonable objection.

§ 5.2.2 The Contractor shall not contract with a proposed person or entity to whom the Owner or Architect has made reasonable and timely objection. The Contractor shall not be required to contract with anyone to whom the Contractor has made reasonable objection.

§ 5.2.3 If the Owner or Architect has reasonable objection to a person or entity proposed by the Contractor, the Contractor shall propose another to whom the Owner or Architect has no reasonable objection. If the proposed but rejected Subcontractor was reasonably capable of performing the Work, the Contract Sum and Contract Time shall be increased or decreased by the difference, if any, occasioned by such change, and an appropriate Change Order shall be issued before commencement of the substitute Subcontractor's Work. However, no increase in the Contract Sum or Contract Time shall be allowed for such change unless the Contractor has acted promptly and responsively in submitting names as required.

§ 5.2.4 The Contractor shall not change a Subcontractor, person or entity previously selected if the Owner or Architect makes reasonable objection to such substitute.

§ 5.3 SUBCONTRACTUAL RELATIONS

§ 5.3.1 By appropriate agreement, written where legally required for validity, the Contractor shall require each Subcontractor, to the extent of the Work to be performed by the Subcontractor, to be bound to the Contractor by terms of the Contract Documents, and to assume toward the Contractor all the obligations and responsibilities, including the responsibility for safety of the Subcontractor's Work, which the Contractor, by these Documents, assumes toward the Owner and Architect. Each subcontract agreement shall preserve and protect the rights of the Owner and Architect under the Contract Documents with respect to the Work to be performed by the Subcontractor so that subcontracting thereof will not prejudice such rights, and shall allow to the Subcontractor, unless specifically provided otherwise in the subcontract agreement, the benefit of all rights, remedies and redress against the Contractor that the Contractor, by the Contract Documents, has against the Owner. Where appropriate, the Contractor shall require each Subcontractor to enter into similar agreements with Sub-subcontractors. The Contractor shall make available to each proposed Subcontractor, prior to the execution of the subcontract agreement, copies of the Contract Documents to which the Subcontractor will be bound, and, upon written request of the Subcontractor, identify to the Subcontractor terms and conditions of the proposed subcontract agreement which may be at variance with the Contract Documents. Subcontractors will similarly make copies of applicable portions of such documents available to their respective proposed Sub-subcontractors.

§ 5.3.2 Each subcontract shall be in writing and shall specifically provide that the Owner is an intended third-party beneficiary of such subcontract.

§ 5.3.3 The Contractor will provide copies of its subcontracts, agreements and current information on the status of its accounts upon demand by the Owner.

§ 5.4 CONTINGENT ASSIGNMENT OF SUBCONTRACTS

§ 5.4.1 Each subcontract agreement for a portion of the Work is assigned by the Contractor to the Owner provided that:

- **.1** assignment is effective only after termination of the Contract by the Owner for cause pursuant to Section 14.2 and only for those subcontract agreements which the Owner accepts by notifying the Subcontractor and Contractor in writing; and
- **.2** assignment is subject to the prior rights of the surety, if any, obligated under bond relating to the Contract.

§ 5.4.2 Upon such assignment, if the Work has been suspended for more than 30 days, the Subcontractor's compensation shall be equitably adjusted for increases in cost resulting from the suspension.

ARTICLE 6 CONSTRUCTION BY OWNER OR BY SEPARATE CONTRACTORS

§ 6.1 OWNER'S RIGHT TO PERFORM CONSTRUCTION AND TO AWARD SEPARATE CONTRACTS

§ 6.1.1 The Owner reserves the right to perform construction or operations related to the Project with the Owner's own forces, and to award separate contracts in connection with other portions of the Project or other construction or operations on the site under Conditions of the Contract identical or substantially similar to these including those portions related to insurance and waiver of subrogation. If the Contractor claims that delay or additional cost is involved because of such action by the Owner, the Contractor shall make such Claim as provided in Section 4.3.

§ 6.1.2 When separate contracts are awarded for different portions of the Project or other construction or operations on the site, the term "Contractor" in the Contract Documents in each case shall mean the Contractor who executes each separate Owner-Contractor Agreement.

§ 6.1.3 The Owner shall provide for coordination of the activities of the Owner's own forces and of each separate contractor with the Work of the Contractor, who shall cooperate with them. The Contractor shall participate with other separate contractors and the Owner in reviewing their construction schedules when directed to do so. The Contractor shall make any revisions to the construction schedule deemed necessary after a joint review and mutual agreement. The construction schedules shall then constitute the schedules to be used by the Contractor, separate contractors and the Owner until subsequently revised.

§ 6.1.4 Unless otherwise provided in the Contract Documents, when the Owner performs construction or operations related to the Project with the Owner's own forces, the Owner shall be deemed to be subject to the same obligations and to have the same rights which apply to the Contractor under the Conditions of the Contract, including, without excluding others, those stated in Article 3, this Article 6 and Articles 10, 11 and 12.

§ 6.1.5 The Contractor accepts assignment of, and liability for, all purchase orders and other agreements for procurement of materials and equipment that are identified as part of the Contract Documents. The Contractor shall be responsible for such pre-purchased items, if any, as if the Contractor were the original purchaser. The Contract Sum includes, without limitation, all costs and expenses in connection with delivery, storage, insurance, installation and testing of items covered in any assigned purchase orders or agreements. All warranty and correction of the Work obligations under the Contract Documents shall also apply to any pre-purchased items, unless the Contract Documents specifically provide otherwise.

§ 6.2 MUTUAL RESPONSIBILITY

§ 6.2.1 The Contractor shall afford the Owner and separate contractors reasonable opportunity for introduction and storage of their materials and equipment and performance of their activities, and shall connect and coordinate the Contractor's construction and operations with theirs as required by the Contract Documents.

§ 6.2.2 If part of the Contractor's Work depends for proper execution or results upon construction or operations by the Owner or a separate contractor, the Contractor shall, prior to proceeding with that portion of the Work, promptly report to the Architect apparent discrepancies or defects in such other construction that would render it unsuitable for such proper execution and results. Failure of the Contractor so to report shall constitute an acknowledgment that the Owner's or separate contractor's completed or partially completed construction is fit and proper to receive the Contractor's Work, except as to defects not then reasonably discoverable.

§ 6.2.3 The Owner shall be reimbursed by the Contractor for costs incurred by the Owner which are payable to a separate contractor because of delays, improperly timed activities or defective construction of the Contractor. The Owner shall be responsible to the Contractor for costs incurred by the Contractor because of delays, improperly timed activities, damage to the Work or defective construction of a separate contractor.

§ 6.2.4 The Contractor shall promptly remedy damage wrongfully caused by the Contractor to completed or partially completed construction or to property of the Owner or separate contractors as provided in Section 10.2.5.

§ 6.2.5 The Owner and each separate contractor shall have the same responsibilities for cutting and patching as are described for the Contractor in Section 3.14.

§ 6.3 OWNER'S RIGHT TO CLEAN UP

§ 6.3.1 If a dispute arises among the Contractor, separate contractors and the Owner as to the responsibility under their respective contracts for maintaining the premises and surrounding area free from waste materials and rubbish, the Owner may clean up and the Architect will allocate the cost among those responsible.

ARTICLE 7 CHANGES IN THE WORK

§ 7.1 GENERAL

§ 7.1.1 Changes in the Work may be accomplished after execution of the Contract, and without invalidating the Contract, by Change Order, Construction Change Directive or order for a minor change in the Work, subject to the limitations stated in this Article 7 and elsewhere in the Contract Documents.

§ 7.1.2 A Change Order shall be based upon agreement among the Owner, Contractor and Architect; a Construction Change Directive requires agreement by the Owner and Architect and may or may not be agreed to by the Contractor; an order for a minor change in the Work may be issued by the Architect alone.

§ 7.1.3 Changes in the Work shall be performed under applicable provisions of the Contract Documents, and the Contractor shall proceed promptly, unless otherwise provided in the Change Order, Construction Change Directive or order for a minor change in the Work.

§ 7.2 CHANGE ORDERS

§ 7.2.1 A Change Order is a written instrument prepared by the Architect and signed by the Owner, Contractor and Architect, stating their agreement upon all of the following:

.1 change in the Work;

.2 the amount of the adjustment, if any, in the Contract Sum; and

.3 the extent of the adjustment, if any, in the Contract Time.

§ 7.2.2 Methods used in determining adjustments to the Contract Sum may include those listed in Section 7.3.3.

§ 7.2.3 A Change Order, when issued, shall be full compensation, or credit, for the extra work included, omitted, or substituted. It shall show on its face the adjustment in time for completion of the Project as a result of the change in the Work. Each Change Order shall include all costs related thereto, including all overhead, miscellaneous expenses and incidentals.

§ 7.3 CONSTRUCTION CHANGE DIRECTIVES

§ 7.3.1 A Construction Change Directive is a written order prepared by the Architect and signed by the Owner and Architect, directing a change in the Work prior to agreement on adjustment, if any, in the Contract Sum or Contract Time, or both. The Owner may by Construction Change Directive, without invalidating the Contract, order changes in the Work within the general scope of the Contract consisting of additions, deletions or other revisions, the Contract Sum and Contract Time being adjusted accordingly.

§ 7.3.2 A Construction Change Directive shall be used in the absence of total agreement on the terms of a Change Order.

§ 7.3.3 If the Construction Change Directive provides for an adjustment to the Contract Sum, the adjustment shall be based on one of the following methods:

.1 mutual acceptance of a lump sum properly itemized and supported by sufficient substantiating data to permit evaluation;

.2 unit prices stated in the Contract Documents or subsequently agreed upon;

.3 cost to be determined in a manner agreed upon by the parties and a mutually acceptable fixed or percentage fee; or

.4 as provided in Section 7.3.6.

§ 7.3.4 Upon receipt of a Construction Change Directive, the Contractor shall promptly proceed with the change in the Work involved and advise the Architect of the Contractor's agreement or disagreement with the method, if any, provided in the Construction Change Directive for determining the proposed adjustment in the Contract Sum or Contract Time.

§ 7.3.5 A Construction Change Directive signed by the Contractor indicates the agreement of the Contractor therewith, including adjustment in Contract Sum and Contract Time or the method for determining them. Such agreement shall be effective immediately and shall be recorded as a Change Order.

§ 7.3.6 If the Contractor does not respond promptly or disagrees with the method for adjustment in the Contract Sum, the method and the adjustment shall be determined by the Architect on the basis of reasonable expenditures and savings of those performing the Work attributable to the change, including, in case of an increase in the Contract Sum, a reasonable allowance for overhead and profit. In such case, and also under Section 7.3.3.3, the Contractor shall keep and present, in such form as the Architect may prescribe, an itemized accounting together with appropriate supporting data. Unless otherwise provided in the Contract Documents, costs for the purposes of this Section 7.3.6 shall be limited to the following:

.1 costs of labor, including social security, old age and unemployment insurance, fringe benefits required by agreement or custom, and workers' compensation insurance;

.2 costs of materials, supplies and equipment, including cost of transportation, whether incorporated or consumed;

.3 rental costs of machinery and equipment, exclusive of hand tools, whether rented from the Contractor or others;

.4 costs of premiums for all bonds and insurance, permit fees, and sales, use or similar taxes related to the Work; and

.5 additional costs of supervision and field office personnel directly attributable to the change.

§ 7.3.7 The amount of credit to be allowed by the Contractor to the Owner for a deletion or change which results in a net decrease in the Contract Sum shall be actual net cost as confirmed by the Architect. When both additions and credits covering related Work or substitutions are involved in a change, the allowance for overhead and profit shall be figured on the basis of net increase, if any, with respect to that change.

§ 7.3.8 Pending final determination of the total cost of a Construction Change Directive to the Owner, amounts not in dispute for such changes in the Work shall be included in Applications for Payment accompanied by a Change Order indicating the parties' agreement with part or all of such costs. For any portion of such cost that remains in dispute, the Architect will make an interim determination for purposes of monthly certification for payment for those costs. That determination of cost shall adjust the Contract Sum on the same basis as a Change Order, subject to the right of either party to disagree and assert a claim in accordance with Article 4.

§ 7.3.9 When the Owner and Contractor agree with the determination made by the Architect concerning the adjustments in the Contract Sum and Contract Time, or otherwise reach agreement upon the adjustments, such agreement shall be effective immediately and shall be recorded by preparation and execution of an appropriate Change Order.

§ 7.4 MINOR CHANGES IN THE WORK

§ 7.4.1 The Architect will have authority to order minor changes in the Work not involving adjustment in the Contract Sum or extension of the Contract Time and not inconsistent with the intent of the Contract Documents. Such changes shall be effected by written order and shall be binding on the Owner and Contractor. The Contractor shall carry out such written orders promptly.

ARTICLE 8 TIME

§ 8.1 DEFINITIONS

§ 8.1.1 Unless otherwise provided, Contract Time is the period of time, including authorized adjustments, allotted in the Contract Documents for Substantial Completion of the Work.

§ 8.1.2 The date of commencement of the Work is the date established in the Agreement.

§ 8.1.3 The date of Substantial Completion is the date certified by the Architect in accordance with Section 9.8.

§ 8.1.4 The term "day" as used in the Contract Documents shall mean calendar day unless otherwise specifically defined.

§ 8.2 PROGRESS AND COMPLETION

§ 8.2.1 Time limits stated in the Contract Documents are of the essence of the Contract. By executing the Agreement the Contractor confirms that the Contract Time is a reasonable period for performing the Work.

§ 8.2.2 The Contractor shall not knowingly, except by agreement or instruction of the Owner in writing, prematurely commence operations on the site or elsewhere prior to the effective date of insurance required by Article 11 to be furnished by the Contractor and Owner. The date of commencement of the Work shall not be changed by the

effective date of such insurance. Unless the date of commencement is established by the Contract Documents or a notice to proceed given by the Owner, the Contractor shall notify the Owner in writing not less than five days or other agreed period before commencing the Work to permit the timely filing of mortgages, mechanic's liens and other security interests.

§ 8.2.3 The Contractor shall proceed expeditiously with adequate forces and shall achieve Substantial Completion within the Contract Time.

§ 8.2.4 If the progress or completion of the Work be delayed by any fault, neglect, wrongful act or failure to act, on the part of the Contractor or anyone acting for or on behalf of the Contractor, then the Contractor shall, at its own cost, work such overtime or require the appropriate subcontractor to work such overtime as may be necessary to make up for all time lost and to avoid delay in the progress and completion of the Work.

§ 8.2.5 Should the progress or completion of the Work be delayed by any fault, neglect, act or failure to act on the part of the Contractor or anyone acting for or on behalf of the Contractor so as to cause any additional cost, expense, liability or damage to the Owner or any damage or additional cost or expense for which the Owner may or shall become liable, the Contractor shall and does hereby agree to compensate the Owner for and to indemnify the Owner against all such cost, expenses, liabilities and damages.

§ 8.3 DELAYS AND EXTENSIONS OF TIME

§ 8.3.1 If the Contractor is delayed at any time in the commencement or progress of the Work by an act or neglect of the Owner or Architect, or of an employee of either, or of a separate contractor employed by the Owner, or by changes ordered in the Work, or by labor disputes, fire, unusual delay in deliveries, unavoidable casualties or other causes beyond the Contractor's control, or by delay authorized by the Owner pending mediation and arbitration, or by other causes which the Architect determines may justify delay, then the Contract Time shall be extended by Change Order for such reasonable time as the Architect may determine. Time extensions will not be granted for delays caused by the Contractor or any entity directly or indirectly under the control of the Contractor.

§ 8.3.1.1 Time extensions approved by the Architect will extend the Contract Time only and will not justify a request by the Contractor for additional money for duration related costs, except to the extent the Contractor establishes to the Architect's and the Owner's satisfaction that any additional duration related costs claimed were necessarily incurred as a result of the extension of time, and that the claimed costs are reasonable.

§ 8.3.1.2 Notwithstanding any other provision of the Contract Documents but subject to sub-subparagraph 8.3.1.1 above, if the Contractor is delayed in the progress of the Work for any reason, including any act or omission of the Owner or the Architect or any entity for which either may be responsible, an extension of the Contract Time shall be the Contractor's exclusive remedy and the Contractor waives any right it might otherwise have to damages due to delays or disruptions of any kind to all or any part of the Work, including any acceleration of all or any part of the Work arising as a result of any delay.

§ 8.3.2 Claims relating to time shall be made in accordance with applicable provisions of Section 4.3.

§ 8.3.3 The Contractor shall bear the cost of any reasonable additional services of the Architect made necessary by delays in completion of the Work due to actions or inactions of the Contractor or any subcontractors. The Contractor shall promptly pay any such costs upon demand by the Owner. At the Owner's option, these costs may be deducted from any amounts otherwise due the Contractor.

ARTICLE 9 PAYMENTS AND COMPLETION

§ 9.1 CONTRACT SUM

§ 9.1.1 The Contract Sum is stated in the Agreement and, including authorized adjustments, is the total amount payable by the Owner to the Contractor for performance of the Work under the Contract Documents.

§ 9.2 SCHEDULE OF VALUES

§ 9.2.1 Before the first Application for Payment, the Contractor shall submit to the Architect a schedule of values allocated to various portions of the Work, prepared in such form and supported by such data to substantiate its accuracy as the Architect may require. This schedule, unless objected to by the Architect, shall be used as a basis for reviewing the Contractor's Applications for Payment.

§ 9.3 APPLICATIONS FOR PAYMENT

§ 9.3.1 At least ten days before the date established for each progress payment, the Contractor shall submit to the Architect an itemized Application for Payment for operations completed in accordance with the schedule of values. Such application shall be notarized, if required, and supported by such data substantiating the Contractor's right to payment as the Owner or Architect may require, such as copies of requisitions from Subcontractors and material suppliers, and reflecting retainage if provided for in the Contract Documents.

§ 9.3.1.1 As provided in Section 7.3.8, such applications may include requests for payment on account of changes in the Work which have been properly authorized by Construction Change Directives, or by interim determinations of the Architect, but not yet included in Change Orders.

§ 9.3.1.2 Such applications may not include requests for payment for portions of the Work for which the Contractor does not intend to pay to a Subcontractor or material supplier, unless such Work has been performed by others whom the Contractor intends to pay.

§ 9.3.2 Unless otherwise provided in the Contract Documents, payments shall be made on account of materials and equipment delivered and suitably stored at the site for subsequent incorporation in the Work. If approved in advance by the Owner, payment may similarly be made for materials and equipment suitably stored off the site at a location agreed upon in writing. Payment for materials and equipment stored on or off the site shall be conditioned upon compliance by the Contractor with procedures satisfactory to the Owner to establish the Owner's title to such materials and equipment or otherwise protect the Owner's interest, and shall include the costs of applicable insurance, storage and transportation to the site for such materials and equipment stored off the site.

§ 9.3.2.1 In requesting payment for materials stored on or off the site, the Contractor shall submit with its Application for Payment an itemized list of the stored materials prepared in sufficient detail to identify the materials and their value. Evidence such as bills of sale or other proof that the materials listed have been paid for by the Contractor may be requested by the Owner or Architect.

§ 9.3.2.2 For materials stored off the site, the Contractor shall submit with its Application for Payment evidence that the materials are stored at the location previously agreed to in writing; that the storage location is bonded; that the materials are insured while in storage and while in transit to the site; and that transportation to the site will be provided. No payment will be certified for material stored off the site until the storage location has been agreed upon in writing and the other requirements of this subparagraph have been fulfilled.

§ 9.3.3 The Contractor warrants that title to all Work covered by an Application for Payment will pass to the Owner no later than the time of payment. The Contractor further warrants that upon submittal of an Application for Payment all Work for which Certificates for Payment have been previously issued and payments received from the Owner shall, to the best of the Contractor's knowledge, information and belief, be free and clear of liens, claims, security interests or encumbrances in favor of the Contractor, Subcontractors, material suppliers, or other persons or entities making a claim by reason of having provided labor, materials and equipment relating to the Work.

§ 9.3.4 If any subcontractor, laborer or materialman of the Contractor or any person directly or indirectly acting for, through or under it or any of them, serves a notice of claim of lien on funds, files or maintains a mechanic's lien or claim against the Project or any part thereof, or against any funds due or to become due from the Owner to the Contractor, the Contractor agrees to cause such liens and claims to be satisfied, removed or discharged at its own expense by bond, payment or otherwise within ten (10) days from the date of notice thereof, and upon its failure so to do the Owner shall have the right, in addition to all other rights and remedies provided under the Contract Documents or by law, to cause such liens or claims to be satisfied, removed or discharged by whatever means the Owner chooses, at the entire cost and expense of the Contractor (such cost and expense to include legal fees and disbursements). The Contractor agrees to indemnify, protect and save harmless the Owner from and against any and all such liens and claims and actions brought or judgments rendered thereon, and from and against any and all loss, damages, liability, costs and expenses, including legal fees and disbursements, which the Owner may sustain or incur in connection therewith.

§ 9.4 CERTIFICATES FOR PAYMENT

§ 9.4.1 The Architect will, within seven days after receipt of the Contractor's Application for Payment, either issue to the Owner a Certificate for Payment, with a copy to the Contractor, for such amount as the Architect determines is properly due, or notify the Contractor and Owner in writing of the Architect's reasons for withholding certification in whole or in part as provided in Section 9.5.1.

§ 9.4.2 The issuance of a Certificate for Payment will constitute a representation by the Architect to the Owner, based on the Architect's evaluation of the Work and the data comprising the Application for Payment, that the Work has progressed to the point indicated and that, to the best of the Architect's knowledge, information and belief, the quality of the Work is in accordance with the Contract Documents. The foregoing representations are subject to an evaluation of the Work for conformance with the Contract Documents upon Substantial Completion, to results of subsequent tests and inspections, to correction of minor deviations from the Contract Documents prior to completion and to specific qualifications expressed by the Architect. The issuance of a Certificate for Payment will further constitute a representation that the Contractor is entitled to payment in the amount certified. However, the issuance of a Certificate for Payment will not be a representation that the Architect has (1) made exhaustive or continuous on-site inspections to check the quality or quantity of the Work, (2) reviewed construction means, methods, techniques, sequences or procedures, (3) reviewed copies of requisitions received from Subcontractors and material suppliers and other data requested by the Owner to substantiate the Contractor's right to payment, or (4) made examination to ascertain how or for what purpose the Contractor has used money previously paid on account of the Contract Sum.

§ 9.4.3 The Owner may withhold payment to the Contractor notwithstanding the Architect's certification if it is necessary in the Owner's opinion to do so to protect the Owner from loss due to any of the reasons set forth in subparagraph 9.5.1.

§ 9.5 DECISIONS TO WITHHOLD CERTIFICATION

§ 9.5.1 The Architect may withhold a Certificate for Payment in whole or in part, to the extent reasonably necessary to protect the Owner, if in the Architect's opinion the representations to the Owner required by Section 9.4.2 cannot be made. If the Architect is unable to certify payment in the amount of the Application, the Architect will notify the Contractor and Owner as provided in Section 9.4.1. If the Contractor and Architect cannot agree on a revised amount, the Architect will promptly issue a Certificate for Payment for the amount for which the Architect is able to make such representations to the Owner. The Architect may also withhold a Certificate for Payment or, because of subsequently discovered evidence, may nullify the whole or a part of a Certificate for Payment previously issued, to such extent as may be necessary in the Architect's opinion to protect the Owner from loss for which the Contractor is responsible, including loss resulting from acts and omissions described in Section 3.3.2, because of:

- **.1** defective Work not remedied;
- **.2** third party claims filed or reasonable evidence indicating probable filing of such claims unless security acceptable to the Owner is provided by the Contractor;
- **.3** failure of the Contractor to make payments properly to Subcontractors or for labor, materials or equipment;
- **.4** reasonable evidence that the Work cannot be completed for the unpaid balance of the Contract Sum;
- **.5** damage to the Owner or another contractor;
- **.6** reasonable evidence that the Work will not be completed within the Contract Time, and that the unpaid balance would not be adequate to cover actual or liquidated damages for the anticipated delay; or
- **.7** persistent failure to carry out the Work in accordance with the Contract Documents.

§ 9.5.2 When the above reasons for withholding certification are removed, certification will be made for amounts previously withheld.

§ 9.6 PROGRESS PAYMENTS

§ 9.6.1 After the Architect has issued a Certificate for Payment, the Owner shall make payment in the manner and within the time provided in the Contract Documents, and shall so notify the Architect.

§ 9.6.2 The Contractor shall promptly pay each Subcontractor, upon receipt of payment from the Owner, out of the amount paid to the Contractor on account of such Subcontractor's portion of the Work, the amount to which said Subcontractor is entitled, reflecting percentages actually retained from payments to the Contractor on account of such Subcontractor's portion of the Work. The Contractor shall, by appropriate agreement with each Subcontractor, require each Subcontractor to make payments to Sub-subcontractors in a similar manner.

§ 9.6.3 The Architect will, on request, furnish to a Subcontractor, if practicable, information regarding percentages of completion or amounts applied for by the Contractor and action taken thereon by the Architect and Owner on account of portions of the Work done by such Subcontractor.

§ 9.6.4 Neither the Owner nor Architect shall have an obligation to pay or to see to the payment of money to a Subcontractor except as may otherwise be required by law.

§ 9.6.5 Payment to material suppliers shall be treated in a manner similar to that provided in Sections 9.6.2, 9.6.3 and 9.6.4.

§ 9.6.6 A Certificate for Payment, a progress payment, or partial or entire use or occupancy of the Project by the Owner shall not constitute acceptance of Work not in accordance with the Contract Documents.

§ 9.6.7 Unless the Contractor provides the Owner with a payment bond in the full penal sum of the Contract Sum, payments received by the Contractor for Work properly performed by Subcontractors and suppliers shall be held by the Contractor for those Subcontractors or suppliers who performed Work or furnished materials, or both, under contract with the Contractor for which payment was made by the Owner. Nothing contained herein shall require money to be placed in a separate account and not commingled with money of the Contractor, shall create any fiduciary liability or tort liability on the part of the Contractor for breach of trust or shall entitle any person or entity to an award of punitive damages against the Contractor for breach of the requirements of this provision.

§ 9.7 FAILURE OF PAYMENT

§ 9.7.1 If the Architect does not issue a Certificate for Payment, through no fault of the Contractor, within seven days after receipt of the Contractor's Application for Payment, or if the Owner does not pay the Contractor within seven days after the date established in the Contract Documents the amount certified by the Architect or awarded by arbitration, then the Contractor may, upon seven additional days' written notice to the Owner and Architect, stop the Work until payment of the amount owing has been received. The Contract Time shall be extended appropriately and the Contract Sum shall be increased by the amount of the Contractor's reasonable costs of shut-down, delay and start-up, plus interest as provided for in the Contract Documents.

§ 9.8 SUBSTANTIAL COMPLETION

§ 9.8.1 Substantial Completion is the stage in the progress of the Work when the Work or designated portion thereof is sufficiently complete in accordance with the Contract Documents so that the Owner can occupy or utilize the Work for its intended use. The Owner's receiving a Certificates of Occupancy is a condition precedent to the Contractor's achieving Substantial Completion.

§ 9.8.2 When the Contractor considers that the Work, or a portion thereof which the Owner agrees to accept separately, is substantially complete, the Contractor shall prepare and submit to the Architect a comprehensive list of items to be completed or corrected prior to final payment. Failure to include an item on such list does not alter the responsibility of the Contractor to complete all Work in accordance with the Contract Documents.

§ 9.8.3 Upon receipt of the Contractor's list, the Architect will make an inspection to determine whether the Work or designated portion thereof is substantially complete. If the Architect's inspection discloses any item, whether or not included on the Contractor's list, which is not sufficiently complete in accordance with the Contract Documents so that the Owner can occupy or utilize the Work or designated portion thereof for its intended use, the Contractor shall, before issuance of the Certificate of Substantial Completion, complete or correct such item upon notification by the Architect. In such case, the Contractor shall then submit a request for another inspection by the Architect to determine Substantial Completion.

§ 9.8.3.1 If more than two inspections by the Architect are necessary, such additional inspections will be done at the Contractor's expense. The Architect's fees and expenses for any such additional inspections will be deducted from amounts due the Contractor on the subsequent Application for Payment.

§ 9.8.4 When the Work or designated portion thereof is substantially complete, the Architect will prepare a Certificate of Substantial Completion which shall establish the date of Substantial Completion, shall establish responsibilities of the Owner and Contractor for security, maintenance, heat, utilities, damage to the Work and insurance, and shall fix the time within which the Contractor shall finish all items on the list accompanying the Certificate. Warranties required by the Contract Documents shall commence on the date of Substantial Completion of the Work or designated portion thereof unless otherwise provided in the Certificate of Substantial Completion.

§ 9.8.5 The Certificate of Substantial Completion shall be submitted to the Owner and Contractor for their written acceptance of responsibilities assigned to them in such Certificate. Upon such acceptance and consent of surety, if any, the Owner shall make payment of retainage applying to such Work or designated portion thereof. Such payment shall be adjusted for Work that is incomplete or not in accordance with the requirements of the Contract Documents.

§ 9.9 PARTIAL OCCUPANCY OR USE

§ 9.9.1 The Owner may occupy or use any completed or partially completed portion of the Work at any stage when such portion is designated by separate agreement with the Contractor, provided such occupancy or use is consented to by the insurer as required under Section 11.4.1.5 and authorized by public authorities having jurisdiction over the Work. Such partial occupancy or use may commence whether or not the portion is substantially complete, provided the Owner and Contractor have accepted in writing the responsibilities assigned to each of them for payments, retainage, if any, security, maintenance, heat, utilities, damage to the Work and insurance, and have agreed in writing concerning the period for correction of the Work and commencement of warranties required by the Contract Documents. When the Contractor considers a portion substantially complete, the Contractor shall prepare and submit a list to the Architect as provided under Section 9.8.2. Consent of the Contractor to partial occupancy or use shall not be unreasonably withheld. The stage of the progress of the Work shall be determined by written agreement between the Owner and Contractor or, if no agreement is reached, by decision of the Architect.

§ 9.9.2 Immediately prior to such partial occupancy or use, the Owner, Contractor and Architect shall jointly inspect the area to be occupied or portion of the Work to be used in order to determine and record the condition of the Work.

§ 9.9.3 Unless otherwise agreed upon, partial occupancy or use of a portion or portions of the Work shall not constitute acceptance of Work not complying with the requirements of the Contract Documents.

§ 9.10 FINAL COMPLETION AND FINAL PAYMENT

§ 9.10.1 Upon receipt of written notice that the Work is ready for final inspection and acceptance and upon receipt of a final Application for Payment, the Architect will promptly make such inspection and, when the Architect finds the Work acceptable under the Contract Documents and the Contract fully performed, the Architect will promptly issue a final Certificate for Payment stating that to the best of the Architect's knowledge, information and belief, and on the basis of the Architect's on-site visits and inspections, the Work has been completed in accordance with terms and conditions of the Contract Documents and that the entire balance found to be due the Contractor and noted in the final Certificate is due and payable. The Architect's final Certificate for Payment will constitute a further representation that conditions listed in Section 9.10.2 as precedent to the Contractor's being entitled to final payment have been fulfilled.

§ 9.10.1.1 All warranties and guarantees required under the Contract Documents shall be assembled and delivered by the Contractor to the Architect as part of the final Application for Payment. The final Certificate for Payment will not be issued by the Architect until all warranties and guarantees have been received and accepted by the Owner.

§ 9.10.1.2 If more than two inspections by the Architect are necessary, such additional inspections will be done at the Contractor's expense. The Architect's fees and expenses for any such additional inspections will be deducted from amounts due the Contractor on the final Application for Payment.

§ 9.10.2 Neither final payment nor any remaining retained percentage shall become due until the Contractor submits to the Architect (1) an affidavit that payrolls, bills for materials and equipment, and other indebtedness connected with the Work for which the Owner or the Owner's property might be responsible or encumbered (less amounts withheld by Owner) have been paid or otherwise satisfied, (2) a certificate evidencing that insurance required by the Contract Documents to remain in force after final payment is currently in effect and will not be canceled or allowed to expire until at least 30 days' prior written notice has been given to the Owner, (3) a written statement that the Contractor knows of no substantial reason that the insurance will not be renewable to cover the period required by the Contract Documents, (4) consent of surety, if any, to final payment and (5), if required by the Owner, other data establishing payment or satisfaction of obligations, such as receipts, releases and waivers of liens, claims, security interests or encumbrances arising out of the Contract, to the extent and in such form as may be designated by the

Owner. If a Subcontractor refuses to furnish a release or waiver required by the Owner, the Contractor may furnish a bond satisfactory to the Owner to indemnify the Owner against such lien. If such lien remains unsatisfied after payments are made, the Contractor shall refund to the Owner all money that the Owner may be compelled to pay in discharging such lien, including all costs and reasonable attorneys' fees.

§ 9.10.3 If, after Substantial Completion of the Work, final completion thereof is materially delayed through no fault of the Contractor or by issuance of Change Orders affecting final completion, and the Architect so confirms, the Owner shall, upon application by the Contractor and certification by the Architect, and without terminating the Contract, make payment of the balance due for that portion of the Work fully completed and accepted. If the remaining balance for Work not fully completed or corrected is less than retainage stipulated in the Contract Documents, and if bonds have been furnished, the written consent of surety to payment of the balance due for that portion of the Work fully completed and accepted shall be submitted by the Contractor to the Architect prior to certification of such payment. Such payment shall be made under terms and conditions governing final payment, except that it shall not constitute a waiver of claims.

§ 9.10.4 The making of final payment shall constitute a waiver of Claims by the Owner except those arising from:

.1 liens, Claims, security interests or encumbrances arising out of the Contract and unsettled;

.2 failure of the Work to comply with the requirements of the Contract Documents; or

.3 terms of special warranties required by the Contract Documents.

§ 9.10.5 Acceptance of final payment by the Contractor, a Subcontractor or material supplier shall constitute a waiver of claims by that payee except those previously made in writing and identified by that payee as unsettled at the time of final Application for Payment.

§ 9.10.6 Final payment will be made by the Owner to the Contractor within thirty (30) days after the final Certificate for Payment has been issued by the Architect.

ARTICLE 10 PROTECTION OF PERSONS AND PROPERTY

§ 10.1 SAFETY PRECAUTIONS AND PROGRAMS

§ 10.1.1 The Contractor shall be responsible for initiating, maintaining and supervising all safety precautions and programs in connection with the performance of the Contract. This requirement applies continuously and is not limited to normal working hours.

§ 10.2 SAFETY OF PERSONS AND PROPERTY

§ 10.2.1 The Contractor shall take reasonable precautions for safety of, and shall provide reasonable protection to prevent damage, injury or loss to:

.1 employees on the Work and other persons who may be affected thereby;

.2 the Work and materials and equipment to be incorporated therein, whether in storage on or off the site, under care, custody or control of the Contractor or the Contractor's Subcontractors or Sub-subcontractors; and

.3 other property at the site or adjacent thereto, such as trees, shrubs, lawns, walks, pavements, roadways, structures and utilities not designated for removal, relocation or replacement in the course of construction.

§ 10.2.2 The Contractor shall give notices and comply with applicable laws, ordinances, rules, regulations and lawful orders of public authorities bearing on safety of persons or property or their protection from damage, injury or loss.

§ 10.2.3 The Contractor shall erect and maintain, as required by existing conditions and performance of the Contract, reasonable safeguards for safety and protection, including posting danger signs and other warnings against hazards, promulgating safety regulations and notifying owners and users of adjacent sites and utilities.

§ 10.2.4 When use or storage of explosives or other hazardous materials or equipment or unusual methods are necessary for execution of the Work, the Contractor shall exercise utmost care and carry on such activities under supervision of properly qualified personnel.

§ 10.2.5 The Contractor shall promptly remedy damage and loss (other than damage or loss insured under property insurance required by the Contract Documents) to property referred to in Sections 10.2.1.2 and 10.2.1.3 caused in whole or in part by the Contractor, a Subcontractor, a Sub-subcontractor, or anyone directly or indirectly employed by any of them, or by anyone for whose acts they may be liable and for which the Contractor is responsible under Sections 10.2.1.2 and 10.2.1.3, except damage or loss attributable to acts or omissions of the Owner or Architect or anyone directly or indirectly employed by either of them, or by anyone for whose acts either of them may be liable, and not attributable to the fault or negligence of the Contractor. The foregoing obligations of the Contractor are in addition to the Contractor's obligations under Section 3.18.

§ 10.2.6 The Contractor shall designate a responsible member of the Contractor's organization at the site whose duty shall be the prevention of accidents. This person shall be the Contractor's superintendent unless otherwise designated by the Contractor in writing to the Owner and Architect.

§ 10.2.7 The Contractor shall not load or permit any part of the construction or site to be loaded so as to endanger its safety.

§ 10.3 HAZARDOUS MATERIALS

§ 10.3.1 If reasonable precautions will be inadequate to prevent foreseeable bodily injury or death to persons resulting from a material or substance, including but not limited to asbestos or polychlorinated biphenyl (PCB), encountered on the site by the Contractor, the Contractor shall, upon recognizing the condition, immediately stop Work in the affected area and report the condition to the Owner and Architect in writing.

§ 10.3.2 The Owner shall obtain the services of a licensed laboratory to verify the presence or absence of the material or substance reported by the Contractor and, in the event such material or substance is found to be present, to verify that it has been rendered harmless. Unless otherwise required by the Contract Documents, the Owner shall furnish in writing to the Contractor and Architect the names and qualifications of persons or entities who are to perform tests verifying the presence or absence of such material or substance or who are to perform the task of removal or safe containment of such material or substance. The Contractor and the Architect will promptly reply to the Owner in writing stating whether or not either has reasonable objection to the persons or entities proposed by the Owner. If either the Contractor or Architect has an objection to a person or entity proposed by the Owner, the Owner shall propose another to whom the Contractor and the Architect have no reasonable objection. When the material or substance has been rendered harmless, Work in the affected area shall resume upon written agreement of the Owner and Contractor. The Contract Time shall be extended appropriately and the Contract Sum shall be increased in the amount of the Contractor's reasonable additional costs of shut-down, delay and start-up, which adjustments shall be accomplished as provided in Article 7.

§ 10.3.3 To the fullest extent permitted by law, the Owner shall indemnify and hold harmless the Contractor, Subcontractors, Architect, Architect's consultants and agents and employees of any of them from and against claims, damages, losses and expenses, including but not limited to attorneys' fees, arising out of or resulting from performance of the Work in the affected area if in fact the material or substance presents the risk of bodily injury or death as described in Section 10.3.1 and has not been rendered harmless, provided that such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself), except to the extent such damage, loss or expense is due to the negligence of a party seeking indemnity.

§ 10.4 The Owner shall not be responsible under Section 10.3 for materials and substances brought to the site by the Contractor unless such materials or substances were required by the Contract Documents. The Contractor agrees not to use fill, products or other materials to be incorporated into the Work which may contain any asbestos or PCB, or are hazardous, toxic or comprised of any items that are hazardous or toxic.

§ 10.5 If, without negligence on the part of the Contractor, the Contractor is held liable for the cost of remediation of a hazardous material or substance solely by reason of performing Work as required by the Contract Documents, the Owner shall indemnify the Contractor for all cost and expense thereby incurred.

§ 10.6 EMERGENCIES

§ 10.6.1 In an emergency affecting safety of persons or property, the Contractor shall act, at the Contractor's discretion, to prevent threatened damage, injury or loss. Additional compensation or extension of time claimed by the Contractor on account of an emergency shall be determined as provided in Section 4.3 and Article 7.

ARTICLE 11 INSURANCE AND BONDS

§ 11.1 CONTRACTOR'S LIABILITY INSURANCE

§ 11.1.1 The Contractor shall purchase from and maintain in a company or companies lawfully authorized to do business in the jurisdiction in which the Project is located such insurance as will protect the Contractor from claims set forth below which may arise out of or result from the Contractor's operations under the Contract and for which the Contractor may be legally liable, whether such operations be by the Contractor or by a Subcontractor or by anyone directly or indirectly employed by any of them, or by anyone for whose acts any of them may be liable:

.1 claims under workers' compensation, disability benefit and other similar employee benefit acts which are applicable to the Work to be performed;

.2 claims for damages because of bodily injury, occupational sickness or disease, or death of the Contractor's employees;

.3 claims for damages because of bodily injury, sickness or disease, or death of any person other than the Contractor's employees;

.4 claims for damages insured by usual personal injury liability coverage;

.5 claims for damages, other than to the Work itself, because of injury to or destruction of tangible property, including loss of use resulting therefrom;

.6 claims for damages because of bodily injury, death of a person or property damage arising out of ownership, maintenance or use of a motor vehicle;

.7 claims for bodily injury or property damage arising out of completed operations; and

.8 claims involving contractual liability insurance applicable to the Contractor's obligations under Section 3.18.

§ 11.1.2 The insurance required by Section 11.1.1 shall be written for not less than limits of liability specified in the Contract Documents or required by law, whichever coverage is greater. Coverages must be written on an occurrence basis and shall be maintained without interruption from date of commencement of the Work until date of final payment and termination of any coverage required to be maintained after final payment. Companies on which insurance is written must be acceptable to the Owner. The Owner shall be named as an additional insured under the Contractor's liability insurance.

§ 11.1.3 Certificates of insurance acceptable to the Owner shall be filed with the Owner prior to commencement of the Work. These certificates and the insurance policies required by this Section 11.1 shall contain a provision that coverages afforded under the policies will not be canceled or allowed to expire until at least 30 days' prior written notice has been given to the Owner. If any of the foregoing insurance coverages are required to remain in force after final payment and are reasonably available, an additional certificate evidencing continuation of such coverage shall be submitted with the final Application for Payment as required by Section 9.10.2. Information concerning reduction of coverage on account of revised limits or claims paid under the General Aggregate, or both, shall be furnished by the Contractor with reasonable promptness in accordance with the Contractor's information and belief.

§ 11.1.4 The Contractor's liability insurance shall be written for amounts of not less than the following, and greater if required by law:

.1	Worker's Compensation	Statutory
	Employer's Liability	$1,000,000
.2	Commercial General Liability for premises/ operations including independent contractor's protective, personal injury, contractually assumed liability, products and completed operations, broad form property damage (Including, X, C and U coverage where applicable)	$2,000,000 each occurrence/ general aggregate
.3	Comprehensive Automobile (including non-owned and hired motor vehicles)	$1,000,000 combined single limit
.4	Umbrella Liability Coverage	$10,000,000

§ 11.1.5 Products and completed operations coverage shall be maintained for one year after final payment.

§ 11.2 OWNER'S LIABILITY INSURANCE

§ 11.2.1 The Owner shall be responsible for purchasing and maintaining the Owner's usual liability insurance.

§ 11.3 PROJECT MANAGEMENT PROTECTIVE LIABILITY INSURANCE

§ 11.3.1 Optionally, the Owner may require the Contractor to purchase and maintain Project Management Protective Liability insurance from the Contractor's usual sources as primary coverage for the Owner's, Contractor's and Architect's vicarious liability for construction operations under the Contract. Unless otherwise required by the Contract Documents, the Owner shall reimburse the Contractor by increasing the Contract Sum to pay the cost of purchasing and maintaining such optional insurance coverage, and the Contractor shall not be responsible for purchasing any other liability insurance on behalf of the Owner. The minimum limits of liability purchased with such coverage shall be equal to the aggregate of the limits required for Contractor's Liability Insurance under Sections 11.1.1.2 through 11.1.1.5.

§ 11.3.2 To the extent damages are covered by Project Management Protective Liability insurance, the Owner, Contractor and Architect waive all rights against each other for damages, except such rights as they may have to the proceeds of such insurance. The policy shall provide for such waivers of subrogation by endorsement or otherwise.

§ 11.3.3 The Owner shall not require the Contractor to include the Owner, Architect or other persons or entities as additional insureds on the Contractor's Liability Insurance coverage under Section 11.1, if Project Management Protective Liability insurance is purchased as described herein.

§ 11.4 PROPERTY INSURANCE

§ 11.4.1 Unless otherwise provided, the Owner shall purchase and maintain, in a company or companies lawfully authorized to do business in the jurisdiction in which the Project is located, property insurance written on a builder's risk "all-risk" or equivalent policy form in the amount of the initial Contract Sum, plus value of subsequent Contract modifications and cost of materials supplied or installed by others, comprising total value for the entire Project at the site on a replacement cost basis without optional deductibles. Such property insurance shall be maintained, unless otherwise provided in the Contract Documents or otherwise agreed in writing by all persons and entities who are beneficiaries of such insurance, until final payment has been made as provided in Section 9.10 or until no person or entity other than the Owner has an insurable interest in the property required by this Section 11.4 to be covered, whichever is later. This insurance shall include interests of the Owner, the Contractor, Subcontractors and Sub-subcontractors in the Project.

§ 11.4.1.1 Property insurance shall be on an "all-risk" or equivalent policy form and shall include, without limitation, insurance against the perils of fire (with extended coverage) and physical loss or damage including, without duplication of coverage, theft, vandalism, malicious mischief, collapse, earthquake, flood, windstorm, falsework, testing and startup, temporary buildings and debris removal including demolition occasioned by enforcement of any applicable legal requirements, and shall cover reasonable compensation for Architect's and Contractor's services and expenses required as a result of such insured loss.

§ 11.4.1.2 If the Owner does not intend to purchase such property insurance required by the Contract and with all of the coverages in the amount described above, the Owner shall so inform the Contractor in writing prior to commencement of the Work. The Contractor may then effect insurance which will protect the interests of the Contractor, Subcontractors and Sub-subcontractors in the Work, and by appropriate Change Order the cost thereof shall be charged to the Owner. If the Contractor is damaged by the failure or neglect of the Owner to purchase or maintain insurance as described above, without so notifying the Contractor in writing, then the Owner shall bear all reasonable costs properly attributable thereto.

§ 11.4.1.3 If the property insurance requires deductibles, the Owner shall pay costs not covered because of such deductibles.

§ 11.4.1.4 This property insurance shall cover portions of the Work stored off the site, and also portions of the Work in transit.

§ 11.4.1.5 Partial occupancy or use in accordance with Section 9.9 shall not commence until the insurance company or companies providing property insurance have consented to such partial occupancy or use by endorsement or otherwise. The Owner and the Contractor shall take reasonable steps to obtain consent of the insurance company or companies and shall, without mutual written consent, take no action with respect to partial occupancy or use that would cause cancellation, lapse or reduction of insurance.

§ 11.4.2 Boiler and Machinery Insurance. The Owner shall purchase and maintain boiler and machinery insurance required by the Contract Documents or by law, which shall specifically cover such insured objects during installation and until final acceptance by the Owner; this insurance shall include interests of the Owner, Contractor, Subcontractors and Sub-subcontractors in the Work, and the Owner and Contractor shall be named insureds.

§ 11.4.3 Loss of Use Insurance. The Owner, at the Owner's option, may purchase and maintain such insurance as will insure the Owner against loss of use of the Owner's property due to fire or other hazards, however caused. The Owner waives all rights of action against the Contractor for loss of use of the Owner's property, including consequential losses due to fire or other hazards however caused.

§ 11.4.4 If the Contractor requests in writing that insurance for risks other than those described herein or other special causes of loss be included in the property insurance policy, the Owner shall, if possible, include such insurance, and the cost thereof shall be charged to the Contractor by appropriate Change Order.

§ 11.4.5 If during the Project construction period the Owner insures properties, real or personal or both, at or adjacent to the site by property insurance under policies separate from those insuring the Project, or if after final payment property insurance is to be provided on the completed Project through a policy or policies other than those insuring the Project during the construction period, the Owner shall waive all rights in accordance with the terms of Section 11.4.7 for damages caused by fire or other causes of loss covered by this separate property insurance. All separate policies shall provide this waiver of subrogation by endorsement or otherwise.

§ 11.4.6 Before an exposure to loss may occur, the Owner shall file with the Contractor a copy of each policy that includes insurance coverages required by this Section 11.4. Each policy shall contain all generally applicable conditions, definitions, exclusions and endorsements related to this Project. Each policy shall contain a provision that the policy will not be canceled or allowed to expire, and that its limits will not be reduced, until at least 30 days' prior written notice has been given to the Contractor.

§ 11.4.7 Waivers of Subrogation. The Owner and Contractor waive all rights against (1) each other and any of their subcontractors, sub-subcontractors, agents and employees, each of the other, and (2) the Architect, Architect's consultants, separate contractors described in Article 6, if any, and any of their subcontractors, sub-subcontractors, agents and employees, for damages caused by fire or other causes of loss to the extent covered by property insurance obtained pursuant to this Section 11.4 or other property insurance applicable to the Work, except such rights as they have to proceeds of such insurance held by the Owner as fiduciary. The Owner or Contractor, as appropriate, shall require of the Architect, Architect's consultants, separate contractors described in Article 6, if any, and the subcontractors, sub-subcontractors, agents and employees of any of them, by appropriate agreements, written where legally required for validity, similar waivers each in favor of other parties enumerated herein. The policies shall provide such waivers of subrogation by endorsement or otherwise. A waiver of subrogation shall be effective as to a person or entity even though that person or entity would otherwise have a duty of indemnification, contractual or otherwise, did not pay the insurance premium directly or indirectly, and whether or not the person or entity had an insurable interest in the property damaged.

§ 11.4.8 A loss insured under Owner's property insurance shall be adjusted by the Owner as fiduciary and made payable to the Owner as fiduciary for the insureds, as their interests may appear, subject to requirements of any applicable mortgagee clause and of Section 11.4.10. The Contractor shall pay Subcontractors their just shares of insurance proceeds received by the Contractor, and by appropriate agreements, written where legally required for validity, shall require Subcontractors to make payments to their Sub-subcontractors in similar manner.

§ 11.4.9 If required in writing by a party in interest, the Owner as fiduciary shall, upon occurrence of an insured loss, give bond for proper performance of the Owner's duties. The cost of required bonds shall be charged against proceeds received as fiduciary. The Owner shall deposit in a separate account proceeds so received, which the Owner shall distribute in accordance with such agreement as the parties in interest may reach, or in accordance with an arbitration award in which case the procedure shall be as provided in Section 4.6. If after such loss no other special agreement is made and unless the Owner terminates the Contract for convenience, replacement of damaged property shall be performed by the Contractor after notification of a Change in the Work in accordance with Article 7.

§ 11.4.10 The Owner as fiduciary shall have power to adjust and settle a loss with insurers unless one of the parties in interest shall object in writing within five days after occurrence of loss to the Owner's exercise of this power; if such objection is made, the dispute shall be resolved as provided in Sections 4.5 and 4.6. The Owner as fiduciary shall, in the case of arbitration, make settlement with insurers in accordance with directions of the arbitrators. If distribution of insurance proceeds by arbitration is required, the arbitrators will direct such distribution.

§ 11.5 PERFORMANCE BOND AND PAYMENT BOND

§ 11.5.1 The Owner shall have the right to require the Contractor to furnish bonds covering faithful performance of the Contract and payment of obligations arising thereunder as stipulated in bidding requirements or specifically required in the Contract Documents on the date of execution of the Contract. The bonds shall be written on AIA Document A312 and shall be executed by a responsible surety licensed in North Carolina and acceptable to the Owner.

§ 11.5.2 Upon the request of any person or entity appearing to be a potential beneficiary of bonds covering payment of obligations arising under the Contract, the Contractor shall promptly furnish a copy of the bonds or shall permit a copy to be made.

§ 11.6 GENERAL REQUIREMENTS

§ 11.6.1 All insurance procured by the Contractor under this Article shall be provided by insurance companies having policyholder ratings not lower than "A" and financial ratings not lower than "XII" in the Best's Insurance Guide, latest edition in effect as of the date of the Agreement, and subsequently in effect at the time of renewal of any policies required under this Article.

§ 11.6.2 If the Owner or the Contractor is damaged by the failure of the other party to purchase or maintain the insurance required under this Article, the party who failed to purchase or maintain the required insurance shall bear all costs (including attorneys' fees) properly attributable thereto.

ARTICLE 12 UNCOVERING AND CORRECTION OF WORK

§ 12.1 UNCOVERING OF WORK

§ 12.1.1 If a portion of the Work is covered contrary to the Architect's request or to requirements specifically expressed in the Contract Documents, it must, if required in writing by the Architect, be uncovered for the Architect's examination and be replaced at the Contractor's expense without change in the Contract Time.

§ 12.1.2 If a portion of the Work has been covered which the Architect has not specifically requested to examine prior to its being covered, the Architect may request to see such Work and it shall be uncovered by the Contractor. If such Work is in accordance with the Contract Documents, costs of uncovering and replacement shall, by appropriate Change Order, be at the Owner's expense. If such Work is not in accordance with the Contract Documents, correction shall be at the Contractor's expense unless the condition was caused by the Owner or a separate contractor in which event the Owner shall be responsible for payment of such costs.

§ 12.2 CORRECTION OF WORK

§ 12.2.1 BEFORE OR AFTER SUBSTANTIAL COMPLETION

§ 12.2.1.1 The Contractor shall promptly correct Work rejected by the Architect or failing to conform to the requirements of the Contract Documents, whether discovered before or after Substantial Completion and whether or not fabricated, installed or completed. Costs of correcting such rejected Work, including additional testing and inspections and compensation for the Architect's services and expenses made necessary thereby, shall be at the Contractor's expense.

§ 12.2.2 AFTER SUBSTANTIAL COMPLETION

§ 12.2.2.1 In addition to the Contractor's obligations under Section 3.5, if, within one year after the date of Substantial Completion of the Work or designated portion thereof or after the date for commencement of warranties established under Section 9.9.1, or by terms of an applicable special warranty required by the Contract Documents, any of the Work is found to be not in accordance with the requirements of the Contract Documents, the Contractor shall correct it promptly after receipt of written notice from the Owner to do so unless the Owner has previously given the Contractor a written acceptance of such condition. The Owner shall give such notice promptly after discovery of the condition. During the one-year period for correction of Work, if the Owner, after discovery of the condition, fails to notify the Contractor and give the Contractor an opportunity to make the correction, the Owner waives the rights to require correction by the Contractor and to make a claim for breach of warranty. If the Contractor fails to correct nonconforming Work within a reasonable time during that period after receipt of notice from the Owner or Architect, the Owner may correct it in accordance with Section 2.4.

§ 12.2.2.2 The one-year period for correction of Work shall be extended with respect to portions of Work first performed after Substantial Completion by the period of time between Substantial Completion and the actual performance of the Work.

§ 12.2.2.3 The one-year period for correction of Work shall not be extended by corrective Work performed by the Contractor pursuant to this Section 12.2.

§ 12.2.3 The Contractor shall remove from the site portions of the Work which are not in accordance with the requirements of the Contract Documents and are neither corrected by the Contractor nor accepted by the Owner.

§ 12.2.4 The Contractor shall bear the cost of correcting destroyed or damaged construction, whether completed or partially completed, of the Owner or separate contractors caused by the Contractor's correction or removal of Work which is not in accordance with the requirements of the Contract Documents.

§ 12.2.5 Nothing contained in this Section 12.2 shall be construed to establish a period of limitation with respect to other obligations which the Contractor might have under the Contract Documents. Establishment of the one-year period for correction of Work as described in Section 12.2.2 relates only to the specific obligation of the Contractor to correct the Work, and has no relationship to the time within which the obligation to comply with the Contract Documents may be sought to be enforced, nor to the time within which proceedings may be commenced to establish the Contractor's liability with respect to the Contractor's obligations other than specifically to correct the Work.

§ 12.3 ACCEPTANCE OF NONCONFORMING WORK

§ 12.3.1 If the Owner prefers to accept Work which is not in accordance with the requirements of the Contract Documents, the Owner may do so instead of requiring its removal and correction, in which case the Contract Sum will be reduced as appropriate and equitable. Such adjustment shall be effected whether or not final payment has been made.

ARTICLE 13 MISCELLANEOUS PROVISIONS

§ 13.1 GOVERNING LAW

§ 13.1.1 The Contract shall be governed by the law of the place where the Project is located.

§ 13.2 SUCCESSORS AND ASSIGNS

§ 13.2.1 The Owner and Contractor respectively bind themselves, their partners, successors, assigns and legal representatives to the other party hereto and to partners, successors, assigns and legal representatives of such other party in respect to covenants, agreements and obligations contained in the Contract Documents. Except as provided in Section 13.2.2, neither party to the Contract shall assign the Contract as a whole without written consent of the other. If either party attempts to make such an assignment without such consent, that party shall nevertheless remain legally responsible for all obligations under the Contract.

§ 13.2.2 The Owner may, without consent of the Contractor, assign the Contract to an institutional lender providing construction financing for the Project. In such event, the lender shall assume the Owner's rights and obligations under the Contract Documents. The Contractor shall execute all consents reasonably required to facilitate such assignment.

§ 13.3 WRITTEN NOTICE

§ 13.3.1 Written notice shall be deemed to have been duly served if delivered in person to the individual or a member of the firm or entity or to an officer of the corporation for which it was intended, or if delivered at or sent by registered or certified mail to the last business address known to the party giving notice.

§ 13.4 RIGHTS AND REMEDIES

§ 13.4.1 Duties and obligations imposed by the Contract Documents and rights and remedies available thereunder shall be in addition to and not a limitation of duties, obligations, rights and remedies otherwise imposed or available by law.

§ 13.4.2 No action or failure to act by the Owner, Architect or Contractor shall constitute a waiver of a right or duty afforded them under the Contract, nor shall such action or failure to act constitute approval of or acquiescence in a breach thereunder, except as may be specifically agreed in writing.

§ 13.4.3 If any provision of the Contract Documents is held to be illegal, invalid or unenforceable under any law, such provision shall be fully severable, and all other provisions shall remain in full force and effect.

§ 13.5 TESTS AND INSPECTIONS

§ 13.5.1 Tests, inspections and approvals of portions of the Work required by the Contract Documents or by laws, ordinances, rules, regulations or orders of public authorities having jurisdiction shall be made at an appropriate time. Unless otherwise provided, the Contractor shall make arrangements for such tests, inspections and approvals with an independent testing laboratory or entity acceptable to the Owner, or with the appropriate public authority, and shall bear all related costs of tests, inspections and approvals. The Contractor shall give the Architect timely notice of when and where tests and inspections are to be made so that the Architect may be present for such procedures. The Owner shall bear costs of tests, inspections or approvals which do not become requirements until after bids are received or negotiations concluded.

§ 13.5.2 If the Architect, Owner or public authorities having jurisdiction determine that portions of the Work require additional testing, inspection or approval not included under Section 13.5.1, the Architect will, upon written authorization from the Owner, instruct the Contractor to make arrangements for such additional testing, inspection or approval by an entity acceptable to the Owner, and the Contractor shall give timely notice to the Architect of when and where tests and inspections are to be made so that the Architect may be present for such procedures. Such costs, except as provided in Section 13.5.3, shall be at the Owner's expense.

§ 13.5.3 If such procedures for testing, inspection or approval under Sections 13.5.1 and 13.5.2 reveal failure of the portions of the Work to comply with requirements established by the Contract Documents, all costs made necessary by such failure including those of repeated procedures and compensation for the Architect's services and expenses shall be at the Contractor's expense.

§ 13.5.4 Required certificates of testing, inspection or approval shall, unless otherwise required by the Contract Documents, be secured by the Contractor and promptly delivered to the Architect.

§ 13.5.5 If the Architect is to observe tests, inspections or approvals required by the Contract Documents, the Architect will do so promptly and, where practicable, at the normal place of testing.

§ 13.5.6 Tests or inspections conducted pursuant to the Contract Documents shall be made promptly to avoid unreasonable delay in the Work.

§ 13.6 INTEREST

§ 13.6.1 Payments due and unpaid under the Contract Documents shall bear interest from the date payment is due at such rate as the parties may agree upon in writing or, in the absence thereof, at the legal rate prevailing from time to time at the place where the Project is located.

§ 13.7 COMMENCEMENT OF STATUTORY LIMITATION PERIOD

§ 13.7.1

§ 13.8 Project Records. The Contractor and its subcontractors shall maintain the following Project records: bid estimates, payment records, payroll records, meeting minutes, daily reports, logs, diaries, schedules, internal correspondence, notes and memoranda and all correspondence between and among all of the parties involved in the Project including but not limited to all lower tier subcontractors, suppliers, manufacturers and vendors, the Architect and the Owner. These Project records shall be made readily available to the Owner upon request for a period of seven (7) years after final completion of the Project.

§ 13.9 The Contractor shall maintain and shall require all subcontractors to maintain a drug free workplace.

ARTICLE 14 TERMINATION OR SUSPENSION OF THE CONTRACT

§ 14.1 TERMINATION BY THE CONTRACTOR

§ 14.1.1 The Contractor may terminate the Contract if the Work is stopped for a period of 30 consecutive days through no act or fault of the Contractor or a Subcontractor, Sub-subcontractor or their agents or employees or any other persons or entities performing portions of the Work under direct or indirect contract with the Contractor, for any of the following reasons:

.1 issuance of an order of a court or other public authority having jurisdiction which requires all Work to be stopped;

.2 an act of government, such as a declaration of national emergency which requires all Work to be stopped;

.3 because the Architect has not issued a Certificate for Payment and has not notified the Contractor of the reason for withholding certification as provided in Section 9.4.1, or because the Owner has not made payment on a Certificate for Payment within the time stated in the Contract Documents; or

.4 the Owner has failed to furnish to the Contractor promptly, upon the Contractor's request, reasonable evidence as required by Section 2.2.1.

§ 14.1.2 The Contractor may terminate the Contract if, through no act or fault of the Contractor or a Subcontractor, Sub-subcontractor or their agents or employees or any other persons or entities performing portions of the Work under direct or indirect contract with the Contractor, repeated suspensions, delays or interruptions of the entire Work by the Owner as described in Section 14.3 constitute in the aggregate more than 100 percent of the total number of days scheduled for completion, or 120 days in any 365-day period, whichever is less.

§ 14.1.3 If one of the reasons described in Section 14.1.1 or 14.1.2 exists, the Contractor may, upon seven days' written notice to the Owner and Architect, terminate the Contract and recover from the Owner payment for Work executed and for proven loss with respect to materials, equipment, tools, and construction equipment and machinery, including reasonable overhead, profit and damages.

§ 14.1.4 If the Work is stopped for a period of 60 consecutive days through no act or fault of the Contractor or a Subcontractor or their agents or employees or any other persons performing portions of the Work under contract with the Contractor because the Owner has persistently failed to fulfill the Owner's obligations under the Contract Documents with respect to matters important to the progress of the Work, the Contractor may, upon seven additional days' written notice to the Owner and the Architect, terminate the Contract and recover from the Owner as provided in Section 14.1.3.

§ 14.2 TERMINATION BY THE OWNER FOR CAUSE

§ 14.2.1 The Owner may terminate the Contract if the Contractor:

.1 persistently or repeatedly refuses or fails to supply enough properly skilled workers or proper materials;

.2 fails to make payment to Subcontractors for materials or labor in accordance with the respective agreements between the Contractor and the Subcontractors;

.3 persistently disregards laws, ordinances, or rules, regulations or orders of a public authority having jurisdiction; or

.4 otherwise is guilty of substantial breach of a provision of the Contract Documents.

§ 14.2.2 When any of the above reasons exist, the Owner, upon certification by the Architect that sufficient cause exists to justify such action, may without prejudice to any other rights or remedies of the Owner and after giving the Contractor and the Contractor's surety, if any, seven days' written notice, terminate employment of the Contractor and may, subject to any prior rights of the surety:

.1 take possession of the site and of all materials, equipment, tools, and construction equipment and machinery thereon owned by the Contractor;

.2 accept assignment of subcontracts pursuant to Section 5.4; and

.3 finish the Work by whatever reasonable method the Owner may deem expedient. Upon request of the Contractor, the Owner shall furnish to the Contractor a detailed accounting of the costs incurred by the Owner in finishing the Work.

§ 14.2.3 When the Owner terminates the Contract for one of the reasons stated in Section 14.2.1, the Contractor shall not be entitled to receive further payment until the Work is finished.

§ 14.2.4 If the unpaid balance of the Contract Sum exceeds costs of finishing the Work, including compensation for the Architect's services and expenses made necessary thereby, and other damages incurred by the Owner and not expressly waived, such excess shall be paid to the Contractor. If such costs and damages exceed the unpaid balance, the Contractor shall pay the difference to the Owner. The amount to be paid to the Contractor or Owner, as the case may be, shall be certified by the Architect, upon application, and this obligation for payment shall survive termination of the Contract.

§ 14.2.5 The Contractor shall bear the costs of any additional services of the Architect resulting from the Owner's termination of the Contract pursuant to this paragraph 14.2.

§ 14.2.6 In the event the Owner's termination for cause set out in paragraph 14.2.2 is deemed invalid or unjustified, then such termination shall automatically become a termination for convenience under paragraph 14.4.

§ 14.3 SUSPENSION BY THE OWNER FOR CONVENIENCE

§ 14.3.1 The Owner may, without cause, order the Contractor in writing to suspend, delay or interrupt the Work in whole or in part for such period of time as the Owner may determine.

§ 14.3.2 The Contract Sum and Contract Time shall be adjusted for increases in the cost and time caused by suspension, delay or interruption as described in Section 14.3.1. Adjustment of the Contract Sum shall include profit. No adjustment shall be made to the extent:

.1 that performance is, was or would have been so suspended, delayed or interrupted by another cause for which the Contractor is responsible; or

.2 that an equitable adjustment is made or denied under another provision of the Contract.

§ 14.4 TERMINATION BY THE OWNER FOR CONVENIENCE

§ 14.4.1 The Owner may, at any time, terminate the Contract for the Owner's convenience and without cause.

§ 14.4.2 Upon receipt of written notice from the Owner of such termination for the Owner's convenience, the Contractor shall:

.1 cease operations as directed by the Owner in the notice;

.2 take actions necessary, or that the Owner may direct, for the protection and preservation of the Work; and

.3 except for Work directed to be performed prior to the effective date of termination stated in the notice, terminate all existing subcontracts and purchase orders and enter into no further subcontracts and purchase orders.

§ 14.4.3 In case of such termination for the Owner's convenience, the Contractor shall be entitled to receive payment for Work executed, and actual costs incurred by reason of such termination.

EXHIBIT B

PROJECT COST ELEMENTS

I. CONSTRUCTION MANAGEMENT SERVICES

DESCRIPTION	PRECON. FEE	BASIC FEE	GEN. CONDS	A/E COST	OWNER COST	DIRECT COST
Project Superintendent(s)			X			
Assistant Superintendent(s)			X			
Field Engineer			X			
Corporate Executives		X				
Principal in Charge		X				
Project Executive			X			
Legal (Basic Services)		X				
Project Manager			X			
Accounting		X				
Scheduling			X			
Life-Cycle	X					
Energy Management	X					
Production Engineering	X					
Purchasing			X			
Value Engineering	X					
Systems Development	X					
Estimating	X					
Cost Engineers	X					
Project Coordinator			X			
Project Expeditor			X			
Drafting Detailer			X			
Drawing Checker			X			
E.E.O. Officer		X				
Secretarial			X			
Clerk-Typist		X				
Mechanical Coordinator			X			
Electrical Coordinator			X			
Project Engineer			X			
Scheduling Engineer			X			
Time Keeper/Checker			X			
Safety Engineer			X			
Superintendents Transportation			X			
Off-Site Staff Travel Costs			X			
Off-Site Staff Transportation			X			
On-Site Project Manager Trans.			X			
Engineers Transportation			X			
Project Staff Moving Expense			X			
Project Staff Subsistence Costs			X			
Project Budget Estimating	X		X			
Project Phasing	X		X			

NOTE: ALL PERSONNEL COSTS SHALL INCLUDE SALARIES AND FRINGE BENEFITS.

II. SAFETY, SECURITY, AND SERVICES

DESCRIPTION	BASIC FEE	GEN. CONDS.	A/E COST	OWNER COST	DIRECT COST
Safety Equipment		X			
First Aid Supplies		X			
Handrails & Toe Boards					X
Opening Protection					X
Fire Extinguishers/Fire Watch					X
Security Guard/Watchman Svcs.					X
Weekly Cleanup					X
Final Cleanup					X
Temporary Fencing					X
Covered Walkways					X
Barricades					X
Safety Nets					X
Ambulance Costs					X
Debris Hauling/Removal					X
Traffic Control					X
2-Way Radio Equipment					X
Trash Chute & Hoppers					X
Snow & Ice Removal					X

NOTE: ALL PERSONNEL COSTS SHALL INCLUDE SALARIES AND FRINGE BENEFITS

III. FACILITIES, EQUIPMENT, AND SERVICES

DESCRIPTION	BASIC FEE	GEN. CONDS.	A/E COST	OWNER COST	DIRECT COST
Office Trailer Rental		X			
Tool/Utility Trailer Rental					X
Water/Ice					X
Temp. Lighting/Wiring					X
Power Expenses					X
Temp. Water Services					X
Temp. Heat Expenses					X
Temp. Toilets/Sewer Services					X
Change/Shower Rooms					X
Lunch Rooms					X
Temporary Stairs					X
Temp. Enclosures/Partitions					X
Protect Signs/Bulletin Boards					X
Telephone Expenses*		X			
Temporary Roads					X
Trucks					X
Air Compressors					X
Dewatering Equipment					X
Generators					X
Miscellaneous Equipment					X
Fuel Repairs/Maintenance					X

Note: ALL PERSONNEL COSTS SHALL INCLUDE SALARIES AND FRINGE BENEFITS

* site office telephone expenses only, home office is part of fee.

IV. VERTICAL HOISTING

DESCRIPTION	BASIC FEE	GEN. CONDS	A/E COST	OWNER COST	DIRECT COST
Hoist & Tower Rental					X
Small Material Hoist Rental					X
Hoist Slings & Fronts					X
Hoist Operators					X
Hoist Safety Inspections					X
Hoist Material Skips					X
Hoist Material Hoppers					X
Erect & Dismantle Hoists					X
Fuel/Repairs/Maintenance					X
Hoist Communication					X
Crane Rental					X
Crane Operators					X
Crane Safety Inspections					X
Erect & Dismantle Crane					X
Fuel/Repairs/Maintenance					X
Crane Raising/Jumping Costs					X
Temporary Elevator Rental					X
Elevator Operation Cost					X
Elevator Repairs & Maintenance					X
Cage Rider @ Elevator					X
Safety Inspections					X
Forklift Rental					X
Forklift Operators					X
Forklift Safety Inspections					X
Fuel/Repairs/Maintenance					X
Elevator Service Costs					X

NOTE: ALL PERSONNEL COSTS SHALL INCLUDE SALARIES AND FRINGE BENEFITS

V. REPRODUCTION AND PRINTING

DESCRIPTION	PRECON FEE	BASIC FEE	GEN. CONDS	A/E COST	OWNER COST	DIRECT COST
Design Phase						
Cost Study Documents				X		
Systems Study Documents				X		
Bid Package Documents			X	X		
Bidding Instructions			X	X		
Construction Documents			X	X		
Postage & Express Costs			X	X		
As-Built Documents (drafting)			X	X		
As-Built Documents (printing)			X	X		
Construction Phase						
Accounting Forms		X				
Field Reporting Forms						X
Contract Agreements		X				
Schedule Report Forms		X				
Estimating Forms		X				
Cost Reporting Forms		X				
Presentation Charts & Graphics		X				
Value Analysis Studies	X					
Data Processing (In-House)		X				
Reference Materials		X				
Duplication Expense (misc.)						X
Shop Drawing Printing						X
Maintenance Manuals						X
Operating Manuals						X
Special Forms		X				
Postage & Delivery Expense			X			

Note: ALL PERSONNEL COSTS SHALL INCLUDE SALARIES AND FRINGE BENEFITS

VI. QUALITY CONTROL

DESCRIPTION	BASIC FEE	GEN. CONDS.	A/E COST	OWNER COST	DIRECT COST
Chief Inspector			X		
Field Inspector			X		
Inspectors Office			X		
Inspectors Transportation			X		
Inspectors Equipment			X		
Special Inspection Consultants			X		
Special Testing Consultants				X	
Concrete Testing				X	
Masonry Testing				X	
Compaction Testing				X	
Welding Inspections				X	
Soils Investigations				X	
Special Testing Services				X	
Field Office Supplies/Materials					X
Project Photographs					X
Warranty Inspection Coord.	X				
Air & Water Balancing				X	
Operator On-Site Training					X

Prepare Operation Manuals	X
Prepare Maintenance Manuals	X

NOTE: ALL PERSONNEL COSTS SHALL INCLUDE SALARIES AND FRINGE BENEFITS

VII. PERMITS AND SPECIAL FEES

DESCRIPTION	BASIC FEE	GEN. CONDS.	A/E COST	OWNER COST	DIRECT COST
Storage Yard Rental					X
Parking Lot Rentals					
Parking Fees					X
Curb & Gutter Permits					X
Sign Permits					X
Staking & Layout Fees/Costs					X
Sidewalk Permits					X
Landscape Permits					X
Street/Curb Design Charge					X
Building Permits					X
Plan Check Fees					X
Water Connection Fee*					X
Sanitary Connection Fee*					X
Storm Connection Fee					X
Gas Service Charge					X
Power Service Charge*					X
Steam Service Charge*					X
Chiller Water Service Charge*					X
Special Tap Fees					X
Contractors Licenses		X			
Royalties		X			
Zoning Fees / Consultants				X	
Use Fees					X
Construction Equip. Licenses					X
Construction Equip. Permits					X
A.G.C. Fees	X				

NOTE; ALL PERSONNEL COSTS SHALL INCLUDE SALARIES AND FRINGE BENEFITS
* Represent final connection costs, not temporary

VIII. INSURANCE AND BONDS

DESCRIPTION	BASIC FEE	GEN. CONDS.	A/E COST	OWNER COST	DIRECT COST
Builders Risk Insurance					X
Errors & Omissions			X		
General Liability					X
Completed Operations Liability					X
Excess Liability Coverage					X
Workman’s Compensation*					X
FICA Insurance*					X
Federal Unemployment*					X
State Unemployment*					X
Payment Bond					X
Performance Bond					X
Off-Site Insurance	X				
Off-Site Staff Taxes	X				

NOTE: ALL PERSONNEL COSTS SHALL INCLUDE SALARIES AND FRINGE BENEFITS
* on-site staff only

IX. OTHER COSTS

DESCRIPTION	BASIC FEE	GEN. CONDS.	A/E COST	OWNER COST	DIRECT COST
Project Taxes					X
Construction Equipment					X
Construction Labor Costs					X
Construction Materials					X
Cost of Design & Engineering			X		
A/E Cost for Bid Packages			X		
Preliminary Soils Investigations				X	
Title/Development Cost				X	
Land Costs				X	
Financing/Interest Cost				X	
Interim Financing Costs				X	
Owner Change Contingency				X	
Building Operation After Move-In				X	
Building Maint. After Move-In				X	
Moving Coordination				X	
Moving Costs				X	
Corrective Work Extra					X
Costs of Emergency Work					X
CM General Overhead Cost	X				
CM Profit/Margin	X				
Costs Over GMP	X				

NOTE: ALL PERSONAL COSTS SHALL INCLUDE SALARIES AND FRINGE BENEFITS

Exhibit C

STATE OF _____

COUNTY OF _____

CONTRACTOR'S RELEASE AND WAIVER OF LIENS
(Submit with every Application for Payment)

The undersigned, being duly sworn, deposes and states as set forth below.

1. The undersigned, under a contract with Targacept, Inc. ("Owner") has furnished labor, services and materials on the premises and improvements known as Targacept Animal Care Facility, Fit-Up of First Floor, located at 200 East First Street in Winston-Salem, North Carolina (the "Property").

2. Except as listed below, and except as to applicable retainages, if any, all labor, services and materials furnished on the Property through the last date of the previous Application for Payment submitted by the undersigned have been paid in full.

3. Effective upon receipt of $_____ in payment of the amount owed, and except as to applicable retainages, if any, the undersigned, for itself and any person or entity with which it has contracted for any portion of the labor or materials supplied pursuant to the undersigned's contract referenced above or claiming under or through the undersigned, forever waives, releases and relinquishes any and all claims or rights of lien, liens, and claims of whatever kind, in law or equity, that the undersigned and any person or entity with which it has contracted for any portion of the labor or materials supplied pursuant to the undersigned's contract referenced above or claiming under or through the undersigned, may now or in the future have against the Owner of the Property or its affiliated companies, officers, directors, shareholders, agents, employees, representatives, sureties, trustees, successors and assigns or against the Property or against the funds due or to become due on account of or in any way connected with labor, services and materials furnished on the Property through the date of this affidavit.

4. The undersigned represents and warrants to the Owner that it or the Owner has either not been served a notice of claim of lien on funds by any subcontractors arising from labor, services and materials on the premises and improvements on the Property, or that if such a notice of claim of lien on funds has been served, the undersigned has deposited with the clerk of court a corporate surety bond in accordance with N.C.G.S. § 44A-16(6).

Signed and sealed this ____ day of _____, ____.

Shelco, Inc.
(name of contractor)

(SEAL)

By: _____
Title: _____

STATE OF _____

COUNTY OF _____

Subscribed and sworn to before me this ____ day of _____, ____.

_____
Notary Public

My commission expires:

_____

Exhibit D

STATE OF _____

COUNTY OF _____

CONTRACTOR'S RELEASE AND WAIVER OF LIENS ON FINAL PAYMENT

(Contractor to submit with final Application for Payment)

The undersigned, being duly sworn, deposes and states as set forth below.

1. The undersigned, under a contract with Targacept, Inc. ("Owner") has furnished labor, services and materials on the premises and improvements known as Targacept Animal Care Facility, Fit-Up of First Floor, located at 200 East First Street in Winston-Salem, North Carolina (the "Property").

2. Except as to applicable retainages, if any, all labor, services and materials furnished on the Property through the last date of the previous application for payment submitted by the undersigned have been paid in full.

3. Effective upon receipt of $_____, the undersigned, for itself and any person or entity with which it has contracted for any portion of the labor or materials supplied pursuant to the undersigned's contract referenced above or claiming under or through the undersigned, forever waives, releases and relinquishes any and all claims or rights of lien, liens, and claims of whatever kind, in law or equity, that the undersigned and any person or entity with which it has contracted for any portion of the labor or materials supplied pursuant to the undersigned's contract referenced above or claiming under or through the undersigned, may now or in the future have against the Owner of the Property or its affiliated companies, officers, directors, shareholders, agents, employees, representatives, sureties, trustees, successors and assigns or against the Property or against the funds due or to become due on account of or in any way connected with labor, services and materials furnished on the Property through the date of this affidavit.

4. The undersigned represents and warrants to the Owner that it or the Owner has either not been served a notice of claim of lien on funds by any subcontractors arising from labor, services and materials on the premises and improvements on the Property, or that if such a notice of claim of lien on funds has been served, the undersigned has deposited with the clerk of court a corporate surety bond in accordance with N.C.G.S. § 44A-16(6).

Signed and sealed this ____ day of _____, ____.

Shelco, Inc.
(name of contractor)

(SEAL)

By: _____

Title: _____

STATE OF _____

COUNTY OF _____

Subscribed and sworn to before me this ____ day of _____, ____.

_____
Notary Public

My commission expires:

_____

Exhibit E

STATE OF _____

COUNTY OF _____

SUBCONTRACTOR'S RELEASE AND WAIVER OF LIENS ON FINAL PAYMENT

(Subcontractors and Suppliers to submit with final Application for Payment)

The undersigned, being duly sworn, deposes and states as set forth below.

1. The undersigned, under a contract with _____ ("Contractor or Subcontractor") has furnished labor, services and materials on the premises and improvements known as Targacept Animal Care Facility, Fit-Up of First Floor, located at 200 East First Street in Winston-Salem, North Carolina (the "Property"), owned by Targacept, Inc. ("Owner").

2. Except as to applicable retainages, if any, all labor, services and materials furnished on the Property through the last date of the previous application for payment submitted by the undersigned have been paid in full.

3. Effective upon receipt of $_____, the undersigned, for itself and any person or entity with which it has contracted for any portion of the labor or materials supplied pursuant to the undersigned's contract referenced above or claiming under or through the undersigned, forever waives, releases and relinquishes any and all claims or rights of lien, liens, and claims of whatever kind, in law or equity, that the undersigned and any person or entity with which it has contracted for any portion of the labor or materials supplied pursuant to the undersigned's contract referenced above or claiming under or through the undersigned, may now or in the future have against the Owner of the Property or its affiliated companies, officers, directors, shareholders, agents, employees, representatives, sureties, trustees, successors and assigns or against the Property or against the funds due or to become due on account of or in any way connected with labor, services and materials furnished on the Property through the date of this affidavit.

4. The undersigned represents and warrants to the Contractor and Owner that it has either not served a notice of claim of lien on funds on the Contractor and/or Owner arising from labor, services and materials on the premises and improvements on the Property, or that if such a notice of claim of lien on funds has been served, the undersigned has subsequently served on the Owner and Contractor a cancellation of same in full without condition or reservation.

Signed and sealed this ____ day of _____, ____.

_____
(name of Subcontractor or Supplier company)

(SEAL) By: _____
(signature)

_____
(printed name) (title)

STATE OF _____

COUNTY OF _____

Subscribed and sworn to before me this ____ day of _____, ____.

_____
Notary Public

My commission expires:

_____

Exhibit 10.23

Description of Annual Cash Incentive Program

Targacept, Inc. (the "Company") maintains an incentive award program (the "Program") under which all of its employees, including its named executive officers, are eligible to receive an annual cash incentive bonus. Under the terms of the Program, each employee is assigned a target bonus percentage of his or her base salary. The target bonus percentages for the Company's named executive officers (and other members of its executive (management) committee) are determined by the Compensation Committee of the Board of Directors. At or about the beginning of each fiscal year, the Compensation Committee establishes performance objectives for the Company for that year and ascribes a percentage weight to each objective. The aggregate weight for all of the performance objectives is at least equal to, and may exceed, 100%. Following the end of the fiscal year, the Compensation Committee determines which of the specified objectives have been met, the circumstances surrounding any objectives that have not been met (which may include, for example, a strategic change that occurred during the year) and whether, taking into account the circumstances, the objective should be credited, and the extent to which any adjustment should be made for other Company accomplishments that occurred during the year. The Compensation Committee then sets the cash incentive bonus percentage to be applied under the Program for that year.

For a group of employees that includes the Company's named executive officers, the annual cash incentive bonus is determined based wholly on the cash incentive bonus percentage set by the Compensation Committee as described above. Accordingly, the annual cash incentive bonus for a particular year for each employee in this group is determined by multiplying the amount of his or her base salary for that year times his or her target bonus percentage times the cash incentive bonus percentage set by the Compensation Committee. For the Company's remaining employees, 50% of the annual cash incentive bonus is based on the cash incentive bonus percentage set by the Compensation Committee and the other 50% is based on individual performance.

Exhibit 10.24

Description of Non-Employee Director Compensation Program

Targacept, Inc. (the "Company") maintains a non-employee director compensation program pursuant to which:

- each non-employee director who is first elected or appointed to the Board of Directors after the Company's initial public offering receives a nonqualified option to purchase 25,000 shares of the Company's common stock on the fifth business day after his or her election or appointment (an "Initial Option");
- each non-employee director who is first elected or appointed as chairman of the Board of Directors after the Company's initial public offering receives an additional Initial Option to purchase 10,000 shares of the Company's common stock on the fifth business day after his or her election or appointment;
- each non-employee director receives on an annual basis a nonqualified option to purchase 7,500 shares of the Company's common stock or, in the case of the chairman of the Board of Directors, an option to purchase 12,500 shares of the Company's common stock (an "Annual Option");
- each non-employee director receives an annual cash retainer of $20,000 payable in quarterly installments ($35,000 in the case of the chairman of the Board of Directors); and
- each member of the Audit Committee receives an additional annual cash retainer of $6,000 ($16,000 in the case of the chairman of the committee); each member of the Compensation Committee receives an additional annual cash retainer of $3,000 ($5,500 in the case of the chairman of the committee); and each member of the Governance and Nominating Committee receives an additional annual cash retainer of $3,000 ($5,500 in the case of the chairman of the committee).

Each Initial Option vests and becomes exercisable (i) on the first anniversary of the date of grant with respect to one-third of the shares subject to the option, if the recipient director remains in service as of such date, and (ii) on a pro rata quarterly basis over the next two years with respect to the remaining two-thirds of the shares subject to the option, if the recipient director remains in service during such periods.

Each Annual Option is granted on the fifth business day after the applicable annual or other stockholders meeting at which directors are elected, if the recipient director remains in service as of such grant date, and vests in full on the first anniversary of the date of grant if the recipient director remains in service on that date.

The option price per share for both Initial Options and Annual Options is equal to the fair market value of the common stock as of the date the option is granted, as determined in accordance with the Company's 2006 Stock Incentive Plan (or any successor plan). The option period for both Initial Options and Annual Options is 10 years. Initial Options and Annual Options granted to any director are subject to certain restrictions on exercise if his or her service on the Board of Directors terminates.

Exhibit 23.1

Consent of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in the Registration Statements (Form S-8 Nos. 333-133882 and 333-133881) pertaining to the 2000 Equity Incentive Plan and the 2006 Stock Incentive Plan of Targacept, Inc. of our report dated March 20, 2007, with respect to the financial statements of Targacept, Inc., included in the Annual Report (Form 10-K) for the year ended December 31, 2006.

/s/ Ernst & Young

Greensboro, North Carolina
March 20, 2007

EXHIBIT 31.1

CERTIFICATION

I, J. Donald deBethizy, certify that:

1. I have reviewed this Annual Report on Form 10-K of Targacept, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 22, 2007 By: /s/ J. DONALD DEBETHIZY

J. Donald deBethizy
President and Chief Executive Officer

EXHIBIT 31.2

CERTIFICATION

I, Alan A. Musso, certify that:

1. I have reviewed this Annual Report on Form 10-K of Targacept, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 22, 2007

By: /s/ ALAN A. MUSSO

Alan A. Musso
Vice President, Chief Financial Officer, Secretary and Treasurer

EXHIBIT 32.1

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 10-K of Targacept, Inc. (the "Company") for the period ended December 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, J. Donald deBethizy, President and Chief Executive Officer of the Company, hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 22, 2007

By: /s/ J. DONALD DEBETHIZY

J. Donald deBethizy
President and Chief Executive Officer

EXHIBIT 32.2

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 10-K of Targacept, Inc. (the "Company") for the period ended December 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Alan A. Musso, Vice President, Chief Financial Officer, Secretary and Treasurer of the Company, hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 22, 2007

By: /s/ ALAN A. MUSSO

Alan A. Musso
Vice President, Chief Financial Officer, Secretary and Treasurer