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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION
**Washington, D.C. 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, 2012**

**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.)** |
| **100 North Main Street, Suite 1510**<br>**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 (NASDAQ Global Select Market)** |

**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 whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ☒ Yes ☐ No

Indicate by check mark if disclosure of delinquent filers pursuant to Rule 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of 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, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

| Large accelerated filer ☐ | Accelerated filer ☒ | Non-accelerated filer ☐ (Do not check if a smaller reporting company) | Smaller reporting company ☐ |
|---|---|---|---|

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, 2012, was approximately $123,869,997, based on the price at which the registrant's common stock was last sold on June 30, 2012 ($4.30).

As of February 28, 2013, the registrant had 33,616,675 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 2013 annual meeting of stockholders, 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, 2012, 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 27A of the Securities Act of 1933, as amended, which we refer to as the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, which we refer to as the Exchange Act. For this purpose, any statement contained in this annual report, other than statements of historical fact, regarding, among other things:

- the progress, scope or duration of the development of TC-5619, TC-5214, TC-1734, AZD1446 (TC-6683), TC-6987, TC-6499 or any of our other product candidates or programs, such as the target indication(s) for development, the size, design, population, location, conduct, objective, duration or endpoints of any clinical trial, or the timing for initiation or completion of or availability of results from any clinical trial, for submission or approval of any regulatory filing, for interactions with regulatory authorities, or, where applicable, for a decision by AstraZeneca as to whether to conduct particular development;
- the benefits that may be derived from any of our product candidates or the commercial opportunity in any target indication;
- the timing or amounts of any payments that AstraZeneca may make to us;
- our operations, financial position, revenues, costs or expenses; or
- our strategies, prospects, plans, expectations or objectives

is a forward-looking statement 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,” “scheduled” or other comparable words identify forward-looking statements. Actual results, performance or experience may differ materially from those expressed or implied by any forward-looking statement as a result of various important factors, including our critical accounting policies and risks and uncertainties relating, among other things, to:

- whether favorable findings from our completed clinical trial of TC-5619 in patients with schizophrenia will be replicated in our ongoing clinical trial of TC-5619 and potential future clinical trials of TC-5619;
- whether the designs and endpoints of our ongoing clinical trial of TC-5619 and potential future clinical trials of TC-5619 will be deemed by applicable regulatory authorities to be sufficient to support approval of TC-5619 to treat negative symptoms of schizophrenia or cognitive dysfunction in schizophrenia;
- whether findings from nonclinical studies and assessments of TC-5214 and clinical trials of TC-5214 in a different indication will be predictive of a positive outcome in our planned Phase 2b clinical trial of TC-5214 in overactive bladder;
- the conduct and results of clinical trials and non-clinical studies and assessments of TC-5619, TC-5214, TC-1734, AZD1446, TC-6987, TC-6499 or any of our other product candidates, including the performance of third parties engaged to execute them, delays resulting from any changes to the applicable protocols or difficulties and delays in subject enrollment and data analysis;
- whether the executive turnover and two workforce reductions that we experienced in 2012 will have an adverse impact on the development of any of our product candidates or our business generally;
- whether TC-5214 will be eligible for treatment in the United States as a new chemical entity with a five-year statutory exclusivity period, either because we submit a new drug application for TC-5214 prior to October 1, 2017 or because the applicable statutory provision is re-authorized by the U.S. Congress;
- the control or significant influence that AstraZeneca has over the development of AZD1446, including as to the timing, scope and design of any future clinical trials and as to the conduct at all of further development;

- the impact of the restructuring of AstraZeneca's neuroscience group in 2012 on the development of AZD1446;
- our ability to establish additional strategic alliances, collaborations or licensing or other comparable arrangements on favorable terms;
- our ability to protect our intellectual property; and
- the timing and success of submission, acceptance and approval of regulatory filings.

These and other risks and uncertainties are described in greater detail under the caption "Risk Factors" in Item 1A of Part I of this annual report and in other filings that we make with the Securities and Exchange Commission, or SEC. As a result of the risks and uncertainties to which our business is subject, the results or events indicated by any forward-looking statement may not occur. We caution you not to place undue reliance on any forward-looking statement.

In addition, any forward-looking statement in this annual report represents our views only as of the date of this annual report and should not be relied upon as representing our views as of any later 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, 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 or any future strategic alliances, collaborations or licensing or other comparable arrangements that we may enter into.

## PART I

### Item 1. Business.

**Overview**

We are a biopharmaceutical company engaged in the development of novel NNR Therapeutics™ for the treatment of diseases and disorders of the nervous system. Our NNR Therapeutics selectively target neuronal nicotinic receptors, which we refer to as NNRs. NNRs are found on nerve cells throughout the nervous system and serve as key regulators of nervous system activity.

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 activity in the body by selectively affecting specific NNR subtypes.

We have multiple clinical-stage product candidates in areas in which we believe there are significant medical need and commercial potential, as well as an ongoing collaboration with AstraZeneca. Our most advanced product candidates are described briefly below.

*TC-5619*

TC-5619 is a novel small molecule that modulates the activity of the a7 NNR. We are currently conducting a Phase 2b clinical trial of TC-5619 as a treatment for negative symptoms and cognitive dysfunction in schizophrenia. We are also currently evaluating potential additional Phase 2 clinical development of TC-5619 as a treatment for Alzheimer's disease.

*TC-5214*

TC-5214 modulates the activity of the a3ß4 NNR. We are developing TC-5214 as a treatment for overactive bladder and plan to initiate a Phase 2b clinical trial of this product candidate in the first half of 2013.

*TC-1734*

TC-1734 (formerly known also as AZD3480) is a novel small molecule that modulates the activity of the a4ß2 NNR. We are currently conducting a Phase 2b clinical trial of TC-1734 as a treatment for mild to moderate Alzheimer's disease.

*AZD1446 (TC-6683)*

AZD1446 (TC-6683) is a novel small molecule that modulates the activity of the a4ß2 NNR. We discovered and advanced AZD1446 as part of a now completed preclinical research collaboration conducted under our collaboration agreement with AstraZeneca. We are currently in discussions with AstraZeneca regarding the next development steps for AZD1446.

*TC-6987*

TC-6987 is a novel small molecule that modulates the activity of the a7 NNR. We have previously evaluated TC-6987 in two Phase 2 exploratory studies and are evaluating potential future development options for this product candidate.

*TC-6499*

TC-6499 is a novel small molecule that modulates the activity of the a4ß2 and a3ß4 NNRs. The a3ß4 NNR is located in the gastrointestinal tract, and we believe TC-6499 may have potential as a treatment for gastrointestinal disorders. We are evaluating potential future development options for this product candidate.

**Role of NNRs in the Body**

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 have promise as treatments for these diseases and disorders.

In addition, NNRs located within various target organ systems in the body are involved in transmitting signals between those systems and the spinal cord and brain. As such, these receptors are thought to play a role in a variety of physiological functions, including heart rate, digestion, respiration, salivation and uro-genital function such as urination and sexual arousal.

NNRs are comprised of five protein subunits that are arranged like staves of a barrel around a central pore. Each 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 conditions and that mutations of genes that are associated with specific NNR subunits can increase susceptibility to some diseases and disorders.

Pfizer's smoking cessation product Chantix, which acts on several NNR subtypes as well as other molecular targets in the body and is known outside of the United States as Champix, is currently the only product marketed in the United States that is believed to act predominantly by affecting NNRs. Beyond Chantix, many published studies have described beneficial effects of nicotine in humans and animals and the higher prevalence of diseases such as Alzheimer's disease and Parkinson's disease in non-smokers as compared to smokers, suggesting the therapeutic potential of compounds 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**

We are seeking to provide superior treatment options for complex diseases and disorders to improve the lives of patients by developing innovative new medicines. To achieve our goal, we are pursuing the following strategies:

- *Exploit our pipeline of NNR Therapeutics.* We believe that drugs designed to selectively target specific NNR subtypes can have positive medical effects with limited adverse side effects and have historically focused our drug development activities on NNR Therapeutics. We currently have three chemically and pharmacologically distinct NNR Therapeutics in Phase 2b clinical development in therapeutic areas where we believe there to be significant medical need and commercial potential. We intend to continue to progress these NNR Therapeutics to the next stage of development and, if we have clinical success, beyond.
- *Evaluate opportunities to expand our pipeline deliberatively.* To grow our business in the long term, we will need to expand our pipeline. We plan to continue to evaluate the scientific and commercial merits of internal opportunities for pipeline growth, either by pursuing clinical-stage NNR Therapeutics for additional indications or by advancing earlier-stage compounds with NNR-based mechanisms in our portfolio. We also plan to continue to approach potential prospects for complementing our pipeline with product candidates from external sources opportunistically.
- *Collaborate selectively.* We have historically collaborated with significant pharmaceutical companies and currently have a collaboration with AstraZeneca that is focused on compounds that act on the a4ß2 NNR. We intend to selectively seek additional alliances and collaborations to assist us in furthering the development of some of our product candidates. In particular, we intend to enter into these alliances and collaborations for target indications for which a potential collaborator has unique expertise or that involve large primary care markets that must be served by large sales and marketing organizations. In entering into these alliances and collaborations, our goal will generally be to maintain co-promotion or co-commercialization rights for specialists, particularly in neurology and psychiatry, in the United States and, potentially in the future, other markets. Under our collaboration agreement with AstraZeneca, we have the option to co-promote AZD1446 and the other licensed compounds that arose out of the preclinical research collaboration that we conducted with AstraZeneca to specified classes of physicians in the United States.

**Our Product Development Pipeline**

The following table summarizes our most advanced clinical-stage product candidates.

| Product Candidate | Planned Target Indication(s) | Status of Development | Commercial Rights |
|---|---|---|---|
| TC-5619 | Negative symptoms and cognitive dysfunction in schizophrenia; Alzheimer’s disease | Phase 2b clinical trial in negative symptoms and cognitive dysfunction in schizophrenia ongoing; potential additional Phase 2 clinical development in Alzheimer’s disease under consideration | Targacept |
| TC-5214 | Overactive bladder | Phase 2b clinical trial planned to be initiated in the first half of 2013 | Targacept |
| TC-1734 | Mild to moderate Alzheimer’s disease | Phase 2b clinical trial ongoing | Targacept |
| AZD1446 (TC-6683) | To be determined in conjunction with AstraZeneca | Phase 2 | AstraZeneca |
| TC-6987 | To be determined | Phase 2 | Targacept |

Information regarding our research and development expenses for the fiscal years ended December 31, 2012, 2011 and 2010 is included under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this annual report. All of our long-lived assets are located in the United States.

*TC-5619*

TC-5619 is a novel small molecule that modulates the activity of the a7 NNR. We are currently conducting a Phase 2b clinical trial of TC-5619 as a treatment for negative symptoms and cognitive dysfunction in schizophrenia. Examples of negative symptoms of schizophrenia include anhedonia (inability to experience pleasure), affective flattening (lack of emotional expressiveness), avolition (lack of motivation or drive), social withdrawal and alogia (lack of unprompted comment that occurs in normal speech). Cognitive functions often impaired in schizophrenia include executive function (ability to organize cognitive processes, including the ability to plan, prioritize, stop and start activities, shift from one activity to another activity and monitor one's own behavior), attention, vigilance, memory and learning. In a survey of 46 cognitive neuroscientists and neuropharmacologists conducted in 2004 in connection with a National Institute of Mental Health initiative known as Measurement and Treatment Research to Improve Cognition in Schizophrenia, or MATRICS, a7 was selected more often than any other target as a target of interest in the development of treatments for cognitive dysfunction in schizophrenia.

In addition to our ongoing development in schizophrenia, we are currently evaluating potential Phase 2 clinical development of TC-5619 in Alzheimer's disease.

*Ongoing Phase 2b Clinical Trial in Negative Symptoms and Cognitive Dysfunction in Schizophrenia*

Our ongoing Phase 2b clinical trial of TC-5619 in negative symptoms and cognitive dysfunction in schizophrenia is a double blind, placebo controlled, parallel group study. The term "double blind" means that neither the subjects nor the investigators in the trial know which subjects receive the investigational drug (in this case, TC-5619) and which subjects receive placebo. The trial is planned to enroll approximately 450 subjects at sites in the United States (approximately one-third of sites) and Eastern Europe (approximately two-thirds of sites). The enrollment criteria for the trial call for subjects with stable schizophrenia who are taking a fixed dose of one of several marketed drugs from the class known as atypical antipsychotics.

The trial design provides for a four-week screening period, followed by a 24-week treatment period during which subjects receive either one of two daily doses of TC-5619 (5mg or 50mg) or placebo, randomized in a ratio of 2:1:1 (placebo, low dose, high dose). The primary outcome measure in the trial is change from baseline on the Scale for the Assessment of Negative Symptoms, or SANS, at the end of the treatment period with TC-5619 as compared to placebo. SANS is an investigator assessment of improvement on the negative symptoms of schizophrenia. The composite score on the CogState Schizophrenia Battery, or CSB, a computerized battery of neuropsychiatric tests that assess specific cognitive domains, and the University of California, San Diego Performance-Based Skills Assessment, brief version, are identified as key secondary outcome measures in the trial.

*Completed Phase 2 Clinical Trial in Cognitive Dysfunction in Schizophrenia*

Previously, we completed a Phase 2 clinical trial of TC-5619 in cognitive dysfunction in schizophrenia. The trial was a double blind, placebo controlled, multi-center study conducted in the United States and India. In the trial, 185 subjects with schizophrenia who had stable psychotic symptoms were randomly assigned to receive either TC-5619 or placebo, together with continued treatment with an atypical antipsychotic (either quetiapine, marketed as Seroquel, or risperidone, marketed as Risperdal), for 12 weeks. Approximately half of the subjects were users of tobacco products. Subjects who received TC-5619 received a 1mg daily dose for the first four weeks, a 5mg daily dose for the next four weeks and a 25mg daily dose for the last four weeks. This type of scheduled dosing adjustment is sometimes referred to as "forced titration."

The primary outcome measure of the trial was change from baseline on the Groton Maze Learning task of the CSB on each of three measurement dates for TC-5619 as compared to placebo. The Groton Maze Learning task is designed to assess executive function. The trial protocol defined a positive outcome on the Groton Maze Learning task as superiority (one-sided p-value < 0.10) for the TC-5619 dose group as compared to the placebo dose group after adjusting statistically to account for multiple comparisons.

In the trial, the results on the Groton Maze Learning task met the pre-defined success criteria (adjusted p-value = 0.054), as well as at two of the trial's three measurement dates (at 4 weeks, unadjusted p-value = 0.018; and at 12 weeks, unadjusted p-value = 0.041), and were favorable for tobacco users as compared to non-tobacco users (where there was no activity on this measure) and for subjects at study sites in the United States as compared to subjects at study sites in India. Each of the p-values noted above was derived after data log transformation, a commonly utilized statistical technique where the data does not follow a normal distribution.

In addition, we observed encouraging signals (one-sided p-value < 0.10 on one of the measurement dates) in the trial on several secondary efficacy outcome measures, including SANS, Clinical Global Impression – Global Improvement, an investigator assessment of overall response, Subject Global Impression – Cognition scale, a subject self-assessment of cognitive change, and two of six computer-based items of the CSB. Other secondary efficacy outcome measures of the trial, including a composite measure of the CSB and Clinical Global Impression – Severity of Illness, an investigator assessment of severity of illness based on total clinical experience, did not demonstrate a drug effect in the dataset that included all subjects and occasionally statistically favored placebo over TC-5619 (including on the verbal memory item of the CSB after four weeks).

*Completed Phase 2 Clinical Trials in Adults with ADHD and Adults with ADHDi*

Previously, we completed a Phase 2 clinical trial of TC-5619 in adults with attention deficit/hyperactivity disorder, or ADHD, and a subsequent Phase 2 clinical trial of TC-5619 in adults with inattentive-predominant attention deficit/hyperactivity disorder, or ADHDi. The ADHD trial was a double blind, placebo controlled, forced titration, multi-center, 12-week study conducted in the United States. Each subject in the trial was randomly assigned to receive a daily dose of either TC-5619, beginning with 1mg and increasing to 5mg and then to 25mg, or placebo. TC-5619 did not meet the primary outcome measure of the trial, but showed encouraging signals on some of the trial's efficacy measures in the subpopulation of subjects with ADHDi. The ADHDi trial was a double blind, placebo controlled, parallel group, multi-center, 12-week study conducted in the United States. Subjects in the trial were randomly assigned to receive a daily dose of 5mg TC-5619, 25mg TC-5619 or placebo. TC-5619 did not meet the primary outcome measure of the trial, and we are not pursuing further development of TC-5619 in ADHD or ADHDi.

*TC-5214*

TC-5214 modulates the activity of the a3ß4 NNR. We are developing TC-5214 as a treatment for overactive bladder and plan to initiate a Phase 2b clinical trial in the first half of 2013. TC-5214 is one of the two enantiomers of the racemate mecamylamine hydrochloride. Enantiomers are mirror images of each other that have the same chemical but potentially different biological properties and together form a chemical mixture known as a racemate. TC-5214 had previously been in Phase 3 co-development with AstraZeneca as a treatment for major depressive disorder (MDD) under a now terminated collaboration agreement.

We determined to pursue development of TC-5214 for overactive bladder based primarily on various nonclinical and clinical findings, including:

- exaggerated bladder effects in studies of TC-5214 in rodents, including urinary retention and beneficial changes in bladder contraction and capacity and urination frequency;
- potent activity of TC-5214 at nicotinic receptors located in or around the bladder considered to play a key role in bladder contraction and believed to be involved in signaling of the urge to urinate;

- 90% elimination of TC-5214 in humans unchanged through the bladder, supporting use of a low dose and creating the potential to minimize unwanted side effects;
- a well-established safety and tolerability profile for TC-5214 resulting from prior clinical evaluation in approximately 2,400 subjects; and
- elements of the side effect profile for TC-5214 arising from the completed MDD program that are qualitatively similar to observations made with marketed medications for overactive bladder.

*Completed Clinical Program in MDD*

We and AstraZeneca previously conducted a multi-clinical trial Phase 3 program for TC-5214 as an adjunct therapy, and a Phase 2b clinical trial of TC-5214 as a "switch" monotherapy, in each case in adults with MDD who do not respond adequately to initial therapy. None of these clinical trials met its primary endpoint (as used in this annual report, the terms "endpoint" and "outcome measure" have the same meaning). In the first quarter of 2012, we and AstraZeneca announced that, based on the totality of the results of the Phase 3 program, a regulatory filing for TC-5214 as an adjunct therapy for MDD would not be pursued and we reported the discontinuation of a "switch" monotherapy trial. AstraZeneca subsequently terminated a separate collaboration agreement we had for TC-5214, effective in May 2012.

*TC-1734*

TC-1734 is a novel small molecule that modulates the activity of the a4ß2 NNR. We are currently conducting a Phase 2b clinical trial of TC-1734 as a treatment for mild to moderate Alzheimer's disease. Our ongoing study is the second clinical trial of TC-1734 in mild to moderate Alzheimer's disease. The first was conducted by AstraZeneca under our collaboration agreement, and its outcome was inconclusive. In March 2013, AstraZeneca exercised its right to terminate TC-1734 from our collaboration agreement. As a result, all rights and licenses for TC-1734 that we granted under the agreement to AstraZeneca terminate and revert to us 90 days after the date of AstraZeneca's action. Previously, we had received $6.2 million in nonrefundable payments from AstraZeneca in connection with our ongoing clinical trial.

*Ongoing Phase 2b Clinical Trial in Mild to Moderate Alzheimer's Disease*

Our ongoing Phase 2b clinical trial of TC-1734 in mild to moderate Alzheimer's disease is a potential registration study that is the subject of a Special Protocol Assessment agreement with the U.S. Food and Drug Administration, or FDA. It is a double blind study designed to evaluate TC-1734 head-to-head against donepezil, which is marketed as Aricept and is the medication most often prescribed for mild to moderate Alzheimer's disease. The trial design provides for approximately 300 subjects diagnosed with probable Alzheimer's disease classified as mild or moderate in severity to be randomly assigned to receive donepezil or a fixed 30mg dose of TC-1734 daily over 12 months. We are conducting the study at sites predominantly in Eastern Europe and also in the United States. The study has co-primary outcome measures, change from baseline after 12 months of treatment with TC-1734 as compared to donepezil on the Alzheimer's Disease Assessment Scale-cognitive subscale, or ADAS-Cog, and on a functional measure. The functional measure for European sites is the Alzheimer's Disease Cooperative Study — Activities of Daily Living Inventory, and the functional measure for U.S. sites is the Clinician's Interview Based Impression of Change Plus Caregiver Input, each of which assesses subjects' ability to perform typical day-to-day activities.

*Completed Phase 2b Clinical Trial in Mild to Moderate Alzheimer's Disease*

In 2008, AstraZeneca completed a Phase 2b double blind, placebo controlled, dose finding, multi-center clinical trial of TC-1734 in mild to moderate Alzheimer's disease, known as the "Sirocco" trial. The Sirocco trial was conducted at sites in Western Europe, Eastern Europe and Canada. In the trial, 567 subjects diagnosed with probable Alzheimer's disease classified as mild or moderate in severity were randomly assigned to one of three dose groups of TC-1734, to donepezil, or to placebo and dosed over a 12-week period. The primary outcome measure of the trial was change from baseline on ADAS-Cog after 12 weeks of treatment with TC-1734 as compared to placebo. Some of the secondary outcome measures of the trial included the Alzheimer's Disease Cooperative Study—Clinical Global Impression of Change, or ADCS-CGIC, which is a 7-point clinician assessment of change in behavior and the ability to function, the Mini Mental State Examination, or MMSE, which is a quantitative, 30-point cognition scale, and a computer-based test battery developed by CDR Ltd. to test cognitive function.

The results of the Sirocco trial were inconclusive in that the active comparator, donepezil, did not meet the trial's criteria for statistical significance versus placebo on the primary outcome measure. TC-1734 also did not meet the trial's criteria for statistical significance versus placebo on the primary outcome measure. However, in an analysis conducted post hoc in which the most mildly impaired subjects (MMSE = 25 or 26) were excluded, the middle dose of TC-1734 tested achieved a favorable outcome (one-sided p-value = 0.04) and donepezil showed a strong trend (one-sided p-value = 0.065).

Subjects dosed with TC-1734 showed an improvement on ADCS-CGIC and the MMSE, two of the trial's secondary outcome measures, at two of the three doses tested as compared to subjects dosed with placebo. Of the three TC-1734 doses evaluated, subjects in the middle dose group showed the most improvement on both measures as compared to subjects dosed with placebo, with a 0.5 point advantage on ADCS-CGIC and a 0.9 point advantage on the MMSE. Subjects dosed with donepezil also showed an improvement as compared to subjects dosed with placebo on ADCS-CGIC, with a 0.2 point advantage, and the MMSE, with a 1.0 point advantage. No improvement was shown in any domain of the CDR test battery in the pooled dataset of all subjects in the donepezil dose group or any of the TC-1734 dose groups as compared to the placebo dose group.

*Completed Clinical Trials in Other Indications*

In addition to the previous trial in Alzheimer's disease, we or AstraZeneca have completed Phase 2 clinical trials of TC-1734 in various other indications characterized by cognitive impairment. These studies have generated a range of efficacy results, including: (1) achievement of the primary outcome measure(s) (in age associated memory impairment, or AAMI, a common condition characterized by gradual memory loss or other cognitive impairment that generally occurs with normal aging, and in adults with ADHD); (2) encouraging signals (in early-stage trials in AAMI and mild cognitive impairment, or MCI); and (3) failure to achieve the primary outcome measure (in cognitive dysfunction in schizophrenia). These trials are summarized below.

AAMI (later study)

- a double blind, placebo controlled, multi-center study that we conducted in the United States
- subjects were between the ages of 50 and 80 and classified with AAMI based on inclusion criteria reflecting both subjective and objective memory impairment
- there were three co-primary endpoints, change from baseline on the Power of Attention and Episodic Memory factors of the CDR test battery and on the Subject Global Impression– Cognition scale at the end of 16 weeks of dosing with TC-1734 as compared to placebo
- TC-1734 met all three co-primary endpoints ($p < 0.05$) at 50mg and met the Power of Attention endpoint at 25mg

| | |
|---|---|
| Adults with ADHD | • a double blind, placebo controlled crossover design study that we and AstraZeneca conducted at a single site in the United States in which each subject served as his or her own control<br>• two doses of TC-1734 tested<br>• the primary outcome measure was change from baseline on the CAARS-INV total score after two weeks dosing with TC-1734 as compared to placebo, and the result was statistically significant in favor of one of the doses (50mg TC-1734, $p < 0.01$) on an intent to treat basis |
| AAMI (earlier study); MCI | • two double blind, placebo controlled, crossover design Phase 2 studies that we conducted, one in each indication, assessing the effects of multiple doses of TC-1734 at various time points using the CDR test battery<br>• TC-1734 demonstrated positive effects in the AAMI study at some, but not all, dose levels and measures tested, with the results most favorable at 50mg<br>• the results of the MCI trial were more favorable at 100mg TC-1734 and did not favor 50mg TC-1734 on any measure |
| Cognitive Dysfunction in Schizophrenia | • a double blind, placebo controlled, dose finding, multi-center study that AstraZeneca conducted in the United States and Canada<br>• subjects were clinically stable schizophrenics who were active smokers and taking a marketed atypical antipsychotic<br>• TC-1734 did not meet pre-defined success criteria on the primary endpoints, change from baseline on scores for attention/vigilance, working memory, verbal learning, speed of processing and reasoning and problem solving as measured by a computerized test battery after 12 weeks of treatment with TC-1734 as compared to placebo |

*AZD1446 (TC-6683)*

AZD1446 (TC-6683) is a novel small molecule that modulates the activity of the a4ß2 NNR. We discovered and advanced AZD1446 as part of a now completed preclinical research collaboration that we and AstraZeneca conducted under our collaboration agreement. AstraZeneca is responsible for conducting and funding the development and potential future commercialization of AZD1446 and has previously completed various early-stage clinical studies. Under a March 2013 amendment to our collaboration agreement, AstraZeneca has the right to pursue development and commercialization of AZD1446, as well as other compounds licensed from us under our collaboration agreement, in any therapeutic area, rather than only in cognitive disorders or schizophrenia. We are currently in discussions with AstraZeneca regarding the next development steps for AZD1446.

*TC-6987*

TC-6987 is a novel small molecule that modulates the activity of the a7 NNR. We are evaluating potential future development options for TC-6987. Previously, we completed two exploratory Phase 2 clinical trials of TC-6987, one in asthma and one in Type 2 diabetes. As we have previously disclosed, we will not pursue further development of TC-6987 in Type 2 diabetes and have no current plans to conduct additional development of TC-6987 in asthma.

*TC-6499*

TC-6499 is a novel small molecule that modulates the activity of the a4ß2 and a3ß4 NNRs. The a3ß4 NNR is located in the gastrointestinal tract and, based on observations from previous Phase 1 development of TC-6499 in contemplation of later-stage development as a treatment for pain, we believe the product candidate may have

potential as a treatment for gastrointestinal disorders. In an exploratory four-week study of TC-6499 that we completed in 24 subjects with constipation-predominant irritable bowel syndrome at a single site in 2011, TC-6499 outperformed placebo on an objective secondary efficacy outcome measure, the number of spontaneous bowel movements per week, but not on the primary efficacy outcome measure (a subjective subject rating of global symptom relief).

**Medical Need and Commercial Opportunity in Our Target Indications**

The indications for which our most advanced product candidates are currently in development include negative symptoms and cognitive dysfunction in schizophrenia, overactive bladder and Alzheimer's disease.

Schizophrenia is a chronic, severe and disabling form of psychosis. The disease generally includes three domains, positive symptoms, negative symptoms and cognitive dysfunction. The negative symptoms and cognitive dysfunction play a primary role in the inability of many schizophrenic patients to function normally. The biopharmaceutical market research firm Decision Resources estimated that there were approximately 4.7 million people with schizophrenia in the world's seven major pharmaceutical markets in 2011. Estimates as to the prevalence of schizophrenia patients who suffer from negative symptoms vary, and it has been estimated that up to 75% of persons with schizophrenia are cognitively impaired. There is currently no drug approved in the United States or Europe specifically for the treatment of negative symptoms of schizophrenia or cognitive dysfunction in schizophrenia.

Overactive bladder is a disorder that causes a sudden and frequent urge to urinate that may be difficult to suppress and may lead to incontinence and the need to wake up at night to urinate. Overactive bladder poses a significant reduction in quality of life due to a decreased ability to socialize and participate in normal life activities, sleep disturbances and decreased emotional well-being. Decision Resources estimated that there were approximately 69.5 million people with overactive bladder in the world's seven major pharmaceutical markets in 2009.

Alzheimer's disease, the most common form of dementia, is a progressive, debilitating disorder that attacks neurons in the brain, resulting in loss of memory, thinking and language skills and behavioral changes. Decision Resources estimated that there were approximately 20.0 million people with Alzheimer's disease in the world's seven major pharmaceutical markets in 2011. Alzheimer's disease progresses in stages from mild to moderate to severe and gradually destroys a person's memory and ability to learn, reason, make judgments, communicate and carry out daily activities. Mild Alzheimer's disease is characterized by mild forgetfulness and difficulty acquiring basic information and communicating. Patients generally exhibit the symptoms of mild Alzheimer's disease for two to four years before progressing to the moderate stage. Moderate Alzheimer's disease is characterized by increasing forgetfulness, failure to recognize friends and family, disorientation regarding time and place even in familiar locations and personality changes. Patients can exhibit the symptoms of moderate Alzheimer's disease for several years before progressing to the severe stage. Severe Alzheimer's disease is characterized by difficulty performing simple tasks and activities associated with daily living. Patients with severe Alzheimer's disease require continuous care and generally do not survive for more than three years.

**Preclinical Assets and Pentad Drug Discovery Technologies**

In addition to our clinical-stage product candidates, we have a library of discovery or preclinical stage compounds. The most advanced of these compounds is a late-preclinical compound included in our Parkinson's disease program, which is not currently active. We have previously been awarded three grants from The Michael J. Fox Foundation for Parkinson's Research. Two of the grants were to test the potential of compounds with novel NNR pharmacologies to address abnormal involuntary movements, or dyskinesias, that are a side effect of a treatment commonly used to treat the motor deficits of Parkinson's disease called levodopa. The third grant was to identify compounds that bind to specific NNRs and can be radiolabeled and used as imaging agents to better understand any relationship between those NNRs and Parkinson's disease.

We also have sophisticated proprietary computer-based molecular design methodologies and extensive biological and chemical data for a library of diverse compounds developed and collected over more than 25 years. We refer to these technologies collectively as Pentad. In our previous drug discovery activities, we used Pentad to assess 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 and pharmaceutical profiles.

**Discontinued Product**

As a result of increased fees charged by the FDA and declining prescriptions, we discontinued the commercialization of Inversine, which is currently our only approved product, effective as of September 30, 2009. Inversine is approved in the United States for the management of moderately severe to severe essential hypertension and uncomplicated cases of malignant hypertension, which are high blood pressure disorders. Inversine was first approved for marketing in 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.

**Strategic Alliances and Collaborations**

*AstraZeneca AB*

In December 2005, we entered into a collaborative research and license agreement with AstraZeneca AB. The agreement became effective in January 2006 and was initially focused in cognitive disorders. In March 2013, we and AstraZeneca amended the agreement. As amended, the agreement permits AstraZeneca to pursue development and commercialization of compounds that it has licensed from us in any therapeutic area.

Our agreement with AstraZeneca initially included a number of different elements, including a multi-year preclinical research collaboration that we and AstraZeneca conducted until January 2010. AZD1446 is the most advanced compound that arose from the research collaboration, and we are currently in discussions with AstraZeneca regarding the next development steps for AZD1446.

In addition, we granted to AstraZeneca under the agreement a license to develop and commercialize TC-1734. In March 2013, AstraZeneca exercised its right to terminate TC-1734 from the agreement. As a result, all rights and licenses for TC-1734 that we granted under the agreement to AstraZeneca terminate and revert to us 90 days after AstraZeneca's action. AstraZeneca also had the right under the agreement to license TC-5619 following completion of our prior Phase 2 clinical trial in cognitive dysfunction in schizophrenia. In 2011, AstraZeneca elected not to exercise this license right.

*Payment Term*s. AstraZeneca has paid us a total of $88.1 million, including an initial fee, milestone and other product candidate-related payments, and research support payments, under the agreement since inception. We are eligible to receive other payments of up to $57 million, if development, regulatory and first commercial sale milestone events for AZD1446 are achieved for a specified indication under consideration for development and sales-related milestone events are then achieved for AZD1446, and up to $73 million, if development, regulatory and first commercial sale milestone events for AZD1446 are achieved for any other indication. We are also eligible to receive stepped royalties on any future AZD1446 product sales for any indication. If AZD1446 is subsequently developed under the agreement for other indications, we would also be eligible to receive payments of up to $35 million for each successive indication, if development, regulatory and first detail milestone events are achieved.

AstraZeneca's obligation to pay royalties to us for AZD1446 and each other 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 12 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 with respect to AZD1446 expire in 2028. The foreign patent rights with respect to AZD1446 that have issued and correspond to our U.S. patent rights expire in 2027. We also have pending U.S. and foreign patent applications with respect to AZD1446 that, if issued as patents, would expire in 2027. None of these years of expiration reflect any patent term extension that may be available in a particular country. It is uncertain whether any of the pending U.S. and foreign patent applications, even if issued as a patent, would be sufficient to extend our royalty term under the agreement for AZD1446 in any particular country. 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.

*Completed Preclinical Research Collaboration*. The agreement provided for a preclinical research collaboration that we and AstraZeneca conducted between January 2006 and January 2010 to discover and develop additional compounds that act on the a4ß2 NNR. AstraZeneca paid us research fees based on an agreed reimbursement rate for research services rendered by us in the collaboration. AstraZeneca has exclusively licensed six of these compounds, including AZD1446, together with metabolites of these compounds and derivatives and other compounds related to these compounds that meet specified criteria.

*Development and Commercialization Costs*. AstraZeneca is responsible for the clinical development and commercialization of AZD1446 and any other licensed compounds that arose from the research collaboration that it elects to advance and for funding substantially all associated costs. In addition, we have received $6.2 million in payments from AstraZeneca in connection with events associated with our ongoing clinical trial of TC-1734 in mild to moderate Alzheimer's disease. We have the option to co-promote AZD1446 and any other licensed compounds that arose from the research collaboration that are selected for advancement to specified classes of specialist physicians in the United States. 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*. We are not permitted outside of the collaboration to develop or commercialize compounds that act on the a4ß2 NNR and meet pre-defined criteria for the treatment of Alzheimer's disease, ADHD, cognitive dysfunction in schizophrenia or other conditions characterized by cognitive impairment, or schizophrenia. AstraZeneca was previously also subject to this restriction, but the restriction on AstraZeneca has lapsed. 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.

*Termination*. AstraZeneca can terminate the agreement without cause upon 90 days' notice given any time. 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 major pharmaceutical market, we can terminate the agreement only with respect to that compound or major pharmaceutical 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.

*Previous Collaboration Agreements*

In December 2009, we entered into a collaboration and license agreement with AstraZeneca AB for the global development and commercialization of TC-5214 in MDD. Following completion of a Phase 3 clinical program for TC-5214 conducted under the agreement, we and AstraZeneca announced that a regulatory filing for TC-5214 as an adjunct therapy for MDD would not be pursued and we reported the discontinuation of a "switch" monotherapy trial. AstraZeneca subsequently terminated the agreement effective in May 2012. As a result of the termination, all rights and licenses for TC-5214 that we granted under the agreement to AstraZeneca terminated and reverted to us.

In July 2007, we entered into a product development and commercialization agreement with SmithKlineBeecham Corporation and Glaxo Group Limited, which we refer to collectively in this annual report as GlaxoSmithKline, that set forth the terms of an alliance designed to discover, develop and market product candidates that selectively target specified NNR subtypes in specified therapeutic focus areas. In February 2010, GlaxoSmithKline announced plans to cease discovery research in selected neuroscience areas and terminated our agreement effective in May 2011.

**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 jurisdictions internationally that we consider key pharmaceutical markets. We also rely upon trade secrets and contracts to protect our proprietary information.

As of February 28, 2013, our patent estate included 68 patents issued in the United States, 53 patent applications pending in the United States and approximately 900 counterpart patents and 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 particularly important to the protection of our most advanced product candidates.

| Product Candidate | Patent Scope | Patent Expiration |
|---|---|---|
| TC-5619 | Composition of matter for a racemic mixture that includes TC-5619 | March 2019 |
| | Composition of matter for a family of racemic compounds that includes a racemic mixture that includes TC-5619 | August 2019 |
| | Composition of matter for a sub-family of racemic compounds that includes a racemic mixture that includes TC-5619 | December 2018 |
| | Composition of matter for salt forms of TC-5619, including the preferred salt | January 2029 |
| | Methods of use of a racemic mixture that includes TC-5619 for treatment of symptoms of schizophrenia | February 2023 |
| | Methods of use of a racemic mixture that includes TC-5619 for treatment of Alzheimer's disease | February 2023 |
| | Methods of use of a racemic mixture that includes TC-5619 for treatment of schizophrenia | November 2025 |
| | Commercial method and composition of matter for synthetic intermediates for manufacture of TC-5619 | August 2028 |
| TC-5214 | Pharmaceutical composition of TC-5214 | January 2020 |
| | Methods of use of TC-5214 (pending) | March 2033 (projected assuming issuance, patent not issued) |
| TC-1734 (TC-1734) | Composition of matter for TC-1734 | July 2018 |
| | Composition of matter for a family of compounds that includes TC-1734 | April 2016 |
| | Composition of matter for the preferred salt of TC-1734 | August 2026 |
| | Methods of use of a family of compounds that includes TC-1734 for treatment and prevention of central nervous system, or CNS, disorders | February 2017 |
| | Methods of use for TC-1734 for treatment and prevention of CNS disorders | July 2018 |
| AZD1446 (TC-6683) | Composition of matter for AZD1446 | August 2028 |
| | Composition of matter for a family of compounds that includes AZD1446 | January 2028 |
| TC-6987 | Composition of matter for a family of racemic compounds that includes a racemic mixture that includes TC-6987 | August 2019 |
| | Composition of matter for a sub-family of racemic compounds that includes a racemic mixture that includes TC-6987 | December 2018 |

In addition to these patents, for some of these product candidates, we have later-expiring patents and patent applications that cover the product candidate, its use as part of combination therapy or otherwise or its preparation. These patents, including any patents that issue from other pending applications, could provide additional protection or a longer period of protection. We also have issued patents and pending patent applications with equivalent or substantially comparable protection for our product candidates in jurisdictions internationally that we consider key pharmaceutical 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 term extension cannot extend the remaining term of a patent beyond a total of 14 years from the date of FDA approval. The patent term restoration period is generally one-half of 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 date of an NDA. Only one patent applicable to an approved drug is eligible for an extension, and, with limited exceptions, 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**

In addition to the agreement governing our collaboration with AstraZeneca, we consider the following license agreements to be important to our business.

*University of South Florida Research Foundation*

Pursuant to a license agreement with University of South Florida Research Foundation, or USFRF, we hold an exclusive worldwide license under patents and patent applications owned by USFRF to develop and commercialize TC-5214, mecamylamine hydrochloride and other specified compounds. The licensed patent rights include issued patents covering the pharmaceutical composition of TC-5214 and methods of use of each of TC-5214, the other enantiomer of mecamylamine hydrochloride and mecamylamine hydrochloride for the treatment of various disorders.

Under the license agreement with USFRF, we are obligated to pay to USFRF:

- an annual license fee of $50,000 until we or a sublicensee files an NDA or foreign equivalent for use of a product subject to the license to treat a neuropsychiatric disease or disorder;
- an annual fee of $20,000 to maintain our right of first refusal to acquire rights under the licensed patents and patent applications beyond the scope of our current license;
- royalties on net sales of products subject to the license or, if less, a percentage of royalties that we receive from a sublicensee;
- aggregate payments of up to $200,000 based on the achievement of specified regulatory milestones; and
- 10% of other amounts, including milestone payments, that we receive for a sublicense from a sublicensee, subject to increase to a higher percentage in specified circumstances.

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 one or more products subject to the license. In particular, we are required to spend a specified minimum amount on research and development of products subject to the license over each consecutive three-year period during the term of the

agreement until we or a sublicensee file an NDA or foreign equivalent for use of a product subject to the license to treat a neuropsychiatric disease or disorder. If USFRF believes that we are not meeting our diligence obligation, it is entitled to terminate the agreement if we do not cure our failure within a specified cure period. If we do not agree with USFRF's determination and specified initial dispute resolution procedures are unsuccessful, we can submit the matter to binding arbitration.

We may terminate the agreement at any time. USFRF may terminate the agreement if we fail to make a required royalty payment when due, or commit a material breach of the agreement, and do not cure the failure or breach within specified cure periods. If not earlier terminated, the agreement will terminate upon expiration of the last to expire of the licensed patent rights that includes a valid claim.

*University of Kentucky Research Foundation*

Pursuant to a sponsored research agreement, University of Kentucky Research Foundation, or UKRF, agreed to assign its rights to inventions that resulted in patents related to TC-1734 to R.J. Reynolds Tobacco Company. These patents were subsequently assigned by R.J. Reynolds Tobacco Company 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 for a license to these patents from any licensee.

**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. We seek to protect our proprietary information, in part, by 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, marketing and distribution experience with respect to pharmaceutical products and no internal sales or distribution capabilities. Our current strategy is to selectively seek alliances and collaborations, particularly for target indications for which a potential collaborator has unique expertise or that involve large primary care markets that must be served by large sales and marketing organizations. In entering into these alliances and collaborations, our goal will generally be to maintain co-promotion or co-commercialization rights in the United States and, potentially in the future, other markets. To be successful if we exercise these rights, we would have to develop a specialized sales and marketing organization with sufficient technical expertise.

We discontinued the commercialization of Inversine, which is currently our only approved product, effective as of September 30, 2009. Inversine had been distributed by Cord Logistics, Inc., a Cardinal Health company, pursuant to an exclusive distribution agreement. We have terminated our agreement with Cord Logistics. We paid Cord Logistics $0 in 2012 and 2011 and approximately $31,000 in 2010.

**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 rely and expect to continue to rely on a number of contract manufacturers to manufacture our product candidates for use in any preclinical research and 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 FDA and other governmental regulation.

**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, which is known outside of the United States as Champix, acts on several NNR subtypes as well as other molecular targets in the body. Chantix is approved as an aid for smoking cessation. In addition, we believe that several prominent pharmaceutical companies have product candidates that target NNRs in development, including Abbott Laboratories, Bristol-Myers Squibb, Novartis, EnVivo Pharmaceuticals, Galantos Pharma, Upsher Smith, Psychogenics, Asmacure, Bionomics, Aniona, Savant HWP and Neuroderm. 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 pursue the development and commercialization of therapeutics for diseases and disorders that we target, whether independently or by alliance, 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. We believe that the primary competitive products for use in indications that we are currently targeting with our most advanced product candidates include:

- for overactive bladder, anticholinergics such as Vesicare from Astellas Pharma, Detrol LA from Pfizer/Almirall, Enablex from Warner Chilcott/Bayer, Toviaz from Pfizer, Sanctura XR from Allergan and Ditropan XL from Ortho-McNeil Pharma, beta3-adrenergic receptor agonists such as Mybretiq from Astellas Pharma, and the botulinum toxin Botox from Allergan; and
- for mild to moderate Alzheimer's disease, acetylcholinesterase inhibitors such as Aricept from Pfizer/Eisai, Razadyne from Johnson & Johnson and Exelon from Novartis; Aricept is also indicated for severe Alzheimer's disease and Namenda from Forest Laboratories, which acts by regulating the neurotransmitter glutamate, is indicated for moderate to severe Alzheimer's disease.

There is currently no product approved in the United States, Europe or, to our knowledge, elsewhere specifically for the treatment of negative symptoms of schizophrenia or cognitive dysfunction in schizophrenia. There are however multiple third-party product candidates currently in clinical development, including modulators of the a7 NNR, targeting these areas.

Many of the products noted above have well-known brand names, are distributed by large pharmaceutical companies with substantial resources, have achieved widespread acceptance among physicians and patients and are or may become available in lower priced generic form. Furthermore, pharmaceutical, biopharmaceutical 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 and favorable side effect profiles of our products. 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 into products and to exploit these products 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 favoring the use of lower priced generic products over branded products.

**Regulatory Matters**

*Government Regulation and Product Approval*

Government authorities in the United States, at the federal, state and local level, and in other countries extensively regulate, among other things, the research, development, testing, manufacture, quality control,

approval, labeling, packaging, storage, recordkeeping, promotion, advertising, distribution, marketing and export and import of drugs such as our product candidates. Our product candidates must be approved by the FDA through the NDA process before they may be legally marketed in the United States.

*U.S. Drug Development Process*

In the United States, the FDA regulates drugs under the Federal Food, Drug, and Cosmetic Act, or FDCA, and implementing regulations. The process of obtaining regulatory approvals and complying with applicable federal, state, local and foreign laws and regulations require the expenditure of substantial time and financial resources. Failure to comply with United States requirements at any time during the product development process, the approval process or after approval may subject a company to administrative or judicial sanctions. These sanctions could include the FDA's refusal to approve pending applications, withdrawal of an approval, a clinical hold, warning letters, product recalls, product seizures, total or partial suspension of production or distribution injunctions, fines, refusals of government contracts, restitution, disgorgement, or civil or criminal penalties.

The process required by the FDA before a drug may be marketed in the United States generally involves the following:

- completion of preclinical laboratory tests, animal studies and formulation studies conducted in accordance with good laboratory practices and other applicable regulations;
- submission to the FDA of an IND, which must become effective before human clinical trials may begin;
- performance of adequate and well-controlled human clinical trials conducted in accordance with regulations and guidelines establishing good clinical practices to establish the safety and efficacy of the drug for its intended use;
- submission to the FDA of an NDA in a form and content that the FDA deems to be acceptable for filing;
- satisfactory completion of an FDA inspection of the manufacturing facility or facilities at which the drug is produced to assess compliance with cGMP in order to assure that the facilities, methods and controls are adequate to preserve the drug's identity, strength, quality and purity; and
- FDA review and approval of the NDA.

The testing and approval processes require substantial time, effort and financial resources.

Once a drug is identified for development it enters the preclinical testing stage. Preclinical tests include laboratory evaluations of chemistry, toxicity and formulation, as well as animal studies to assess the characteristics and potential effects of the drug. The results of preclinical testing are submitted to the FDA, along with other information about drug chemistry, manufacturing and controls and a proposed clinical trial protocol, as part of an IND. Long-term preclinical tests, such as animal tests of reproductive toxicity and the ability or tendency to produce cancer, may continue after the IND is submitted. The IND becomes effective 30 days after receipt by the FDA, unless within the 30-day time period the FDA places the subject clinical trial on a clinical hold. In such a case, the company responsible for the clinical trial (the sponsor) and the FDA must resolve any outstanding concerns before the clinical trial can begin. Clinical holds also may be imposed by the FDA at any time before or during studies due to safety concerns or non-compliance with applicable law or regulation.

All clinical trials must be conducted under the supervision of one or more qualified investigators in accordance with regulations and guidelines establishing good clinical practice. These regulations include the requirement that all research subjects provide informed consent. Further, an institutional review board, or IRB, for each institution participating in a clinical trial must review and approve the plan for the clinical trial before it commences at the institution. An IRB considers, among other things, whether the risks to individuals participating in the trials are minimized and reasonable in relation to the anticipated benefits. The IRB also

approves the information regarding the trial and the consent form that must be provided to each trial subject or his or her legal representative and monitors the study until completed. An IRB may impose conditions to the initiation or continued conduct of trial at the institution for which the IRB is responsible.

Each new clinical protocol must be submitted to the IND for FDA review and to the applicable IRBs for approval. Protocols detail, among other things, the objectives of the study, dosing procedures, subject selection and exclusion criteria, and the parameters to be used to monitor subject safety.

Clinical trials are typically conducted in three sequential phases that may overlap or be combined:

- *Phase 1:* Involves one or more clinical trials in healthy volunteers to evaluate safety, dosage tolerance, absorption, metabolism, distribution and excretion. In the case of some drugs for severe or life-threatening diseases, the initial human testing may be conducted in patients, particularly where the drug may be too inherently toxic to administer ethically to healthy volunteers;
- *Phase 2:* Involves one or more clinical trials in a limited patient population to identify possible adverse effects and safety risks, to evaluate preliminarily the efficacy of the drug for specific targeted diseases and to determine dosage tolerance and optimal dosage; and
- *Phase 3:* Involves one or more clinical trials to further evaluate dosage, clinical efficacy and safety in an expanded patient population at geographically dispersed study sites. These trials are intended to establish the overall risk-benefit ratio of the drug and provide, if appropriate, an adequate basis for product labeling.

Progress reports detailing the results of clinical trials must be submitted at least annually to the FDA and safety reports must be submitted to the FDA and the investigators for serious and unexpected adverse events. Any clinical trial, whether Phase 1, Phase 2 or Phase 3, may fail to be completed successfully within any specified period, or at all. The FDA or the sponsor may suspend a clinical trial at any time on various grounds, including a finding that the trial participants are being exposed to an unacceptable health risk. Similarly, an IRB can suspend or terminate approval of a clinical trial at its institution if the clinical trial is not being conducted in accordance with the IRB's requirements or if the drug under investigation has been associated with unexpected serious harm to patients.

During the development of a new drug, companies have opportunities to meet with the FDA at certain times, typically prior to submission of an IND, after Phase 2 development and before an NDA is submitted. Meetings at other times may also be requested. These meetings provide an opportunity for the company developing the drug to share information about the data gathered to date, for the FDA to provide advice, and for the company and the FDA to reach agreement on the next phase of development. Companies sometimes use the end-of-Phase 2 meeting to discuss their Phase 2 clinical trial results and present their plans for the pivotal clinical trials that they believe will support marketing approval.

If a Phase 2 clinical trial is the subject of discussion at an end-of-Phase 2 meeting with the FDA, a company may be able to request a Special Protocol Assessment, or SPA, the purpose of which is to reach agreement with the FDA on the protocol design and statistical analysis for the pivotal clinical trials that will form the primary basis of an efficacy claim. The FDA is supposed to evaluate the protocol within 45 days of the request to assess whether the proposed trial is adequate, and the evaluation may result in discussions and a request for additional information. An SPA request must be made before the proposed trial begins, and all open issues must be resolved before the trial begins. If an agreement is reached, it will be documented, made part of the administrative record, be binding on the FDA and not be changed unless the company fails to follow the agreed-upon protocol, data supporting the request are found to be false or incomplete or the FDA determines that a substantial scientific issue essential to determining the safety or effectiveness of the drug was identified after the testing began. Even if an SPA is agreed to, approval of the NDA is not guaranteed because a final determination that an agreed-upon protocol satisfies a specific objective, such as the demonstration of efficacy, or supports an approval decision, will be based on a complete review of all the data in the NDA.

If a drug is intended to treat a serious or life threatening condition for which there is an unmet medical need, a company may request that the FDA consider the drug for a fast track development program at the time of submitting its IND or at any time prior to receiving marketing approval. The fast track program is designed to facilitate the development and expedite the review of drugs for the treatment of specific conditions.

The Food and Drug Administration Safety and Innovation Act, which was enacted in 2012, enables a sponsor to request that a drug be designated as a breakthrough therapy. Breakthrough therapy designation is intended to expedite the development and review of drugs for serious or life-threatening conditions. The request is submitted concurrently with or as an amendment to an IND. The request must include supporting information, including the basis for considering the drug as intended to treat a serious condition and a summary of the preliminary clinical evidence that the drug may demonstrate substantial improvement over available therapies. A sponsor must describe the preliminary clinical evidence, including, for example, justification for the clinical study endpoint used and a brief description of statistical analyses. The FDA will make a determination whether or not to grant the request within 60 days after receipt of the submission. The FDA is in the process of developing guidance related to the designation of breakthrough therapies.

Concurrently with clinical trials, companies usually complete additional animal studies and must also develop additional information about the chemistry and physical characteristics of the drug and finalize a process for manufacturing the drug as a product in commercial quantities in accordance with cGMP requirements. The manufacturing process must be capable of consistently producing quality batches of the drug, and, among other things, the manufacturer must develop methods for testing the identity, strength, quality and purity of the final product. Additionally, appropriate packaging must be selected and tested and stability studies must be conducted to demonstrate that the product does not undergo unacceptable deterioration over its shelf life.

*U.S. Review and Approval Processes*

The results of product development, preclinical studies and clinical trials, along with descriptions of the manufacturing process, analytical chemistry tests, proposed labeling, and other relevant information, are submitted to the FDA as part of an NDA requesting approval to market the product. FDA approval of the NDA is required before marketing of the product may begin in the United States. The cost of preparing and submitting an NDA is substantial. Under federal law, the submission of most NDAs is additionally subject to a substantial application user fee and the manufacturer or sponsor under an approved NDA is also subject to annual establishment registration and product listing fees. These fees are typically increased annually. A waiver or reduction of the fees may be obtained under specified limited circumstances.

In addition, under the Pediatric Research Equity Act, or PREA, an NDA or supplement to an NDA must contain data to assess the safety and effectiveness of the drug for the claimed indications in all relevant pediatric subpopulations and to support dosing and administration for each pediatric subpopulation for which the drug is safe and effective. The FDA may grant a deferral for submission of data or a full or partial waiver. Unless otherwise required by regulation, PREA does not apply to any drug for an indication for which orphan designation, as described below, has been granted.

The FDA reviews all NDAs submitted to ensure that they are sufficiently complete for substantive review before it accepts them for filing. The FDA has 60 days from its receipt of an NDA to determine if it will accept the submission for a substantive review, which is referred to as filing the NDA or as accepting the NDA for filing. The FDA may request additional information rather than file an NDA. In this event, the NDA must be resubmitted with the additional information. The resubmitted application also is subject to review before the FDA accepts it for filing. The FDA may refuse to file the NDA. If the submission is accepted for filing, the FDA begins an in-depth substantive review to determine, among other things, whether a product is safe and effective for its intended use and whether its manufacturing is cGMP-compliant to assure and preserve the product’s identity, strength, quality and purity. In that regard, the FDA will inspect the facility or facilities where the product is manufactured before approving an NDA.

Under current performance goals, the FDA has either six or 10 months from the date of its acceptance of an NDA for filing to review and act on the NDA, depending upon whether the NDA is classified by the FDA as eligible for priority (six months) or standard (10 months) review. The review process may be extended by the FDA for an additional three-month period to consider certain information or clarification regarding information already provided in the submission. The FDA may also refer NDAs for novel drug products or for drug products that present difficult questions of safety or efficacy to an advisory committee for review, evaluation and a recommendation as to whether the NDA should be approved. Advisory committees are typically comprised of clinicians and other experts in the relevant area. The FDA is not bound by the recommendation of an advisory committee, but often follows the recommendation.

The FDA approval process is lengthy and difficult and the FDA may refuse to approve an NDA if the applicable regulatory criteria are not satisfied or may require additional clinical or other data and information. Even if any requested additional data or information is submitted, the FDA may ultimately decide that the NDA does not satisfy the criteria for approval. Data obtained from clinical trials are not always conclusive and the FDA may interpret data differently than we or any collaborator of ours does.

NDAs receive either standard or priority review. A drug representing a significant improvement in treatment, prevention or diagnosis of disease may receive priority review. In addition, products studied for their safety and effectiveness in treating serious or life-threatening illnesses and that provide meaningful therapeutic benefit over existing treatments may receive accelerated approval and may be approved on the basis of adequate and well-controlled clinical trials establishing that the drug has an effect on a surrogate endpoint that is reasonably likely to predict clinical benefit or on the basis of an effect on a clinical endpoint other than survival or irreversible morbidity. Priority review and accelerated approval do not change the standards for approval, but may expedite the approval process.

After the FDA evaluates the NDA and the applicable manufacturing facilities, it issues an approval letter or a complete response letter. A complete response letter generally outlines the deficiencies in the submission and may require substantial additional testing or information in order for the FDA to reconsider the NDA. If and when the deficiencies have been addressed to the FDA’s satisfaction in a resubmission of the NDA, the FDA will issue an approval letter. FDA review of a resubmitted NDA can take as long as six months depending on the type of information included.

An approval letter authorizes commercial marketing of the drug with specific prescribing information for specific indications. As a condition of NDA approval, the FDA may require substantial post-approval testing and surveillance to monitor the drug’s safety or efficacy and may impose other conditions, including labeling restrictions and risk evaluation and mitigation strategies, that can materially affect the potential market for and profitability of the drug. Once granted, product approvals may be withdrawn if compliance with regulatory standards is not maintained or problems are identified following initial marketing.

If a drug is the subject of an approved NDA, it may become 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 listed drug. This means, among other things, that it has the same active ingredient(s), route of administration, dosage form and strength, as well as the same labeling, with certain exceptions, and that the labeling must prescribe conditions of use that have been previously approved for the listed drug. If the generic drug product has a different route of administration, dosage form, or strength, the FDA must grant a suitability petition approving the difference(s) from the listed drug before the ANDA may be filed. The ANDA must also contain data and information demonstrating that the generic drug product is bioequivalent to the listed drug or, if the application is submitted pursuant to an approved suitability petition, information to show that the listed drug and the generic drug product can be expected to have the same therapeutic effect as the listed drug when administered to patients for a proposed condition of use. 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 generic 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.

*Marketing Exclusivity*

Market exclusivity provisions under the FDCA also can delay the submission or the approval of certain applications. The FDCA provides a five-year period of non-patent marketing exclusivity within the United States to the first applicant to gain approval of an NDA for a new chemical entity. A drug is a new chemical entity if the FDA has not previously approved any other drug containing the same active moiety, which is generally the molecule or ion responsible for the action of the drug. During the exclusivity period, the FDA may not accept for review an ANDA or an NDA under Section 505(b)(2) of the FDCA submitted by another company for another version of such drug where the applicant does not own or have a legal right of reference to all the data required for approval. However, an application may be submitted after four years if it contains a certification that the listed patents for the approved drug are invalid or not infringed. The FDCA also provides three years of marketing exclusivity for an NDA, Section 505(b)(2) NDA or supplement to an existing NDA if new clinical investigations, other than bioavailability studies, conducted or sponsored by the applicant are deemed by the FDA to be essential to the approval of the application. This may include, for example, new indications for, or new dosages or strengths of, an existing drug. This three-year exclusivity covers only the conditions associated with the new clinical investigations and does not prohibit the FDA from approving ANDAs for drugs containing the original active agent. Five-year and three-year exclusivity will not delay the submission or approval of a full NDA; however, an applicant submitting a full NDA would be required to conduct or obtain a right of reference to all of the preclinical studies and adequate and well-controlled clinical trials necessary to demonstrate safety and effectiveness.

Pediatric exclusivity is another type of exclusivity in the United States. Pediatric exclusivity, if granted, provides an additional six months to an existing exclusivity or statutory delay in approval resulting from a patent certification. This six-month exclusivity, which runs from the end of other exclusivity, whether statutory or patent, may be granted based on the voluntary completion of a pediatric study in accordance with an FDA-issued “Written Request” for the study.

*Orphan Drug Designation*

Under the Orphan Drug Act, the FDA may grant orphan drug designation to a drug intended to treat a rare disease or condition, which is generally a disease or condition that either affects fewer than 200,000 individuals in the United States or affects more than 200,000 individuals in the United States but for which there is no reasonable expectation that the cost of developing and making available in the United States a drug for the disease or condition will be recovered from sales in the United States for that drug. Orphan drug designation must be requested before submitting an NDA. After the FDA grants orphan drug designation, the identity of the therapeutic agent and its potential orphan use are disclosed publicly by the FDA. Orphan drug designation does not convey any advantage in, or shorten the duration of, the regulatory review and approval process.

If a product that has orphan drug designation subsequently receives the first FDA approval for the disease for which it has such designation, the product is entitled to orphan product exclusivity, which means that the FDA may not approve any other applications to market the same drug for the same indication for seven years, except in very limited circumstances (such as a showing of clinical superiority to the product with orphan drug exclusivity). Orphan drug exclusivity does not prevent the FDA from approving a different drug for the same disease or condition or from approving the same drug for a different disease or condition.

The FDA also administers a clinical research grants program, whereby researchers may compete for funding to conduct clinical trials to support the approval of drugs, biologics, medical devices, and medical foods for rare diseases and conditions. A drug does not have to be designated as an orphan drug to be eligible for the grant program. An application for an orphan grant proposes one discrete clinical study to facilitate FDA approval of the product for a rare disease or condition. The study may address an unapproved new product or an unapproved new use for a product already on the market.

*Post-Approval Requirements*

Once an approval is granted, the FDA may withdraw the approval if compliance with regulatory standards is not maintained or if problems occur after the product reaches the market. Later discovery of previously unknown problems with a product may result in restrictions on the product or even complete withdrawal of the product from the market. After approval, some types of changes to the approved product, such as adding new indications, manufacturing changes and additional labeling claims, are subject to further FDA review and approval. Drug manufacturers and other entities involved in the manufacture and distribution of approved drugs are required to register their establishments with the FDA and applicable state agencies and are subject to periodic unannounced inspections for compliance with cGMP and other laws and regulations.

Any products manufactured or distributed by us pursuant to FDA approvals are subject to continuing regulation by the FDA, including, among other things, record-keeping requirements, reporting of adverse experiences with the drug, providing the FDA with updated safety and efficacy information, drug sampling and distribution requirements, complying with certain electronic records and signature requirements, and complying with FDA promotion and advertising requirements. The FDA strictly regulates labeling, advertising, promotion and other types of information on products on the market. Products may be promoted only for the approved indications and in accordance with the provisions of the approved label.

As part of the sales and marketing process, pharmaceutical companies frequently provide samples of approved drugs to physicians. The Prescription Drug Marketing Act, or the PDMA, imposes requirements and limitations upon the provision of drug samples to physicians and prohibits states from licensing distributors of prescription drugs unless the licensing program meets federal guidelines that include minimum standards for storage, handling and record keeping. The PDMA sets forth civil and criminal penalties for violations.

From time to time, legislation is drafted, introduced and passed by the U.S. Congress that could significantly change the statutory provisions governing the approval, manufacturing and marketing of products regulated by the FDA. For example, the Food and Drug Administration Amendments Act of 2007, or FDAAA, gives the FDA the authority to require post-market studies and clinical trials, labeling changes based on new safety information and compliance with a risk evaluation and mitigation strategy approved by the FDA. Failure to comply with any requirements under FDAAA may result in significant penalties. FDAAA also authorizes significant civil money penalties for the dissemination of false or misleading direct-to-consumer advertisements, allows the FDA to require companies to submit direct-to-consumer television drug advertisements for FDA review prior to public dissemination and expands the clinical trial registry so that sponsors of most clinical trials, except for Phase 1 trials, are required to submit certain clinical trial information for inclusion in the clinical trial registry data bank. In addition to the impact of new legislation, FDA regulations and guidance are often revised or reinterpreted in ways that may significantly affect our business and our product candidates.

*Foreign Regulation*

In addition to regulations in the United States, we are subject to a variety of foreign regulations governing clinical trials of our product candidates and commercial sales and distribution of any products. Whether or not we obtain FDA approval for a product candidate or product, we must obtain approval by the comparable regulatory authorities of foreign countries, or of economic areas such as the European Union, before we can commence clinical trials of the product candidate or marketing of the product in those countries or areas. The approval process and requirements governing the conduct of clinical trials, product licensing, pricing and reimbursement vary greatly from place to place, and the time required may be longer or shorter than the time required for FDA approval.

Under European Union regulatory systems, we may submit marketing authorization applications either under a centralized or a decentralized procedure. The centralized procedure, which provides for the grant of a single marketing authorization that is valid for all European Union member states, is compulsory for medicines produced by biotechnology or intended to treat AIDS, cancer, neurodegenerative disorders or diabetes and

optional for medicines that are highly innovative. For drugs without approval in any member state, the decentralized procedure provides for approval by one or more other, or concerned, member states of an assessment of an application performed by one member state, which is known as the reference member state. Under this procedure, an applicant submits an application, or dossier, and related materials (including a draft summary of product characteristics, draft labeling and package leaflet) to the reference member state and concerned member states. The reference member state prepares a draft assessment and drafts of the related materials within 120 days after receipt of a valid application. Within 90 days of receiving the reference member state's assessment report, each concerned member state must decide whether to approve the assessment report and related materials. If a member state cannot approve the assessment report and related materials on the grounds of potential serious risk to public health, any disputed issues may eventually be referred to the European Commission and the decision of the European Commission would be binding on all member states.

As in the United States, we may apply for designation of a product as an orphan drug for the treatment of a specific indication in the European Union before the application for marketing authorization is made. Orphan drugs in Europe enjoy economic and marketing benefits, including up to 10 years of market exclusivity for the approved indication unless another applicant can show that its product is safer, more effective or otherwise clinically superior to the orphan-designated product.

*Reimbursement*

Sales of pharmaceutical products depend in significant part on the availability of third-party reimbursement. Third-party payors include government health programs such as Medicare and Medicaid, managed care providers, private health insurers and other organizations. These third-party payors are increasingly challenging the price and examining the cost-effectiveness of medical products and services, including prescription drugs. In addition, significant uncertainty exists as to the reimbursement status of newly approved prescription drugs and other healthcare products. We may need to conduct expensive pharmacoeconomic studies in order to demonstrate the cost-effectiveness of any of our products that is successfully developed and approved. Our product candidates may not be considered cost-effective. It is time consuming and expensive to seek reimbursement from third-party payors. Reimbursement may not be available or sufficient to allow the sale of any of our products that is successfully developed and approved on a competitive and profitable basis.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003, or the MMA, established the Medicare Part D program to provide a voluntary prescription drug benefit to Medicare beneficiaries. Under Part D, Medicare beneficiaries may enroll in prescription drug plans offered by private entities to provide coverage of outpatient prescription drugs. Part D plans include both stand-alone prescription drug benefit plans and prescription drug coverage as a supplement to Medicare Advantage plans. Unlike Medicare Parts A and B, Part D coverage is not standardized. Part D prescription drug plan sponsors are not required to pay for all covered Part D drugs, and each Part D prescription drug plan can develop its own drug formulary that identifies which drugs it will cover and at what tier or level. However, Part D prescription drug formularies must include drugs within each therapeutic category and class of covered Part D drugs, although not necessarily all of the drugs within each category or class. Any formulary used by a Part D prescription drug plan must be developed and reviewed by a pharmacy and therapeutic committee.

It is not clear what long-term effect the MMA will have on the prices paid for currently approved drugs and the pricing options for newly approved drugs. Government payment for some of the costs of prescription drugs may increase demand for any of our products that is successfully developed and approved. However, any negotiated prices for our products covered by a Part D prescription drug plan will likely be lower than the prices we might otherwise obtain. Moreover, although the MMA applies only to drug benefits for Medicare beneficiaries, private payors often follow Medicare coverage policy and payment limitations in setting their own payment rates. Accordingly, any reduction in payment that results from the MMA may result in a similar reduction in payments from non-governmental payors.

We expect that there will continue to be a number of federal and state proposals to implement governmental pricing controls and limit the growth of healthcare costs, including the cost of prescription drugs. Currently, Medicare is prohibited from negotiating directly with pharmaceutical companies for drugs. However, the U.S. Congress may in the future consider legislation that would lift the ban on federal negotiations.

The American Recovery and Reinvestment Act of 2009 provides funding for the federal government to compare the effectiveness of different treatments for the same illness. A plan for the research would be developed by the Department of Health and Human Services, the Agency for Healthcare Research and Quality and the National Institutes of Health, and periodic reports on the status of the research and related expenditures would be made to the U.S. Congress. Although the results of the comparative effectiveness studies are not intended to mandate coverage policies for public or private payors, it is not clear whether research would have any effect on the sales of any of our products that is successfully developed and approved, if the product or the condition that it is intended to treat becomes the subject of a study. It is also possible that comparative effectiveness research demonstrating benefits of a competitor's product could adversely affect the sales of any of our products that is successfully developed and approved. If third-party payors do not consider our products to be cost-effective compared to other available therapies, they may not cover our products after approval as a benefit under their plans or, if they do, the level of payment may not be sufficient to allow us to sell our products on a profitable basis.

The Patient Protection and Affordable Care Act, or the ACA, as amended by the Health Care and Education Affordability Reconciliation Act of 2010, is expected to have a significant impact on the health care industry. The ACA is expected to expand coverage for the uninsured while at the same time containing overall healthcare costs. Among other things, the ACA is expected to expand and increase industry rebates for drugs covered under Medicaid programs and make changes to the coverage requirements under the Medicare Part D program. We cannot predict the impact of the ACA on pharmaceutical companies because many of the ACA's reforms require the promulgation of detailed regulations to implement the statutory provisions, which has not yet occurred. In addition, although the United States Supreme Court has upheld the constitutionality of most of the ACA, some states have indicated that they intend not to implement certain sections of the ACA and some members of the U.S. Congress are still working to repeal the ACA. These challenges add to the uncertainty of the effects of the ACA.

The Physician Payment Sunshine Act, or Sunshine Act, which was enacted as part of ACA, requires covered manufacturers of drugs covered under Medicare, Medicaid or the Children's Health Insurance Program to report annually to the Secretary of the Department of Health and Human Services payments or other transfers of value made by that entity, or by a third party as directed by that entity, to physicians and teaching hospitals, or to third parties on behalf of physicians or teaching hospitals, during the course of the preceding calendar year. The final rule implementing the Sunshine Act, published on February 8, 2013, requires data collection on payments to begin on August 1, 2013. Failure to submit required information may result in civil monetary penalties of up to $150,000 per year (up to $1 million per year for "knowing failures") for all payments, transfers of value or ownership or investment interests not reported in an annual submission.

If not preempted by the ACA, several states require pharmaceutical manufacturers to report expenses relating to the marketing and promotion of pharmaceutical products and to report gifts and payments to individual physicians in the states. Other states prohibit providing various other marketing related activities. Still other states require the posting of information relating to clinical studies and their outcomes. In addition, some states, such as California, Nevada and Massachusetts, require pharmaceutical manufacturers to implement compliance programs or marketing codes. Currently, several additional states are considering similar proposals. Compliance with these laws is difficult and time consuming, and companies that do not comply with these state laws face civil penalties.

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 provides options for its member states to restrict the range of medicinal products for which their

respective national health insurance systems provide reimbursement and 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. There can be no assurance that any country that has price controls or reimbursement limitations for pharmaceutical products will allow favorable reimbursement and pricing arrangements for any of our products for which we receive marketing approval. Historically, the price structures for products launched in the European Union do not follow those of the United States and tend to be significantly lower.

**Employees**

As of February 28, 2013, we had 40 full-time employees 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 100 North Main Street, Suite 1510, 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 and 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 SEC.

Targacept®, Pentad™ and NNR Therapeutics™ are trademarks of ours. Other service marks, trademarks and trade names appearing in this annual report are the properties of their respective owners.

## Item 1A. Risk Factors.

### *Risks Related to Our Financial Results*

**We have a substantial accumulated deficit and may incur losses for future periods. We may not achieve profitability for any future period or, if we do achieve profitability for a future period, we may not sustain or grow our profitability.**

We were incorporated in 1997 and operated as a wholly owned subsidiary of R.J. Reynolds Tobacco Company until August 2000. As of December 31, 2012, we had an accumulated deficit of $233.9 million. We had net loss of $7.0 million and $8.5 million for the years ended December 31, 2012 and 2011, respectively, and net income of $10.9 million for the year ended December 31, 2010. Our net income for 2010 was due primarily to the recognition into revenue of a portion of the upfront payment that we received under our now terminated agreement with AstraZeneca for major depressive disorder, or MDD that we entered into in December 2009. Our losses for other periods 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 may incur losses for future periods as our product candidates advance into later-stage development and as we progress our programs and invest in additional product opportunities. As a result, we will need to generate significant revenues to achieve profitability in the future or, if we do achieve profitability for any particular period, to sustain or grow our profitability on a quarterly or annual basis.

We derived a substantial portion of our revenue for 2012, 2011 and 2010 from our strategic alliances and collaborations. We expect that a substantial portion of our operating cash flow in the next few years will depend on the following:

- the scope, progress, duration, results and cost of clinical trials, as well as non-clinical studies and assessments, of our product candidates and programs;
- whether we establish additional strategic alliances, collaborations or licensing or other comparable arrangements, or whether we pursue and complete any merger, acquisition or other significant corporate transaction, and, if we do, the associated terms in each case; and
- whether and to what extent milestone events are achieved for AZD1446 under our collaboration agreement with AstraZeneca.

Sources that have contributed to our revenue for any particular year may not continue. For example, we received $245 million in aggregate payments under two collaborations with global pharmaceutical companies that are now terminated and no longer sources of future revenue. Additionally, we do not currently have any source of product revenue.

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

**Our failure to obtain additional capital when needed could force us to delay, reduce or eliminate our product development programs or future commercialization efforts.**

Successful drug development and commercialization requires significant amounts of capital. It is foreseeable that we will in the future require substantial additional capital in order to continue to conduct the development and regulatory activities necessary to bring our product candidates to market (or, where applicable for a particular product candidate, to the stage of development when a potential future collaborator of ours may assume responsibility under the terms of the applicable agreement for funding further development and subsequent commercialization) and potentially to establish sales and marketing capabilities. Our future capital requirements are difficult to forecast and will depend on many factors, including:

- the scope, progress, duration, results and costs of clinical trials, as well as non-clinical studies and assessments, of our product candidates and programs;
- whether we establish additional strategic alliances, collaborations or licensing or other comparable arrangements, or whether we pursue and complete any merger, acquisition or other significant corporate transaction, and, if we do, the associated terms in each case;
- whether and to what extent milestone events are achieved for AZD1446 under our collaboration agreement with AstraZeneca;
- the extent to which we retain development or commercialization rights or responsibilities for our product candidates and incur associated development costs, manufacturing costs or costs to establish sales and marketing functions;
- the number and characteristics of product candidates that we pursue and programs that we conduct;
- the costs to satisfy our obligations under potential future alliances and collaborations;
- the costs of preparing, filing and prosecuting patent applications and maintaining, enforcing and defending patents and other intellectual property rights;
- the costs of manufacturing-related services for our product candidates in development;

- the costs, timing and outcomes of regulatory reviews or other regulatory actions;
- the timing, receipt and amount of sales or royalties, if any, from our potential products;
- the extent of our general and administrative expenses; and
- the rate of technological advancements for the indications that we target.

In addition, we may seek additional capital, whether through offerings of securities utilizing our currently effective Registration Statement on Form S-3 or otherwise, if the conditions for raising capital are favorable or based on 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 may be diluted, and the terms of the securities may include liquidation or other preferences that materially and 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 alliance, collaboration or 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.

We plan to continue, whether alone, with AstraZeneca where applicable or with potential future collaborators, to advance our product candidates through the development process. We currently expect that our existing capital resources will enable us to fund our operations through at least the end of 2015. 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. Our ability to raise additional funds if and when needed on terms that are acceptable to us, or at all, is uncertain. If adequate funds are not available on a timely basis, we may:

- terminate, delay or downsize clinical trials or manufacturing or other development activities for one or more of our product candidates;
- delay establishment of any sales and marketing capabilities or other activities that may be necessary to commercialize our product candidates; or
- scale back or eliminate programs that are designed to expand our product pipeline.

### *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 one or more 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.**

Our ability to generate product or royalty revenue over the next few years will depend substantially on the successful development and commercialization of our clinical-stage product candidates, including in particular TC-5619, TC-5214 and TC-1734 (which are all currently in Phase 2b clinical 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 condition;
- 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 the favorable findings in our completed Phase 2 clinical trial of TC-5619 in schizophrenia patients are not replicated in our ongoing Phase 2b clinical trial in negative symptoms and cognitive dysfunction in schizophrenia or in any future clinical trials of TC-5619, we will not obtain the regulatory approvals required to market and sell TC-5619.**

Favorable results in earlier-stage clinical trials of a product candidate may not be replicated in later clinical trials that involve different numbers of subjects, different dosing regimens and durations, different subject populations, different geographical locations, different outcome measures or other differences in design or execution. There are various differences between our completed Phase 2 clinical trial of TC-5619 in cognitive dysfunction in schizophrenia and our ongoing Phase 2b clinical trial of TC-5619 in negative symptoms and cognitive dysfunction in schizophrenia. In particular, the Scale for the Assessment of Negative Symptoms, or SANS, was a secondary outcome measure that TC-5619 met in the completed trial. Our ongoing trial utilizes SANS as the primary outcome measure and, unlike the completed trial, permits only subjects who meet specified criteria for negative symptoms of schizophrenia to be enrolled. In addition, subjects who received TC-5619 in our completed trial received three different daily doses over a 12-week dosing period (1mg, 5mg and 25mg), and the completed trial was not designed to establish statistically the specific dosage at which TC-5619 had positive effects. Subjects in the ongoing trial who receive TC-5619 receive a fixed daily dose of 5mg or 50mg throughout a 24-week dosing period. Although we were guided by data from the completed trial and earlier studies in selecting the dosages of TC-5619 to be evaluated in our ongoing trial, we cannot be certain that the optimum dosage was selected. Also, our ongoing trial involves a larger number of subjects than the completed trial did. Moreover, with regard to cognitive dysfunction in schizophrenia, in the completed trial, TC-5619 met the protocol criteria for a positive result on the Groton Maze Learning task, the trial's primary outcome measure and one part of the CogState Schizophrenia Battery, or CSB. However, TC-5619 did not demonstrate a drug effect on all of the completed trial's efficacy outcome measures, including the CSB composite score, or on all measurement dates. The ongoing trial utilizes the CSB composite score, rather than the Groton Maze Learning task, as an identified key secondary outcome measure. It is possible that these or other differences between our completed Phase 2 clinical trial and our ongoing Phase 2b clinical trial of TC-5619 will impact the likelihood that the favorable findings in the completed trial will be replicated in the ongoing trial. If the favorable findings in the completed trial are not replicated in the ongoing trial or in any future trials of TC-5619 in schizophrenia patients that we conduct, we will not obtain the regulatory approval required to market and sell TC-5619 as a treatment for either or both of negative symptoms of schizophrenia or cognitive dysfunction in schizophrenia.

**The clinical trial designs and endpoints that will be required to obtain regulatory approval of a drug to treat negative symptoms of schizophrenia or cognitive dysfunction in schizophrenia are uncertain, and we may never receive the regulatory approvals required to market and sell TC-5619 as a treatment for either of these indications.**

There is currently no product approved in the United States, Europe or, to our knowledge, elsewhere specifically for the treatment of negative symptoms of schizophrenia or cognitive dysfunction in schizophrenia. Accordingly, there is not a well-established development path that, with positive outcomes in clinical trials, would be reasonably assured of receiving regulatory approval for TC-5619 in either of these indications. In particular, if our ongoing Phase 2b clinical trial of TC-5619 demonstrates favorable results in the treatment of either or both of negative symptoms of schizophrenia and cognitive dysfunction in schizophrenia and we subsequently conduct later-stage trials of TC-5619, the U.S. Food and Drug Administration, or FDA, or any foreign regulatory authority may determine that the designs or endpoints of our trials are not acceptable to establish the safety and efficacy of TC-5619 for the applicable indication or to support the approval required to market and sell TC-5619, even if the outcomes from the trials are positive.

**Replicating the favorable findings from our completed Phase 2 clinical trial of TC-5619 in cognitive dysfunction in schizophrenia may not be sufficient to obtain the regulatory approvals required to market and sell TC-5619, or regulatory approvals may be limited in a manner that adversely affects the commercial potential of TC-5619.**

As discussed above, in our completed Phase 2 trial in cognitive dysfunction in schizophrenia, TC-5619 met the protocol criteria for a positive result on the Groton Maze Learning task, the trial's primary outcome measure, but did not demonstrate a drug effect on the composite score on the CSB. We believe it is unlikely that replicating a positive result on the Groton Maze Learning task alone in our ongoing Phase 2b clinical trial of TC-5619 and in any later-stage clinical trials that we conduct in the future would be acceptable to support approval from the FDA or foreign regulatory authorities to market and sell TC-5619 to treat cognitive dysfunction in schizophrenia.

In addition, the favorable findings in our completed trial of TC-5619 were driven substantially by outcomes at sites in the United States, as opposed to India, and by subjects who used tobacco, as TC-5619 did not demonstrate an effect in subjects who did not use tobacco. These differences, if replicated in any clinical trials that we conduct that are designed to support regulatory approval of TC-5619 as a treatment for either or both of negative symptoms of schizophrenia and cognitive dysfunction in schizophrenia, could have a negative impact on the likelihood of the FDA or foreign regulatory authorities granting approval to market and sell TC-5619 as a treatment for the applicable indication. Moreover, if the favorable findings in any clinical trials that we conduct that are designed to support regulatory approval are limited to subjects who use tobacco, the FDA or foreign regulatory authorities could limit the patient population for which TC-5619 is approved to tobacco users. Although it is believed that a substantial majority of schizophrenic patients use tobacco, if the patient population for which TC-5619 is approved were to be limited to tobacco users, the commercial potential of TC-5619 could be materially and adversely affected.

**We may choose to pursue only one of negative symptoms of schizophrenia or cognitive dysfunction in schizophrenia in any future clinical trials of TC-5619, which could limit the commercial potential of TC-5619.**

Based on feedback that we have received from the FDA, three co-primary endpoints—one assessing negative symptoms, one assessing cognitive dysfunction and one assessing global function—in each of at least two clinical trials may be required to support approval of TC-5619 for both negative symptoms of schizophrenia and cognitive dysfunction in schizophrenia. It is difficult for any investigational drug to show statistically significant effects on three co-primary endpoints in the same clinical trial. Accordingly, it is likely that we would design any Phase 3 clinical program to support approval for either negative symptoms of schizophrenia or cognitive dysfunction in schizophrenia, depending on the particular outcomes from our ongoing Phase 2b clinical trial, but not both, which could limit the commercial potential of TC-5619.

**TC-5214 has not yet been studied in clinical trials in overactive bladder, and our previous findings from nonclinical studies and assessments and clinical trials in a different indication may not be predictive of a benefit for TC-5214 as a treatment for overactive bladder. If our planned and any future clinical trials of TC-5214 in overactive bladder are not successful, we will not obtain the regulatory approvals required to market and sell TC-5214.**

We are developing TC-5214 as a treatment for overactive bladder. Our decision to conduct this development was based primarily on various findings from nonclinical studies and assessments of TC-5214 and clinical trials of TC-5214 in a different indication that we believe indicate potential benefits of TC-5214 as an overactive bladder therapy. We have not yet conducted any clinical trials of TC-5214 in patients with overactive bladder, and our previous findings may not be predictive of clinical success in this patient population. If our planned and any future clinical trials of TC-5214 in overactive bladder are not successful, we will not obtain the regulatory approvals required to market and sell TC-5214 as a treatment for overactive bladder.

**If we are unable to complete the development program for TC-5214 and submit a new drug application to the FDA on or before September 30, 2017 or if other statutory conditions are not met, TC-5214 may not receive the five-year exclusivity period provided by applicable law, in which case our ability to exclude third parties from themselves marketing TC-5214 in the United States would be substantially dependent on patents after three years.**

The Federal Food, Drug, and Cosmetic Act, or FDCA, provides a five-year period of marketing exclusivity in the United States to the first applicant to obtain approval of a new drug application, or NDA, for a drug that qualifies as a new chemical entity. The exclusivity period runs concurrently with any patents that cover the new chemical entity, but provides exclusivity independent from and irrespective of the patents. Accordingly, a new chemical entity approved in the United States has assurance of a statutory period of marketing exclusivity in the United States whether or not the patents that cover it are sufficiently strong to withstand challenge.

TC-5214 is one of two enantiomers of a racemate previously marketed in the United States. Enantiomers are mirror images of each other that have the same chemical but potentially different biological properties, and a racemate is a chemical mixture comprised of two corresponding enantiomers. Under Section 505(u) of the FDCA as currently in effect, an NDA applicant may, if certain conditions are met, elect that a single enantiomer of a previously approved racemate not be considered the same active ingredient as the racemate and thereby preserve potential eligibility for the single enantiomer as a new chemical entity. The election may only be made for an NDA submitted on or before September 30, 2017, when the statutory provision that permits the election is scheduled to expire unless it is re-authorized by the U.S. Congress. It is uncertain whether the statutory provision will be re-authorized. If for any reason we are unable to submit an NDA for TC-5214 on or before September 30, 2017, or if other statutory conditions are not met, and the statutory provision is not reauthorized, TC-5214 will not receive the five-year exclusivity period and will be limited to a three-year exclusivity period that is provided by the FDCA for certain applications. In that case, we would be substantially reliant on patent protection to provide an extended term of exclusivity in the United States. Like any patent, the patents that we own or license covering TC-5214 and those that may issue in the future are subject to potentially being challenged, invalidated, rendered unenforceable or circumvented, any of which could limit our ability to stop third parties from marketing TC-5214 or related products themselves. If we are unable to enforce or defend patents that cover TC-5214 that we own or license and cannot stop third parties from marketing TC-5214 or related products themselves, any future commercialization of TC-5214 would be materially and adversely affected and our business would suffer.

**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 and regulatory 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 or foreign governmental or regulatory authorities may from time to time change approval policies or adopt new laws or regulations that 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.

A Phase 1 clinical trial program typically takes several months to complete, a Phase 2 clinical trial program typically takes several months to two years to complete and a Phase 3 clinical trial program typically takes one to four years to complete. Moreover, Phase 3 clinical trials may not follow successful completion of Phase 2 clinical trials directly, as additional non-clinical assessments or clinical trials may first be required. Industry sources have reported 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 pivotal clinical trials. However, additional clinical trials may be required by the FDA or foreign regulatory authorities following completion of pivotal clinical trials and prior to seeking approval. Precise estimates vary, but a great majority of investigational drugs that enter clinical trials will never 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;
- clinical trial results may indicate that the product candidate is not effective, whether because the product candidate does not have its intended effects in the clinical trial, because subjects given an inactive comparator (i.e., placebo) in the clinical trial experience benefits comparable to the benefits experienced by subjects given the product candidate, which obscures the effects of the product candidate, or for any other reason;
- the FDA (or any advisory committee on which the FDA relies) may interpret results of clinical trials or manufacturing or other non-clinical studies or assessments to indicate that the product candidate is not safe, effective or acceptable for commercial use, even if we interpret the same results differently; or
- the FDA may deem the processes or facilities that we, our collaborators or our third-party manufacturers propose to use in connection with the manufacture of the product candidate to be unacceptable.

If we obtain the requisite regulatory approval for a particular product candidate, the approval may not extend to all indications for which approval was sought, which could limit the use of the product and materially and adversely impact our revenue.

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. This process is likely to cause delays in the marketing of any of our product candidates that receives approval and could materially and adversely impact our revenue 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 clinical trials of any of our product candidates could occur at any stage of testing. For example, TC-5214 did not achieve the primary endpoint in multiple Phase 3 clinical trials in

major depressive disorder completed in 2011 and 2012. If we experience failures in our ongoing or future clinical trials, or if we are not able to design clinical trials to establish the safety and efficacy of our product candidates and otherwise achieve the objectives of the trials, 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, applicable foreign 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 a clinical trial is commenced, we, the FDA, applicable foreign regulatory authorities and 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 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 or applicable foreign 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.

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

**If clinical trials for any of our product candidates are prolonged or delayed, we would experience a delay in the commercialization of the affected product candidates, which may require us to incur additional costs and delay our receipt of any revenue from potential product sales.**

We cannot predict whether we will encounter problems with any ongoing or planned clinical trials of our product candidates 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 those described below, could delay the initiation or completion of any ongoing or planned clinical trial of any of our product candidates or otherwise negatively impact our ability to obtain regulatory approval for, and to market and sell, the product candidate:

- conditions imposed on us by the FDA or any foreign regulatory authority regarding the scope or design of the clinical trial;
- delays in recruiting and enrolling subjects into the clinical trial;
- delays in obtaining, or our inability to obtain, required approvals from institutional review boards, ethics committees or other reviewing entities at clinical sites selected for participation in the clinical trial;
- insufficient supply or deficient quality of the product candidate or other materials necessary to conduct the clinical trial;
- lower than anticipated retention rate of subjects in the clinical trial;
- negative or inconclusive results from the clinical trial, or results that are inconsistent with earlier results, that necessitate additional study;
- serious and unexpected drug-related side effects experienced by subjects in the clinical trial; 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 subject enrollment, which is a function of many factors—including the size of the patient population, the extent to which other clinical trials are being conducted concurrently that involve the same patient population, the number of participating clinical sites, the proximity of subjects to clinical sites, the nature of the trial protocol, the availability of effective treatments for the relevant disease, the eligibility criteria for the clinical trial and the emphasis placed on ensuring a rigorous adherence to the eligibility criteria. Delays in subject enrollment can result in increased costs and longer development times. The failure to enroll subjects in a clinical trial could delay the completion of the clinical trial beyond our current expectations. For example, we have experienced enrollment delays in our ongoing Phase 2b studies of TC-5619 in negative symptoms and cognitive dysfunction in schizophrenia and TC-1734 in mild to moderate Alzheimer's disease that delayed our projected completion dates for the studies.

In addition, the FDA or foreign regulatory authorities could require us to conduct clinical trials for any of our product candidates with a larger number of subjects than we project. We may not be able to enroll a sufficient number of subjects in a timely or cost-effective manner. Furthermore, enrolled subjects may drop out of clinical trials, which could impair the validity or statistical analysis of those clinical trials.

We do not know whether any clinical trial of any of our product candidates will begin as planned, will need to be restructured or will be completed on schedule, if at all. Delays in clinical trials may 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.

**Regulatory authorities may require more data for any of our product candidates than we currently anticipate, which could cause us to incur additional costs, extend our development timelines or delay our receipt of any revenue from potential product sales.**

The FDA or foreign regulatory authorities may require more preclinical or clinical data for any of our product candidates or more time to evaluate data than we currently anticipate because drugs that act on NNRs are not a well-established class of drugs, because nicotine, which interacts with all nicotinic receptors, has addictive properties and potential for abuse, because of experiences with drugs that act on NNRs that are developed or marketed by third parties or for any other reason. In particular, the FDA has issued a public health advisory with regard to Pfizer's aid to smoking cessation product, Chantix, and requires Chantix (as well as Zyban, which is GlaxoSmithKline's aid to smoking cessation product) to include a boxed warning on its prescribing information. The warning makes prominent the risk of serious mental health events, including changes in behavior, depressed mood, hostility, agitation and suicide-related events, that have been reported in some patients attempting to quit smoking while taking these drugs. The FDA has also issued a separate safety alert reporting a higher incidence of cardiovascular events with Chantix than placebo in completed clinical trials. Chantix acts on several NNR subtypes, as well as other molecular targets in the body. All of our product candidates currently in development affect the activity of one or more NNR subtypes.

It is uncertain whether any adverse medical experiences associated with Chantix will impact the view of the FDA or foreign regulatory authorities regarding our product candidates. If the FDA or any foreign regulatory authority determines that any adverse medical experiences associated with Chantix have relevance to one or more of our product candidates or that compounds that interact with NNRs may have potential for abuse, it may require us to generate more clinical data than we currently anticipate to establish that the affected product candidate is safe or does not have abuse potential, which could increase the cost of the development program for the affected product candidate, extend the development timeline for the affected product candidate or delay our receipt of revenue from potential product sales of the affected product candidate.

**Our ongoing Phase 2b clinical trial of TC-1734 in mild to moderate Alzheimer's disease is evaluating our product candidate as compared to a commonly used marketed medication rather than placebo, which may make a positive outcome more difficult to achieve.**

Our ongoing Phase 2b clinical trial of TC-1734 is designed to evaluate TC-1734 as a treatment for mild to moderate Alzheimer's disease as compared to donepezil, the marketed medication most often prescribed for the disease. As a result, the trial will not have a positive outcome and serve as a step towards potential regulatory approval if TC-1734 does not statistically outperform donepezil, even if TC-1734 could be an effective treatment for mild to moderate Alzheimer's disease. This requirement of superiority to donepezil may make a positive outcome comparatively less likely than if we were evaluating TC-1734 in the trial as compared to an inactive comparator (i.e., placebo). If the trial is not successful, we will never obtain regulatory approval to market and sell TC-1734 as a treatment for mild to moderate Alzheimer's disease.

**Our Special Protocol Assessment agreement with the FDA for our ongoing Phase 2b clinical trial of TC-1734 in mild to moderate Alzheimer's disease does not guarantee regulatory approval or any particular outcome from any future regulatory review of TC-1734, even if we believe that the outcome of the trial when completed is favorable.**

We have obtained a Special Protocol Assessment, or SPA, agreement with the FDA for our ongoing Phase 2b clinical trial of TC-1734 in mild to moderate Alzheimer's disease. The purpose of an SPA is to memorialize an agreement with the FDA on the protocol design and statistical analysis for the clinical trials that will form the primary basis of an efficacy claim. Clinical trials that are designed to support a determination that a drug is safe and effective for a particular use are sometimes referred to as "pivotal" trials. Our SPA with the FDA provides that the ongoing Alzheimer's disease trial will not alone be sufficient to support regulatory approval for TC-1734. If we submit an NDA following completion of the ongoing trial and any additional clinical trials of TC-1734 that we conduct in mild to moderate Alzheimer's disease, the NDA may not be approved by the FDA notwithstanding our SPA, even if we believe that the data from the trials support approval.

Approval of an NDA for TC-1734 is not guaranteed because a final determination by the FDA that an agreed-upon protocol satisfies a specific objective, such as the demonstration of efficacy, or supports an approval decision will be based on a complete review of all of the data in the NDA. The FDA retains significant latitude and discretion in interpreting the terms of an SPA, the data and results from clinical trials and all other information included in the NDA. For example, the FDA may require trial design changes or additional studies if issues arise that it believes to be relevant to determining safety or efficacy, the FDA may reconsider the agreed upon scope of review based on data that subsequently becomes available and the FDA may raise concerns that arise after grant of the SPA that override it. In particular, the FDA may determine that our ongoing study of TC-1734 in mild to moderate Alzheimer's disease, which we are conducting at sites predominantly in Eastern Europe and also in the United States, did not when completed include a sufficient number of subjects at sites in the United States to support regulatory approval to market and sell TC-1734. In addition, in previous toxicology studies of TC-1734 in male rats, testicular abnormalities were observed. These preclinical abnormalities, which were provided to the FDA prior to receiving our SPA agreement and initiating our ongoing study, were seen only in rats and not in any of the four other species studied. The findings in rats could adversely affect the likelihood that the FDA will grant approval to market and sell TC-1734, or the FDA could grant approval of TC-1734 only for a limited population of patients with mild to moderate Alzheimer's disease or require a warning on the prescribing information that limits the overall commercial potential of TC-1734. As a result, even with an SPA, we cannot be certain that the FDA will find any particular clinical trial results acceptable to support regulatory approval to market and sell TC-1734 as a treatment for mild to moderate Alzheimer's disease.

**We have closed our laboratory operations and no longer have the capability to identify or discover internal product candidates. If development of our product candidates currently in clinical development proves to be unsuccessful, we may not be able to overcome the pipeline attrition, which would have a material adverse effect on our business.**

In 2012, we completed two workforce reductions and closed our laboratory operations. Following these actions, we do not have internal discovery and research capabilities or the ability to identify and discover new internal product candidates. We have no current plan to resume discovery or research activities. If in the future we were to resume these activities, we would need to recruit additional scientific and technical personnel and obtain access to laboratory facilities. We currently have three active clinical development programs and, without internal discovery and research, we may not be able to expand our pipeline with internal candidates or at all. If our current development activities are unsuccessful and we experience attrition, our business would be materially and adversely affected, which would materially and adversely impact our stock price.

**Each of our product candidates will remain subject to ongoing regulatory review even if it receives marketing approval. If we fail to comply with continuing regulations or if patients taking our products experience adverse health effects, we could lose the approval or the sale of the affected products could be suspended or otherwise adversely affected.**

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 medical experiences that limit or prevent its widespread use or commercial potential, force us to withdraw it from the market or impede or delay our ability to obtain regulatory approvals in additional countries. If any of our product candidates that becomes an approved product either causes adverse medical experiences or becomes associated with a third-party product that is associated with adverse medical experiences such as those related to Chantix described above under "*Regulatory authorities may require more data for any of our product candidates than we currently anticipate, which could cause us to incur additional costs, extend our development timelines or delay our receipt of any revenue from potential product sales.*," the overall commercial success of the affected product may be negatively impacted.

In addition, if any of our product candidates becomes an approved product, 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 recordkeeping related to the product will remain subject to extensive regulatory requirements. We may be slow to adapt, or may never adapt, to changes in existing regulatory requirements or adoption of new regulatory requirements.

Also, although we have not received any notice that we are the subject of any FDA enforcement action, it is possible that we may be in the future and that could have a material adverse effect on our business. If we fail to comply with the requirements of the FDA and other applicable U.S. or foreign governmental or regulatory authorities or previously unknown problems with our products or product candidates, 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 multiple compounds and are considering a variety of target indications, we may apply our finite resources to pursue a particular product candidate or indication, fail to capitalize on product candidates or indications that may be more profitable or for which there is a greater likelihood of success, or relinquish valuable rights to our disadvantage.**

Because we have finite financial and managerial resources, we must focus on 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. Furthermore, if we do not accurately evaluate the commercial potential or target market for a particular product candidate, or if we incorrectly conclude that utilizing the expertise and resources of a collaborator in the development or potential commercialization of a particular product candidate would benefit us, we may relinquish valuable rights to that product candidate through strategic alliances, collaborations or licensing or other comparable arrangements in cases in which it would have been advantageous for us to retain sole development and commercialization rights. Any of these decisions or conclusions could have a material adverse effect on our business.

### *Risks Related to Our Dependence on Third Parties*

**The successful development and commercialization of AZD1446 depends substantially on our collaboration with AstraZeneca, and AstraZeneca may decide not to conduct any further development of AZD1446.**

Our collaboration agreement with AstraZeneca involves a complex allocation of rights, provides for milestone payments to us if specified development, regulatory and first commercial sale milestone events are achieved and provides us with royalty-based revenue if AZD1446 or another product candidate in the collaboration is successfully commercialized. AstraZeneca has decision-making authority for most matters under the agreement, including, provided it meets its diligence obligations, whether to proceed with further development and potential commercialization of any particular product candidate in the collaboration and, if so, for what indication(s). Under the terms of the agreement, we are not permitted to conduct development of AZD1446 (or any other product candidate in the collaboration) independently or with another collaborator. Although we are currently in discussions with AstraZeneca regarding the next development steps for AZD1446, AstraZeneca may decide not to conduct any further development of AZD1446.

AstraZeneca has significant control and we have little control over the conduct and timing of development efforts for AZD1446. If AstraZeneca fails to devote sufficient financial and other resources to the development of AZD1446, the development and potential commercialization of AZD1446 would be delayed. This would result in a delay in potential milestone payments and, if regulatory approval to market and sell AZD1446 is obtained, royalties that we could receive on any future AZD1446 product sales.

AstraZeneca has the right to terminate our collaboration agreement in its entirety upon 90 days' notice. Termination of the agreement by AstraZeneca at any time could negatively impact our business. In particular, we

would have to fund any further clinical development and commercialization of AZD1446 on our own, which could accelerate our need for additional capital, or alternatively seek another collaborator or licensee for clinical development and commercialization or abandon the development and commercialization of AZD1446.

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

In addition to our collaboration agreement with AstraZeneca, we intend to selectively enter into alliances and collaborations, particularly for target indications for which a potential collaborator has unique expertise or that represent large primary care markets that must be served by large sales and marketing organizations. Our ability to generate revenue from our alliances and collaborations 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 alliances and collaborations involving our product candidates, including our collaboration with AstraZeneca, pose many risks to us, including:

- collaborators have significant discretion in determining the amount and timing of efforts and resources that they will apply to these alliances and collaborations or to the development of our licensed product candidates;
- collaborators may interpret clinical trial or non-clinical study results differently than we do, may pursue further development and commercialization of our product candidates for indications that we do not believe are optimal, may not pursue further development and commercialization of our product candidates at all 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;
- collaborators 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 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 agreements; and
- alliances and collaborations may be terminated, either in their entirety or as to particular product candidates or programs, which may result in a need for a reallocation of internal funds or additional capital to pursue further development of the applicable product candidates. As examples, we previously had a collaboration agreement with AstraZeneca for the development and commercialization of TC-5214 in MDD and a product development and commercialization agreement with GlaxoSmithKline that have been terminated. In addition, in March 2013, AstraZeneca exercised its right to terminate TC-1734 from our ongoing collaboration agreement. These terminations caused us to reallocate internal resources.

Alliances and collaborations may not lead to development of product candidates or commercialization of products in the most efficient manner or at all.

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 alliances and 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 seeking alliances and collaborations to assist us in furthering development and potential commercialization of some of our product candidates. We intend to do so particularly for target indications for which a potential collaborator has unique expertise or that involve large primary care markets that must be served by large sales and marketing organizations.

We face significant competition in seeking appropriate alliances and collaborations. Alliances and collaborations are complex and time-consuming to negotiate and document. We may not be able to negotiate them on acceptable terms, or at all. If we cannot, 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 any 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 manufacturer for TC-5214 fails to devote sufficient resources to TC-5214, or if its performance is substandard, any future clinical trials and any product introductions of TC-5214 may be delayed or there may be a shortage of supply.**

We have a supply agreement with Euticals S.p.A. (as successor to Poli Industria Chimica, S.p.A.) and Interchem Corporation for the pharmaceutical development and supply of the active ingredient form of TC-5214. The agreement with Euticals and Interchem provides for us to purchase our requirements for the active ingredient form of TC-5214 exclusively from Euticals through Interchem during the term of the agreement, subject to specified conditions. Because of the exclusive supply relationship, if Euticals breaches or fails to perform as agreed under the agreement, or if the agreement terminates for any reason, there may be a delay or interruption in manufacturing of TC-5214 that leads to a shortage of supply. If circumstances give us the right to change the manufacturer for the active ingredient form of TC-5214 and we were to make the change for any reason, in addition to the risks associated with changing a contract manufacturer described below under "*If the performance of our contract manufacturers or any present or future collaborator of ours with manufacturing responsibility for a particular product candidate is substandard, our clinical trials and product introductions may be delayed or there may be a shortage of commercial supply.*," we would be dependent on Euticals to effect or facilitate a successful transfer of the manufacturing technology for TC-5214 to a replacement contract manufacturer. Following any future regulatory approval of TC-5214, such a technology transfer would require review and approval by the FDA or applicable foreign regulatory authorities and would also likely require an inspection of the new manufacturer to assess compliance with current good manufacturing practices, or cGMP, mandated by the FDA or foreign regulatory authorities, both of which would be time-consuming and increase the likelihood of a delay or interruption in manufacture or a shortage of supply of TC-5214. Any delay or interruption in manufacture or shortage of supply of TC-5214 could delay or prevent the initiation or completion of clinical trials of TC-5214, the submission of applications for regulatory approvals of TC-5214 or the receipt of regulatory approvals for TC-5214, materially and adversely affect any future commercialization of TC-5214 or result in higher costs or lost product revenue.

**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 many 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 and foreign regulatory authorities require us to comply with regulations and guidelines, commonly referred to as good clinical practice, or GCP, 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. These risks may be heightened for clinical trials that we conduct outside of North America and Western Europe. In particular, we have previously conducted trials of multiple product candidates at sites in India and we are conducting our ongoing Phase 2b trials of TC-5619 in negative symptoms and cognitive dysfunction in schizophrenia and TC-1734 in mild to moderate Alzheimer's disease at sites in Eastern Europe, as well as in the United States.

Language barriers and the limited experience of some clinical investigators in Eastern Europe or other countries in conducting clinical trials in accordance with standards set forth by the FDA and applicable regulatory authorities may increase the risk of non-compliance. The failure of third parties to carry out their obligations could impair the credibility or reliability of the data generated in clinical trials of our product candidates, require a trial to be repeated and increase the overall cost of a development program, delay or prevent the development, approval and commercialization of our product candidates or result in enforcement action against us.

**If the performance of our contract manufacturers or any present or future collaborator of ours with manufacturing responsibility for a particular product candidate 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 early-stage preclinical testing and have contracted with third parties to manufacture, in collaboration with us, our product candidates for clinical trials. 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 our now discontinued product Inversine and its active ingredient.

AstraZeneca has substantially all manufacturing responsibility for AZD1446 under our collaboration agreement. For each of our other product candidates, we typically rely on single third-party contract manufacturers for manufacturing in drug substance form and single third-party contract manufacturers for manufacturing in a formulation for use in clinical trials. We intend to continue to rely on third-party manufacturers (or, where applicable, AstraZeneca or other potential future collaborators) 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 or collaborators 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 receipt of regulatory approvals or the commercialization of our products or result in higher costs or lost product revenue. In particular, any contract manufacturer or applicable collaborator of ours could:

- encounter difficulties in achieving volume production, laboratory testing, quality control or quality assurance or suffer shortages of qualified personnel, any of which could result in its inability to

manufacture sufficient quantities to meet clinical timelines for a particular product candidate, obtain approval to market and sell the product candidate or to commercialize the product candidate; or

- fail to establish and follow cGMP or fail to document its adherence to cGMP, 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.

In addition, any contract manufacturer could:

- terminate or not renew its manufacturing agreement with us, based on its own business priorities, at a time that is costly or inconvenient for us; or
- breach or fail to perform as agreed under the applicable manufacturing agreement.

We expect to rely initially on a single contract manufacturer for any product candidate that we successfully bring to market. Changing any manufacturer that we 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 or foreign regulatory authorities 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, contract manufacturers located in foreign countries may be subject to import limitations or bans. As a result, if any contract manufacturer is unable, for whatever reason, to supply the contracted amounts of any product that is successfully brought to market, a shortage would result which would have a negative impact on our revenue.

Drug manufacturers are subject to ongoing periodic unannounced inspection by the FDA, the U.S. Drug Enforcement Agency and corresponding state and foreign agencies to ensure strict compliance with cGMP, 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 third-party manufacturers' compliance with these regulations and standards. Failure by us or any third-party manufacturers 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.

### *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 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, pharmaceutical compositions, formulations and uses in the treatment of diseases and disorders.

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 product candidates and technology will depend on the success that we have in obtaining valid 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. 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. If we are unable to obtain, enforce or defend the patents with respect to our product candidates, our ability to commercialize our product candidates would be materially and adversely affected and our business would suffer.

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 patent applications filed on or before March 15, 2013, or that we were or will be the first to file for protection of the inventions claimed in any of our U.S. patent applications filed after March 15, 2013 or in any of our issued foreign patents or pending foreign 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 patent covering one of our product candidates may expire before the product candidate can be commercialized or remain in force for only a short period following initial commercialization. In either case, any advantages of the patent would be limited. 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 either in patent laws or in interpretations or enforcement 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 collaborators 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 that 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 and, if we have sublicensed our license rights to a third party, the loss of the license rights may breach our obligations to our sublicensee.**

We are a party to various license agreements. In particular, we license patent rights covering the pharmaceutical composition and methods of use of TC-5214 from University of South Florida Research Foundation. 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, whether as a result of actions or inactions by us or by any potential future collaborator of ours to which we out-license patent rights that we have in-licensed from a third party, the licensor may have the right to terminate the license, in which event we may not be able to market any product that is covered by the licensed patents.

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

Although we generally seek the broadest patent protection available for our 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. 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. If a third party were to receive marketing approval of any 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 foreign regulatory authorities. Even if we have patent protection for the indication for which the product is prescribed, as a practical matter, we would have little recourse as a result of this off-label use. In that event, our revenue from the commercialization of the compound would likely be materially and adversely affected.

**If a third party were to obtain approval to market and sell mecamylamine hydrochloride, TC-5214 could be subject to competition arising from off-label use.**

We have licensed patent rights in the United States covering the pharmaceutical composition and methods of use of TC-5214, one of the enantiomers of mecamylamine hydrochloride. We have licensed method of use patent rights for, but do not have patent rights covering the composition of, mecamylamine hydrochloride. As a result, we may be limited in our ability to prevent others from exploiting mecamylamine hydrochloride, which could have a negative impact on the commercial potential of TC-5214. We believe another company, Cary Pharmaceuticals Inc., may be developing mecamylamine hydrochloride in a fixed dose combination with bupropion as a smoking cessation aid. In addition, mecamylamine hydrochloride is the active ingredient in our approved product Inversine, which we are no longer commercializing. A third party could in the future pursue marketing approval of mecamylamine hydrochloride for the forms of hypertension for which Inversine is approved using the ANDA process. If any third party were to receive marketing approval for mecamylamine hydrochloride for any indication, physicians could prescribe it for other indications that are not described in the product's labeling or approved by the FDA or foreign regulatory authorities. In particular, physicians could potentially prescribe mecamylamine hydrochloride as a treatment for overactive bladder despite differences in the biological properties between TC-5214 and mecamylamine hydrochloride. In that event, if TC-5214 is in the future approved for marketing and sale by the FDA or foreign regulatory authorities, our revenue from sales of TC-5214 could be materially and 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 similarly be sued by third parties. We may also become subject to interference, review 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, regardless of their merit, lack of merit or eventual outcome, would be costly and a significant diversion of our technical personnel's and management's attention from conducting our business, which would harm 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 material 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 and development, manufacturing or sales of any infringing product in the country or countries covered by the patent allegedly 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 allegedly 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 materially and 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 material 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 and sale, our product candidates may not gain market acceptance and may fail to generate significant revenue.**

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 foreign regulatory authorities.

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 revenue.

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

We currently have limited sales, marketing and distribution experience and 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, such as our collaboration with AstraZeneca. In particular, our strategy includes selectively entering into strategic alliances and collaborations with respect to product candidates for indications that require service by large sales and marketing organizations. 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 have little control over AstraZeneca’s performance under our collaboration agreement and would have little control over the performance of potential future collaborators, any of which 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 third-party reimbursement practices or healthcare reform initiatives applicable to our product candidates could limit our potential product revenue.**

Successful commercialization of any of our product candidates for which regulatory approval is obtained will depend in part on the extent to which coverage and adequate payment is available from government health programs, such as Medicare and Medicaid, private health insurers and other third-party payors. If we succeed in bringing a product candidate to the market, it may not be considered cost-effective and reimbursement 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 pharmaceutical companies provide predetermined discounts from list prices and frequently challenge 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 product candidates that we 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 materially and adversely affected.

We believe that the government and third party payors will continue to look for ways to contain or reduce the cost of health care in ways that are likely to affect the business and financial condition of pharmaceutical companies. We cannot predict the impact of these efforts on the coverage of, or prices for, any of our product candidates if they are approved.

**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 revenue.**

The development and commercialization of new drugs is highly competitive. Our business is characterized by extensive research and development 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, biopharmaceutical, biotechnology and other companies and research institutions, many of which have greater financial, technical and other resources and personnel and more experience in research and development, regulatory and drug commercialization than we have. Our competitors may:

- develop products that are more effective, safer, more tolerable, more convenient, less costly or otherwise more competitive than our product candidates;
- obtain FDA or foreign regulatory approval for their products more rapidly than we do;
- adapt more quickly to new technologies and scientific advances than we do;
- initiate or withstand substantial price competition more successfully than we do;
- have greater success in recruiting skilled scientific workers from the limited pool of available talent than we do;
- obtain more effective intellectual property protection than we do;
- 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, which is known outside of the United States as Champix, acts on several NNR subtypes as well as other molecular targets in the body. Chantix is approved as an aid for smoking cessation. In addition, we believe that

several prominent pharmaceutical companies have product candidates that target NNRs in development, including as examples Abbott Laboratories, Bristol-Myers Squibb, Novartis, EnVivo Pharmaceuticals, Galantos Pharma, Upsher Smith, Psychogenics, Asmacure, Bionomics, Aniona, Savant HWP and Neuroderm. 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 pursue the development and commercialization of therapeutics for diseases and disorders that we target, whether independently or by alliance, 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. We believe that the primary competitive products for use in indications that we are currently targeting with our most advanced product candidates include:

- for overactive bladder, anticholinergics such as Vesicare from Astellas Pharma, Detrol LA from Pfizer/Almirall, Enablex from Warner Chilcott/Bayer, Toviaz from Pfizer, Sanctura XR from Allergan and Ditropan XL from Ortho-McNeil Pharma, beta3-adrenergic receptor agonists such as Mybretiq from Astellas Pharma, and the botulinum toxin Botox from Allergan; and
- for mild to moderate Alzheimer’s disease, acetylcholinesterase inhibitors such as Aricept from Pfizer/Eisai, Razadyne from Johnson & Johnson and Exelon from Novartis; Aricept is also indicated for severe Alzheimer’s disease and Namenda from Forest Laboratories, which acts by regulating the neurotransmitter glutamate, is indicated for moderate to severe Alzheimer’s disease.

There is currently no product approved in the United States or Europe specifically for the treatment of negative symptoms of schizophrenia or cognitive dysfunction in schizophrenia. There are however multiple third-party product candidates currently in clinical development, including modulators of the a7 NNR, targeting these areas.

**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, lack of merit or eventual outcome, would be a significant diversion of our management’s attention from conducting our business and could be costly or materially and adversely affect our reputation or the demand for our products.

We have secured product liability insurance coverage in amounts that we believe to be appropriate for our current operations. 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 expect that we will expand our coverage with respect to any products for which we successfully 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.

**If any promotional activities that we undertake fail to comply with the regulations and guidelines of the FDA and applicable foreign 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 foreign regulatory authorities. 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 may in some jurisdictions and 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. If we undertake any promotional activities in the future for any product candidate for which we receive regulatory approval 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***

**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 team, including our Chief Executive Officer and President, Stephen A. Hill, who joined us in December 2012, and our other scientific, technical and managerial personnel. Our key personnel, including Dr. Hill, can terminate their employment with us at any time. The workforce reductions and closing of our laboratory operations that we implemented in 2012 may negatively impact our ability to retain our key personnel, and the loss of the services of any of our senior management team or other key personnel may significantly delay or prevent the achievement of product development and other business objectives. We also rely on consultants and advisors from time to time 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 consulting or advisory contracts with other organizations or other commitments that 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 and managerial personnel, which has been adversely impacted by the workforce reductions we implemented in 2012. We face intense competition for skilled executives in our industry. We may not be able to continue to attract and retain personnel with the advanced qualifications necessary for the growth of our business.

### *Risks Related to Our Common Stock*

**The market price of our common stock has historically been highly volatile.**

The trading price of our common stock has historically been highly volatile, and the stock market in general has experienced extreme price and volume fluctuations. The market prices of securities of pharmaceutical, biopharmaceutical and biotechnology companies have been extremely volatile and have experienced fluctuations that have often been unrelated or disproportionate to operating performance. 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:

- the scope, progress, duration, results and cost of clinical trials, as well as non-clinical studies and assessments, of our product candidates and programs;
- our inability, or the inability of any current or potential future collaborator, to successfully complete clinical trials or non-clinical studies and assessments 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;
- whether we establish additional strategic alliances, collaborations or licensing or other comparable arrangements, or whether we pursue and complete any merger, acquisition or other significant corporate transaction, and, if we do, the associated terms in each case;
- the expiration or termination of our collaboration agreement with AstraZeneca or agreements with any potential future collaborator;
- whether and to what extent milestone events are achieved for AZD1446 under our collaboration agreement with AstraZeneca;
- the cost, timing and outcomes of regulatory approvals or other regulatory actions;
- the extent of our general and administrative expenses;
- general and industry-specific economic conditions that may affect the research and development expenditures of AstraZeneca or any potential future collaborator of ours; and
- general conditions in the pharmaceutical, biopharmaceutical or biotechnology industries or in the U.S. or global credit or financial markets.

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. For 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.**

Our current trading volumes are modest, and 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 as compensation to our employees, directors or consultants, in connection with strategic alliances, collaborations, acquisitions or other transactions 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.

**Provisions of our charter and bylaws, Delaware law or our collaboration agreement with AstraZeneca may discourage or 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. As a result, stockholders who wish to participate in these transactions may not have the opportunity to do so. 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. Furthermore, these provisions could also 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 are 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 or otherwise 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 for the stockholders 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.

Also, AstraZeneca may elect under our collaboration agreement to terminate certain aspects of the agreement if there were to be a “change of control” of us, as that term is defined in the agreement. In particular, AstraZeneca may elect to terminate our co-promotion rights under the agreement. These rights of AstraZeneca could similarly discourage, delay or prevent a merger, acquisition or other change of control of us involving a third party.

**Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**

We lease approximately 18,300 square feet of office space in the building located at 100 North Main Street in Winston-Salem, North Carolina pursuant to a sublease. The term of our sublease expires December 30, 2015. The initial monthly payment under our sublease is approximately $22,100, subject to escalation of approximately 3% for each future year during the term. We also lease approximately 4,100 square feet of storage space in the same building pursuant to a separate sublease. We believe our leased space is suitable for its intended purpose.

**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. Mine Safety Disclosures.**

Not applicable.

## PART II

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

**Market Information**

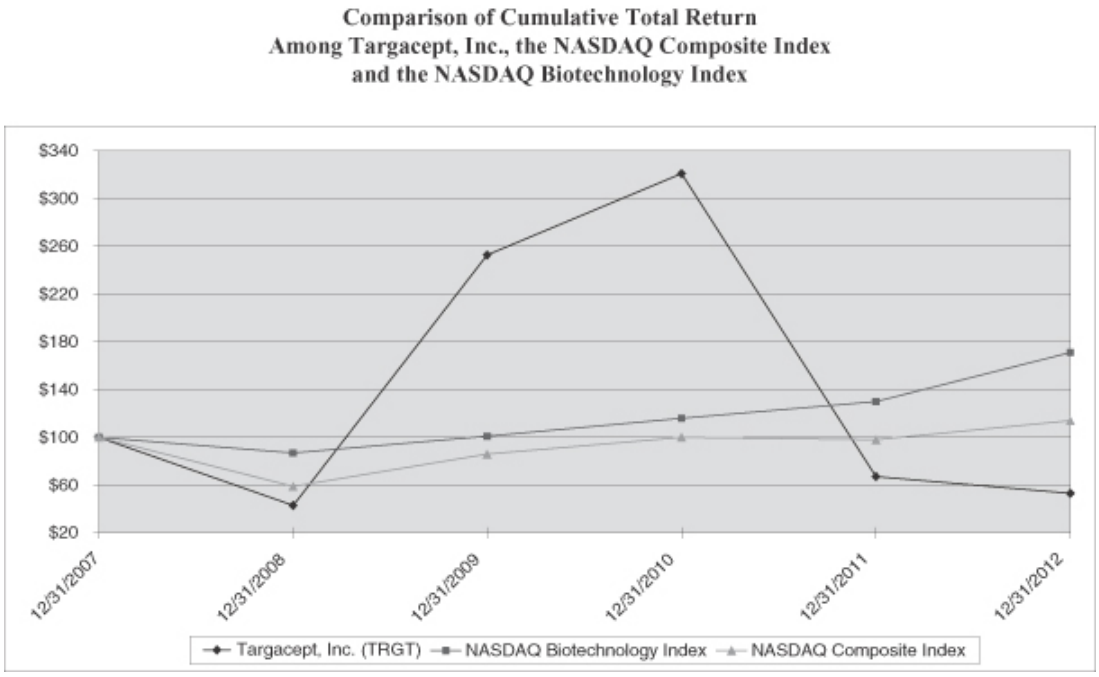
Our common stock currently trades on the NASDAQ Global Select Market under the symbol "TRGT." The following table sets forth, for the periods indicated, the high and low sales prices for our common stock:

| | | *High* | *Low* |
|---|---|---|---|
| 2011: | | | |
| | First Quarter | $30.47 | $24.45 |
| | Second Quarter | $26.92 | $20.48 |
| | Third Quarter | $22.40 | $14.42 |
| | Fourth Quarter | $19.54 | $ 4.91 |
| 2012: | | | |
| | First Quarter | $ 7.70 | $ 4.90 |
| | Second Quarter | $ 5.20 | $ 4.04 |
| | Third Quarter | $ 5.17 | $ 4.15 |
| | Fourth Quarter | $ 4.92 | $ 3.85 |

**Comparative Stock Performance Graph**

*The following graph and related information shall not be deemed "soliciting material" or to be "filed" with the SEC or subject to Regulation 14A or 14C, other than as provided in Item 201 of Regulation S-K, or to the liabilities of Section 18 of the Exchange Act, nor shall such information be incorporated by reference into any future filing under the Securities Act or the Exchange Act, except to the extent that we specifically incorporate it by reference into such a filing.*

The following graph compares the cumulative total stockholder return for our common stock with the cumulative total stockholder return of the NASDAQ Composite Index and the NASDAQ Biotechnology Index. The comparison assumes the investment of $100.00 on December 31, 2007 in each of our common stock, the NASDAQ Composite Index and the NASDAQ Biotechnology Index and the reinvestment of any dividends. We have not paid any dividends on our common stock and do not include dividends in the representation of our performance. The performance shown for any prior period does not predict the performance to be expected for any future period.




| | 12/31/07 | 12/31/08 | 12/31/09 | 12/31/10 | 12/31/11 | 12/31/12 |
|---|---|---|---|---|---|---|
| Targacept, Inc. | 100 | 43 | 253 | 321 | 67 | 53 |
| NASDAQ Biotechnology Index | 100 | 87 | 101 | 116 | 130 | 171 |
| NASDAQ Composite Index | 100 | 59 | 86 | 100 | 98 | 114 |

**Stockholders**

As of February 28, 2013, there were approximately 50 holders of record of our common stock. Because many of our shares are held by brokers or other nominees on behalf of beneficial owners, we are unable to determine precisely the total number of beneficial owners represented by the holders of record. As of February 28, 2013, we estimate the total number of beneficial owners of our common stock whose shares are held by brokers or other nominees on their behalf to be approximately 4,339.

**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 as of the determination date were held by non-affiliates, except for shares held by our executive officers, directors and their affiliated entities. In particular, we have assumed that any stockholder that held 10% or more of our outstanding common stock as of the determination date and is not affiliated with a director was a non-affiliate and expect that we would also make that assumption in the future unless there exists facts and circumstances that indicate that the 10% or greater stockholder exercises control over us. This assumption is not intended to constitute an admission that all executive officers and directors, and any 10% or greater stockholder treated as an affiliate for this purpose, are, in fact, our affiliates or that there are no other persons who may be deemed to be our affiliates.

**Unregistered Sales of Securities; Use of Proceeds from Registered Securities; Issuer Purchases of Equity Securities**

On November 19, 2012, we issued 3,333 shares of our common stock to a single “accredited investor” (as that term is defined by the rules and regulations of the SEC) upon the exercise of a stock option. This option represents a grant that was made under our non-employee director compensation program as it existed prior to completion of our initial public offering in 2006. The entity exercising the option was affiliated with a member of our board of directors at the time of grant and was designated by the director to receive the option in lieu of the director. The exercise price for the option was $0.075 per share, representing an aggregate purchase price for the purchased shares of $249.98. The shares of common stock issued upon exercise were offered and sold in reliance on an exemption from registration under Section 4(2) of the Securities Act based on the recipient’s sophistication in financial matters and access to material information and representations received from the recipient as to its status as an accredited investor.

**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 comprehensive income data for the years ended December 31, 2012, 2011 and 2010 and the balance sheet data as of December 31, 2012 and 2011 from our audited financial statements included in this annual report. We derived the statements of comprehensive income data for the years ended December 31, 2009 and 2008 and the balance sheet data as of December 31, 2010, 2009 and 2008 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, | | | | |
|---|---|---|---|---|---|
| | 2012 | 2011 | 2010 | 2009 | 2008 |
| | (in thousands, except share and per share data) | | | | |
| **Statement of Operations Data:** | | | | | |
| Net operating revenues | $ 57,860 | $ 97,637 | $ 85,713 | $ 25,062 | $ 20,085 |
| Operating expenses: | | | | | |
| Research and development | 49,087 | 95,215 | 64,546 | 40,179 | 40,981 |
| General and administrative | 13,193 | 12,167 | 8,052 | 8,167 | 6,499 |
| Reduction in force | 3,718 | — | — | — | — |
| License fees and royalties | — | — | — | 16,350 | — |
| Cost of product sales | — | — | — | 691 | 749 |
| Total operating expenses | 65,998 | 107,382 | 72,598 | 65,387 | 48,229 |
| (Loss) income from operations | (8,138) | (9,745) | 13,115 | (40,325) | (28,144) |
| Interest income | 1,070 | 1,348 | 1,463 | 1,050 | 2,734 |
| Gain on sale of property and equipment | 55 | — | — | — | — |
| Interest expense | (86) | (132) | (153) | (217) | (251) |
| (Loss) income before income taxes | (7,099) | (8,529) | 14,425 | (39,492) | (25,661) |
| Income tax benefit (expense) | 101 | — | (3,526) | 88 | — |
| Net (loss) income | $ (6,998) | $ (8,529) | $ 10,899 | $ (39,404) | $ (25,661) |
| Basic net (loss) income per share | $ (0.21) | $ (0.27) | $ 0.38 | $ (1.54) | $ (1.04) |
| Diluted net (loss) income per share | $ (0.21) | $ (0.27) | $ 0.36 | $ (1.54) | $ (1.04) |
| Weighted average common shares outstanding— basic | 33,476,316 | 31,637,283 | 28,543,408 | 25,636,419 | 24,664,169 |
| Weighted average common shares outstanding— diluted | 33,476,316 | 31,637,283 | 30,150,324 | 25,636,419 | 24,664,169 |

| | As of December 31, | | | | |
|---|---|---|---|---|---|
| | 2012 | 2011 | 2010 | 2009 | 2008 |
| | (in thousands) | | | | |
| **Balance Sheet Data:** | | | | | |
| Cash, cash equivalents and investments | $ 184,927 | $ 249,270 | $ 252,509 | $ 111,066 | $ 88,363 |
| Working capital | 116,394 | 119,606 | 119,422 | 213,269 | 78,174 |
| Total assets | 189,579 | 258,126 | 262,787 | 319,379 | 98,551 |
| Long-term debt, net of current portion | 1,136 | 1,986 | 1,349 | 1,966 | 3,408 |
| Accumulated deficit | (233,928) | (226,930) | (218,401) | (229,300) | (189,896) |
| Total stockholders' equity | 175,915 | 174,288 | 91,847 | 68,991 | 57,373 |

## 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 what is indicated by any forward-looking statement due to various important factors, risks and uncertainties, including, but not limited to, those set forth under "Cautionary Note Regarding Forward-Looking Statements," which precedes Part I of this annual report, and under "Risk Factors" in Item 1A of Part I of this annual report.*

### Overview

*Background*

We are a biopharmaceutical company engaged in the development of novel NNR Therapeutics for the treatment of diseases and disorders of the nervous system. Our NNR Therapeutics selectively target a class of receptors known as neuronal nicotinic receptors, which we refer to as NNRs. NNRs are found on nerve cells throughout the nervous system and serve as key regulators of nervous system activity. Our most advanced product candidates are TC-5619, TC-5214, TC-1734, AZD1446 (TC-6683), TC-6987 and TC-6499 and they are discussed under the caption "Business" in Item 1 of Part I of this annual report.

We have an ongoing collaboration agreement with AstraZeneca focused on compounds that act on the a4ß2 NNR. Previously, we had a second collaboration agreement with AstraZeneca that we entered into in December 2009 for the global development and commercialization of TC-5214 as a treatment for major depressive disorder (MDD), and we refer to that agreement in this annual report as our "MDD agreement with AstraZeneca." Our MDD agreement with AstraZeneca was terminated effective in May 2012.

Under our ongoing collaboration agreement with AstraZeneca:

- AstraZeneca has an exclusive license to AZD1446 and earlier-stage compounds that arose from the preclinical research collaboration conducted under the agreement;
- AstraZeneca is responsible for substantially all current and future development costs for AZD1446 and each other compound arising from the preclinical research collaboration described below that it elects to advance; and
- from January 2006 to January 2010, we and AstraZeneca conducted a preclinical research collaboration under the agreement to discover and develop compounds that act on the a4ß2 NNR as treatments for conditions characterized by cognitive impairment; AstraZeneca paid us research fees, based on a reimbursement rate specified under the agreement, for research services rendered in the preclinical research collaboration.

Our ongoing collaboration agreement with AstraZeneca can be terminated by AstraZeneca for an uncured material breach by us or upon 90 days' notice given at any time.

Under our MDD agreement with AstraZeneca, we received a $200.0 million upfront payment. Thereafter, AstraZeneca was responsible for 80% and we were responsible for 20% of the cost of the completed clinical program for TC-5214 in MDD, except that AstraZeneca was responsible for 100% of development costs that were required only for countries outside the United States and the European Union. In addition, for each of us and AstraZeneca, costs that were not contemplated at execution to be part of the program were in some cases excluded from the cost-sharing arrangement.

In addition to our agreements with AstraZeneca, we previously had a product development and commercialization agreement with GlaxoSmithKline. This agreement was terminated effective in May 2011.

Since our inception, we have had limited revenue from product sales and have funded our operations principally through public and private offerings of equity securities, payments under collaboration and alliance agreements, grants and equipment financing. We have historically 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.

In the second quarter of 2012, we completed a reduction in force as part of a plan to focus our resources on our more advanced programs. In October 2012, we announced a second reduction in force, as well as our plan to close our laboratory operations. We completed the second reduction in force and the laboratory closings in December 2012. Following completion of the second workforce reduction, we are no longer devoting resources to drug discovery or preclinical research activities.

Except for a small number of periods in which we generated net income due primarily to the recognition into revenue of amounts received under collaboration agreements, we have not been profitable. As of December 31, 2012, we had an accumulated deficit of $233.9 million. We expect that we may incur losses in future periods as our product candidates advance into later-stage development and as we progress our programs and invest in additional product opportunities. Drug development, including clinical trials in particular, is time-consuming, expensive and may never yield a product that will generate revenue.

As a clinical-stage company, our revenues, expenses and results of operations are likely to fluctuate significantly from quarter to quarter and year to year. We believe that period-to-period comparisons of our results of operations should not be relied upon as indicative of our future performance.

*Revenue*

In January 2010, we received the $200.0 million upfront payment under our MDD agreement with AstraZeneca, which we recorded as deferred revenue and began recognizing into revenue on a straight-line basis over the estimated period of our substantive performance obligations under the agreement.

In the first quarter of 2012, we and AstraZeneca announced that, based on the totality of the results of the Phase 3 program, a regulatory filing for TC-5214 as an adjunct therapy for MDD would not be pursued and we reported the discontinuation of a “switch” monotherapy trial. These events resulted in a change in the estimated period of our substantive performance obligations under the agreement. Accordingly, we revised the revenue recognition period for the upfront payment that we previously received and began recognizing the portion of the upfront payment not yet recognized into revenue on a straight-line basis over the remainder of the revised period. We had recognized the full amount of the upfront payment into revenue as of June 30, 2012.

Pursuant to an April 2010 amendment to our ongoing collaboration agreement with AstraZeneca related to an expansion of the development program for TC-5619, we received an $11.0 million payment in May 2010, which we recorded as deferred revenue and recognized into revenue on a straight-line basis over the estimated period of our research and development obligations for TC-5619 under the agreement. We completed our research and development obligations for TC-5619 in the second quarter of 2011. Pursuant to a September 2010 amendment to our ongoing collaboration agreement with AstraZeneca related to a clinical trial of TC-1734 in mild to moderate Alzheimer’s disease, we received a $500,000 payment in the fourth quarter of 2010 and cumulative payments of $5.5 million in the second half of 2011. We recorded all of these payments as deferred revenue and began recognizing them into revenue on a straight-line basis over the estimated period of our obligations with respect to the study. As a result of AstraZeneca’s exercise of its right to terminate TC-1734 from the agreement in March 2013, we expect to recognize into revenue the remaining unrecognized deferred amount, totaling $3.5 million, during 2013.

As of December 31, 2012, we had received $61.6 million in aggregate upfront fees and milestone payments under our ongoing collaboration agreement with AstraZeneca and recognized an additional $26.5 million in

collaboration research and development revenue for research services that we provided in the preclinical research collaboration conducted under that agreement. We immediately recognized an aggregate of $32.6 million of the amounts received under the agreement for achievement of milestone events, because each event met the conditions required for immediate recognition under our revenue recognition policy. We deferred recognition of an aggregate of $29.0 million received under the agreement and are recognizing, or in some cases have fully recognized, these deferred amounts into revenue over the respective periods discussed in Note 12 to our audited financial statements included in this annual report. As of December 31, 2012, we had $3.5 million of the amounts received under our ongoing collaboration agreement with AstraZeneca that remained to be recognized into revenue for future periods.

We received $45.0 million in aggregate payments under our now terminated product development and commercialization agreement and a related stock purchase agreement with GlaxoSmithKline. We immediately recognized an aggregate of $4.0 million of the amounts received under the product development and commercialization agreement for achievement of milestone events, because each event met the conditions required for immediate recognition under our revenue recognition policy. We deferred recognition of $29.5 million received under the two agreements and were recognizing it into revenue over the period discussed in Note 12 to our audited financial statements included in this annual report. As a result of our receipt in February 2011 of notice of termination of the agreement, we recognized the remaining unrecognized deferred amount, $18.4 million, into revenue for the first quarter of 2011. We recorded $11.5 million of the amounts received under the stock purchase agreement, which reflected the fair value of shares of our common stock sold to GlaxoSmithKline in 2007, as capital in excess of par value.

From time to time we seek and are awarded grants or perform work under grants awarded to third-party collaborators from which we derive revenue. During the third quarter of 2011, we were awarded a third grant from the Michael J. Fox Foundation for Parkinson’s Research, or MJFF. Based on the terms of the grant, we received $250,000 upon inception of the grant term and an additional $250,000 in March 2012. In addition, we are a subcontractor under a 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. Based on the terms of this arrangement, we received $191,000 in May 2012. 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 drug discovery and development programs. We record research and development expenses as they are incurred. Research and development expenses represented approximately 74%, 89% and 89% of our total operating expenses for the years ended December 31, 2012, 2011, and 2010, respectively. For 2012, reduction in force charges of $3.7 million, which are not included in research and development expenses, represented 6% of our total operating expenses. There were no reduction in force charges for 2011 or 2010.

Research and development expenses include costs associated with:

- the employment of personnel involved in drug discovery, research and development activities;
- research and development facilities, equipment and supplies;
- clinical trials, including fees paid to contract research organizations to monitor and oversee some of our trials;
- the screening, identification and optimization of product candidates;
- formulation and chemical development;
- production of clinical trial materials, including fees paid to contract manufacturers;

- preclinical animal studies, including the costs to engage third-party research organizations;
- quality assurance activities;
- compliance with FDA regulatory requirements;
- consulting, license and sponsored research fees paid to third parties;
- the development and enhancement of our drug discovery technologies that we refer to as Pentad;
- depreciation of capital assets used to develop our products; and
- stock options granted to personnel in research and development functions.

We utilize our research and development personnel and infrastructure resources across several programs, and many of our costs historically have not been specifically attributable to a single program. Accordingly, we cannot state precisely our total costs incurred on a program-by-program basis.

We have not received FDA or foreign regulatory marketing approval for any of our product candidates. Our current and future expenditures on development programs are subject to numerous uncertainties in timing and cost to completion. Our compounds are tested in numerous preclinical studies for safety, toxicology and efficacy. We then conduct clinical trials for those product candidates that are determined to be the most promising. If we do not establish an alliance or collaboration in which our collaborator assumes responsibility for funding the development of a particular product candidate, we fund these trials ourselves. As we obtain results from clinical trials, we or the collaborator may elect to discontinue or delay trials for some product candidates in order to focus resources on more promising product candidates. Completion of clinical trials may take several years or more, and 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 for a particular product candidate may vary significantly as a result of a variety of factors, including:

- the number of subjects who participate in the trials;
- the number and locations of sites included in the trials;
- the length of time required to enroll trial subjects;
- the therapeutic areas being investigated;
- the duration of the trials and subject follow-up;
- the costs of producing supplies of the product candidate needed for 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.

In addition, our strategy includes entering into alliances and collaborations with third parties to participate in the development and commercialization of some of our product candidates. Where a third party has responsibility for or authority over any or all of the non-clinical or clinical development of a particular product candidate, the estimated completion date may be largely under control of that third party and not under our control. We cannot forecast with any degree of certainty whether any of our product candidates will be subject to future alliances or collaborations or how any such arrangement would affect our development plans or capital requirements. Because of this uncertainty, and because of the numerous uncertainties related to clinical trials and drug development generally, we are unable to determine the duration and completion costs of our development programs or whether or when we will generate revenue from the commercialization and sale of any of our product candidates.

*General and Administrative Expenses*

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

*Income Taxes*

We have incurred cumulative operating losses through December 31, 2012 and have not paid federal, state or foreign income taxes for any period. The application of U.S. generally accepted accounting principles, or GAAP, may for some periods result in non-cash income tax expense or benefit being reflected in our Statement of Comprehensive Income. For the year ended December 31, 2012, we recognized $101,000 of income tax benefit as a result of the application of accounting guidance for intraperiod tax allocation, under which we are required to consider all items (including items recorded in other comprehensive income) in determining the amount of tax benefit that should be allocated to net loss. The non-cash income tax benefit for 2012 was offset in full by income tax expense recorded in other comprehensive income. For the year ended December 31, 2010, we recorded $3.5 million of income tax expense, primarily as a result of the application of accounting guidance for income tax related to stock-based compensation. Exercises of stock options in periods of net income may result in tax deductions for stock-based compensation in excess of expense recorded for the stock options under GAAP. This results in an income tax benefit that is recognized as an increase to capital in excess of par value and, based on Accounting Standards Codification Topic 740, *Income Taxes*, an offsetting charge in the same amount to income tax expense. As of December 31, 2012, we had $7.5 million of cumulative tax deductions for periods of net loss from exercises of stock options in excess of expense recorded for the stock options under GAAP. The benefit of these excess tax deductions had not begun to be realized as of December 31, 2012 because we have incurred cumulative net operating losses since inception. This benefit will not be recognized as an increase to capital in excess of par value until the excess deductions reduce income taxes payable. For the tax year ended December 31, 2011, we did not recognize any income tax expense or benefit.

As of December 31, 2012, we had net operating loss carryforwards of $187.8 million for federal income tax purposes and $176.3 million for state income tax purposes. We also had research and development income tax credit carryforwards of $10.8 million for federal income tax purposes and $587,000 for state income tax purposes as of December 31, 2012. The federal net operating loss carryforwards begin to expire in 2024. The state net operating loss carryforwards begin to expire in 2019. The federal and state research and development tax credits begin to expire in 2021. As a result of various factors, including the subjectivity of measurements used in the calculation of particular tax positions taken or that may in the future be taken in our tax returns, it is uncertain whether or to what extent we will be eligible to use the tax credits.

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. A series of stock issuances gave rise to such an ownership change in December 2004. As a result, an annual limitation is imposed on our use of net operating loss and credit carryforwards that are attributable to periods before the change. In addition, a portion of the net operating loss carryforwards described above may potentially not be usable by us if we experience further ownership changes in the future.

For financial reporting purposes, we have recorded a valuation allowance to fully offset the deferred tax assets related to the carryforwards and tax credits discussed above until it is more likely than not that we will realize any benefit from them.

*Fair Value*

The carrying amounts of our cash and cash equivalents, investments in marketable securities, accounts receivable, accounts payable and accrued expenses are considered to be representative of their respective fair values due to their short-term natures and, in the case of short-term investments, their market interest rates. Likewise, the carrying amounts of our long-term debts are considered to be representative of their fair value due to their market interest rates. Cash that we do not expect to use to fund our short-term liquidity requirements is invested in U.S. Treasury notes and bonds, U.S. and state government agency-backed certificates, corporate debt securities that are rated at least A quality or equivalent, municipal bonds and certificates of deposit. Our investments in marketable securities, which include marketable securities classified on our balance sheet as cash equivalents, are recorded at quoted market prices or observable market inputs and totaled $106.7 million at December 31, 2012.

**Critical Accounting Policies and Estimates**

Our management's discussion and analysis of financial condition and results of operations is based on our audited financial statements, which have been prepared in accordance with GAAP. 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. 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 and the recording of revenues and expenses 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, 2012 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 have historically derived a substantial portion of our revenues from our strategic alliances and collaborations and expect that we will continue to derive a substantial portion of our revenues from our ongoing collaboration agreement with AstraZeneca and, if we enter into potential additional strategic alliances or collaborations, those additional strategic alliances or collaborations over at least the next several years.

Our collaboration and alliance agreements contain multiple elements, including: an upfront fee, which may include an initial payment upon commencement of the contractual relationship, payment representing a common stock purchase premium or payment to secure a right for a future license; research fees for ongoing research and development; payments associated with the achievement of discovery, development, regulatory and commercial milestone events; and royalties based on specified percentages of any net product sales. In determining the accounting for collaboration and alliance agreements, we first determine whether the agreement involves a single unit of accounting or separate units of accounting for revenue recognition purposes by evaluating each deliverable under the terms of the agreement. If a deliverable has value on a standalone basis, we treat the deliverable as a separate unit of accounting. We determine how to allocate amounts received under the agreement among the separate units, based on the respective selling price of each unit, and we determine the revenue recognition applicable to each unit. If an agreement does not have multiple deliverables that have standalone value, we consider the agreement to have one unit of accounting and we determine the revenue recognition applicable to the entire agreement.

We defer recognition of non-refundable upfront fees and recognize them into revenue on a straight-line basis over the estimated period of our substantive performance obligations. If we do not have substantive performance obligations, we recognize non-refundable upfront fees into revenue through the date the deliverable is satisfied. The period over which we recognize the revenue 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, would result in decreases or increases to the recognition of deferred revenue from period to period. As of December 31, 2012, all amounts that we have recorded as deferred revenue are non-refundable.

We recognize collaboration research and development revenue from research services performed under collaboration agreements as research is performed and related expenses are incurred.

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

- there is substantive uncertainty regarding achievement of the milestone event at inception of the arrangement;
- the payment is commensurate with either our performance to achieve the milestone or with the enhancement of the value of the delivered item;
- the payment relates solely to past performance; and
- the payment is reasonable relative to all of the deliverables and payment terms within the arrangement.

If any of these conditions are not met, we defer recognition of the payment and recognize the payment on a straight-line basis as discussed above.

To the extent we are reimbursed under a collaboration or alliance agreement for specific research and development costs, such as third-party manufacturing costs for drug material, we reflect these reimbursable amounts as a component of collaboration research and development revenue and the costs associated with these reimbursable amounts as a component of research and development expenses.

*Accrued Expenses*

In the normal course of our business, we contract with research institutions and contract research organizations that conduct or manage clinical trials or other research and development activities on our behalf and with contract manufacturers that produce drug substance or clinical trial materials for us. The financial terms of these agreements are subject to negotiation, vary among agreements and may result in uneven payment flows. Payments under these agreements depend on the performance of services or the achievement of specified events, such as the production of drug substance or clinical trial materials, the recruitment of clinical trial subjects, the completion of portions of a non-clinical study or clinical trial or similar conditions.

As part of the process of preparing financial statements, we are required to estimate accrued expenses with the objective of matching the recording of expenses in our financial statements to the actual services received and efforts expended. This process involves reviewing open contracts and purchase orders, communicating with our applicable personnel to identify services that have been performed on our behalf, estimating level of services performed and the associated cost incurred for the services when we have not yet been invoiced or otherwise notified of actual cost and reviewing invoices received that have not yet become due and payable. 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. 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. Examples of estimated accrued expenses include:

- fees for services performed by contract research organizations in connection with clinical trials and non-clinical studies;
- fees for services performed by clinical trial sites in connection with clinical trials;
- fees for services performed by contract manufacturers in connection with the production of clinical trial materials; and
- professional service fees.

*Stock-Based Compensation*

We record the grant date fair value of stock options issued to employees and non-employee directors as stock-based compensation expense 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. The Black-Scholes-Merton formula requires us to make various assumptions, including among others the expected term of the award and expected volatility of our common stock. In the event a modification is made to a stock option after the grant date, we record additional stock-based compensation expense equal to the incremental fair value of the stock option immediately subsequent to the modification as compared to the fair value of the stock option immediately preceding the modification. During 2012, we modified some outstanding stock options held by executive and non-executive employees who departed Targacept to partially accelerate vesting and/or extend the permitted period for exercise. These modifications resulted in incremental compensation cost for the year ended December 31, 2012 of $1.4 million. We recorded stock-based compensation expense related to stock options granted to employees and directors of $7.8 million (inclusive of expense resulting from stock option modifications) for the year ended December 31, 2012, $8.5 million for the year ended December 31, 2011 and $4.9 million for the year ended December 31, 2010. As of December 31, 2012, we had $9.2 million in total unrecognized compensation cost related to non-vested stock-based compensation arrangements, which we expect to record over a weighted average period of 3.1 years.

**Results of Operations**

*Years ended December 31, 2012 and December 31, 2011*

*Net Operating Revenues*

| | Year ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | Change |
| | (in thousands) | | |
| Operating revenues: | | | |
| Milestones and license fees from collaborations | $57,420 | $96,979 | $(39,559) |
| Grant revenue | 440 | 658 | (218) |
| Net operating revenues | $57,860 | $97,637 | $(39,777) |

Net operating revenues for the year ended December 31, 2012 decreased by $39.8 million as compared to the year ended December 31, 2011. The lower net operating revenues for 2012 were primarily attributable to a decrease of $39.6 million in license fees and milestones from collaborations. The lower license fees and milestones from collaborations principally resulted from decreases in recognition of deferred revenue of:

- $18.4 million related to our now concluded strategic alliance with GlaxoSmithKline, as all remaining deferred revenue was recognized in the 2011 period in connection with termination of the alliance;
- $18.1 million associated with our now concluded MDD agreement with AstraZeneca due to the completion of our performance obligations in mid-2012; and

- $4.8 million related to the development of TC-5619 under our ongoing collaboration agreement with AstraZeneca, as the TC-5619-related payments became fully recognized in the second quarter of 2011.

These decreases were partially offset by an increase of $1.8 million in recognition of deferred revenue related to the development of TC-1734 under our ongoing collaboration agreement with AstraZeneca. We expect our net operating revenues for 2013 to be substantially lower than 2012, primarily due to the upfront payment received under our MDD agreement with AstraZeneca becoming fully recognized in the second quarter of 2012.

In future periods, we are eligible to receive additional milestone payments under our ongoing collaboration agreement with AstraZeneca. The amount of milestone payments will depend on whether we achieve development, regulatory and commercial milestone events that are inherently uncertain and, if so, when. We expect that the amount of our milestone-based revenue, if any, will continue to vary from period to period.

*Research and Development Expenses*

| | Year ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | Change |
| | (in thousands) | | |
| Research and development expenses | $49,087 | $95,215 | $(46,128) |

Research and development expenses for the year ended December 31, 2012 decreased by $46.1 million as compared to the year ended December 31, 2011. The lower research and development expenses for 2012 were principally attributable to decreases of:

- $29.9 million in costs incurred related to our MDD agreement with AstraZeneca, to $2.2 million for 2012, from $32.0 million for 2011, as the development program conducted under the agreement wound down to completion;
- $7.5 million in other research and development-related operating costs, including infrastructure costs and stock-based compensation and other compensation-related expenses for research and development personnel, to $25.6 million for 2012, from $33.1 million for 2011; this decrease resulted primarily from the workforce reductions completed in the second and fourth quarters of 2012 discussed above;
- $5.4 million in costs incurred for third-party research and development services in connection with preclinical programs to $1.7 million for 2012, from $7.1 million for 2011; and
- $3.4 million in costs incurred for third-party services associated with our clinical-stage product candidates (excluding costs for the completed program in major depressive disorder) to $19.5 million for 2012, from $22.9 million for 2011; this decrease, which was principally due to the completion of two exploratory clinical trials of TC-6987 during the first quarter of 2012, was partially offset by an increased level of activities for our Phase 2 clinical trials of TC-5619 ongoing during 2012 and costs related to our planned Phase 2b study of TC-5214 as a treatment for overactive bladder.

The costs that we incurred for the years ended December 31, 2012 and 2011 for third-party services in connection with research and development of clinical-stage product candidates are shown in the table below:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | Change |
| | (in thousands) | | |
| TC-5619 | $12,662 | $ 9,847 | 2,815 |
| TC-1734 | 3,762 | 4,110 | (348) |
| TC-6987 | 1,655 | 8,858 | (7,203) |
| TC-5214 overactive bladder | 1,440 | — | 1,440 |
| TC-5214 major depressive disorder | 2,175 | 32,046 | (29,871) |
| TC-6499 | — | 96 | (96) |
| AZD1446 | — | — | — |

We expect our research and development expenses for the year ending December 31, 2013 to decrease as compared to 2012, principally as a result of our workforce reductions and closing of laboratory operations that occurred during 2012.

*General and Administrative Expenses*

| | Year ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | Change |
| | (in thousands) | | |
| General and administrative expenses | $13,193 | $12,167 | $1,026 |

General and administrative expenses for the year ended December 31, 2012 increased by $1.0 million as compared to the year ended December 31, 2011. The higher general and administrative expenses were principally attributable to $1.9 million in severance and stock-based compensation expense, including $1.3 million of non-cash charges, resulting from severance payable to our former chief executive officer, who departed Targacept in May 2012, and from the partial accelerated vesting of, and/or extended permitted exercise periods for, some outstanding stock options held by our former chief executive officer and two other executive officers who departed Targacept in the first half of 2012. These severance and stock-based compensation charges were partially offset by a decrease of $505,000 in patent-related charges. Exclusive of the increased stock-based compensation expense and decreased patent-related charges, general and administrative expenses decreased by $372,000 for 2012 as compared to 2011, primarily as a result of the two 2012 workforce reductions.

We expect our general and administrative expenses for 2013 to decrease as compared to 2012, primarily as a result of the two 2012 workforce reductions.

*Reduction in Force*

| | Year ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | Change |
| | (in thousands) | | |
| Reduction in force | $3,718 | $— | $3,718 |

As a result of the two reductions in force we completed during 2012 discussed above, we recorded as expense and paid $3.7 million in severance and other charges.

*Years ended December 31, 2011 and December 31, 2010*

*Net Operating Revenues*

| | Year ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | Change |
| | (in thousands) | | |
| Operating revenues: | | | |
| Milestones and license fees from collaborations | $96,979 | $83,380 | $13,599 |
| Grant revenue | 658 | 2,333 | (1,675) |
| Net operating revenues | $97,637 | $85,713 | $11,924 |

Net operating revenues for the year ended December 31, 2011 increased by $11.9 million as compared to the year ended December 31, 2010. The higher net operating revenues were attributable to an increase of $13.6 million in milestones and license fees from collaborations revenue, partially offset by a decrease of $1.7 million

in grant revenue. The increase in milestones and license fees from collaborations revenue was principally due to increases of $15.1 million in recognition of deferred revenue previously received from GlaxoSmithKline, as all amounts that had yet to be recognized as of the time we received notice of termination of our agreement with GlaxoSmithKline were recognized for the first quarter of 2011, and $551,000 in recognition of cumulative payments of $6.0 million received from AstraZeneca in connection with events associated with our Phase 2b clinical trial of TC-1734 as a treatment for mild to moderate Alzheimer's disease. These increases were partially offset by a decrease of $1.8 million in recognition of deferred revenue associated with payments previously received from AstraZeneca related to TC-5619, as all deferred revenue related to TC-5619 became fully recognized in the second quarter of 2011. The decrease in grant revenue was primarily attributable to $1.5 million received in November 2010 under the U.S. Government's Qualifying Therapeutic Discovery Project tax credit program, which did not recur in 2011.

*Research and Development Expenses*

| | Year ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | Change |
| | (in thousands) | | |
| Research and development expenses | $95,215 | $64,546 | $30,669 |

Research and development expenses for the year ended December 31, 2011 increased by $30.7 million as compared to the year ended December 31, 2010. The higher research and development expenses were principally attributable to increases of:

- $27.3 million in costs incurred for third-party research and development services in connection with our clinical-stage product candidates, including costs for clinical trial activities, formulation activities, production of clinical trial materials and pharmacology, toxicology and other non-clinical studies, to $55.0 million for 2011, from $27.6 million for 2010; this increase was principally due to our cost-sharing obligations with AstraZeneca with respect to the development program in major depressive disorder, the conduct of a Phase 2b clinical trial of TC-1734 and the conduct of two exploratory clinical trials of TC-6987; our costs incurred for third-party research and development services also included costs in connection with Phase 2 clinical trials of TC-5619;
- $2.5 million in costs incurred for third-party research and development services in connection with preclinical programs, to $7.1 million for 2011, from $4.6 million for 2010; and
- $2.3 million in other research and development operating costs, including stock-based compensation, salary and other compensation-related expenses for research and development activities and infrastructure costs, to $33.1 million for 2011, from $30.8 million for 2010; this increase was principally attributable to $2.1 million of additional stock-based compensation expense, which was primarily due to a significantly higher weighted average fair value for stock options that vested during the 2011 period as compared to stock options that vested during the 2010 period. Stock options granted to our employees typically vest over four years.

These increases were partially offset by the inclusion in research and development expenses for 2010 of a $1.5 million upfront payment made to Cornerstone Therapeutics Inc. in August 2010 under a license agreement.

The costs that we incurred for the years ended December 31, 2011 and 2010 for third-party services in connection with research and development of clinical-stage product candidates are shown in the table below:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | Change |
| | (in thousands) | | |
| TC-5214 | $32,046 | $10,771 | $21,275 |
| TC-5619 | 9,847 | 10,483 | (636) |
| TC-6987 | 8,858 | 5,534 | 3,324 |
| TC-1734 | 4,110 | 35 | 4,075 |
| TC-6499 | 96 | 798 | (702) |
| AZD1446 | — | — | — |

*General and Administrative Expenses*

| | Year ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | Change |
| | (in thousands) | | |
| General and administrative expenses | $12,167 | $8,052 | $4,115 |

General and administrative expenses for the year ended December 31, 2011 increased by $4.1 million as compared to the year ended December 31, 2010. The higher general and administrative expenses were principally attributable to increases of $2.8 million in stock-based compensation, salary and other compensation-related expenses for general and administrative personnel and $1.3 million in infrastructure costs associated with support of the increased research and development activities discussed above. The largest component of the increase was stock-based compensation expense, which was primarily due to a significantly higher weighted average fair value for stock options that vested during 2011 as compared to stock options that vested during 2010.

*Income Tax Expense*

| | Year ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | Change |
| | (in thousands) | | |
| Income tax expense | $— | $3,526 | $(3,526) |

There was no income tax expense for the year ended December 31, 2011, as compared to income tax expense of $3.5 million for the year ended December 31, 2010. The change was primarily due to tax deductions for stock-based compensation for the 2010 period in excess of expense recorded under GAAP for the corresponding stock options. Tax deductions in excess of recorded expense are only recognized for years with net income.

**Liquidity and Capital Resources**

*Sources of Liquidity*

We have historically financed our operations and internal growth primarily through public and private offerings of our securities, payments received under collaboration and alliance agreements, including upfront fees, payments for research and development services and payments upon achievement of milestone events, grants and equipment financing.

Our cash, cash equivalents and investments in marketable securities were $184.9 million as of December 31, 2012 and $249.3 million as of December 31, 2011. As of December 31, 2012, we had $77.8 million of cash in bank depository accounts and institutional money market funds at Branch Banking and Trust Company, PNC Bank and Wells Fargo & Company. Substantially all of our remaining cash, cash equivalents and investments were invested as of December 31, 2012 in U.S. Treasury notes and bonds, U.S. and state government agency-backed securities, corporate debt securities that are rated at least A quality or equivalent and certificates of deposit.

*Stock Offerings*

In May 2011, we completed an underwritten public offering of 3,658,537 shares of our common stock. In June 2011, we sold an additional 548,780 shares of our common stock upon the exercise of the overallotment option granted to the underwriters. Our net proceeds from the offering, after deducting underwriters' discounts and commissions and offering expenses paid by us, were $80.8 million. Beginning with our initial public offering in April 2006, we have derived aggregate net proceeds of $195.1 million from public offerings of our common stock. We have also derived aggregate net proceeds of $121.8 million from private placements of convertible preferred stock, all of which occurred prior to our initial public offering.

*Strategic Alliances and Collaborations*

As of December 31, 2012, we had received $61.6 million in aggregate upfront fees and milestone payments under our ongoing collaboration agreement with AstraZeneca and an additional $26.5 million in collaboration research and development revenue for research services that we provided in the preclinical research collaboration conducted under the agreement. Most recently:

- in September and December 2011, under an amendment to the agreement, we received cumulative payments of $5.5 million in connection with events associated with our ongoing Phase 2b study of TC-1734 as a treatment for mild to moderate Alzheimer's disease; and
- in May 2010, we received an $11.0 million payment in connection with a separate amendment to the agreement to modify the terms applicable to TC-5619.

Since inception, we received cumulative payments of $2.6 million upon achievement of milestone events under the agreement related to the development of AZD1446 and other product candidates arising under the preclinical research collaboration conducted under the agreement.

In addition, we are eligible under the agreement to receive contingent payments of up to $57.0 million, if development, regulatory and first commercial sale milestone events for AZD1446 are achieved for a specified indication under consideration for development and sales-related milestone events are then achieved for AZD1446, and up to $73.0 million, if development, regulatory and first commercial sale milestones are achieved for AZD1446 for any other indication. We are also eligible to receive stepped royalties on any future AZD1446 product sales for any indication. If AZD1446 is subsequently developed under the agreement for multiple indications, we would also be eligible to receive contingent payments of up to $35.0 million for each such indication, if development, regulatory, first commercial sale and first detail milestone events are achieved. The likelihood that we will achieve any particular milestone event in any particular period is uncertain, and we may not ever achieve future milestone events with respect to AZD1446.

In December 2009, we entered into our MDD agreement with AstraZeneca. We received a $200.0 million upfront payment from AstraZeneca in January 2010. Under the terms of an existing license agreement, we paid $16.0 million to University of South Florida Research Foundation, or USFRF, in January 2010 based on our receipt of the upfront payment from AstraZeneca. Our MDD agreement with AstraZeneca was terminated effective in May 2012 and is no longer a potential source of future funds.

In July 2007, we entered into a product development and commercialization agreement and a related stock purchase agreement with GlaxoSmithKline. The product development and commercialization agreement was terminated effective in May 2011. We received $45.0 million in aggregate payments from GlaxoSmithKline under the agreements, which are no longer a potential source of future funds.

*Loan Financing*

In July 2010, we entered into a loan agreement with a bank that provided aggregate borrowing capacity of $4.0 million available to us at any time on or prior to June 30, 2011 to fund the purchase of equipment, furnishings, software and other fixed assets. In September 2010, we borrowed $1.2 million under the loan facility at a fixed interest rate of 3.4% per annum. We were obligated only to pay interest on the September 2010 borrowing through the remainder of 2010, and it is repayable in equal monthly installments of $28,000 that began January 1, 2011 and continue through the maturity date of December 1, 2014. In June 2011, we borrowed $2.1 million under the loan facility at a fixed interest rate of 3.471% per annum. The June 2011 borrowing is repayable in equal monthly installments of $48,000 that began July 1, 2011 and continue through the maturity date of June 1, 2015. Pursuant to the loan agreement, we granted a first priority security interest in favor of the bank in the assets acquired with the proceeds of the loan facility. As of December 31, 2012, the outstanding principal balance under the loan facility was $2.0 million and there is no additional borrowing capacity remaining available to us.

In March 2008, we entered into a loan agreement with a bank that provided borrowing capacity of $5.3 million to fund the purchase of equipment, furnishings, software and other fixed assets and enabled the refinancing of a previous loan facility that we had with R.J. Reynolds Tobacco Holdings, Inc. We borrowed $4.8 million upon entering into the loan agreement and borrowed the remaining $489,000 in September 2008. Pursuant to the loan agreement, we granted a first priority security interest in favor of the bank in the assets acquired with the proceeds of the loan facility. The March 2008 loan bore interest at a fixed rate of 5.231% per annum and was repayable in equal monthly installments of $112,000 beginning April 1, 2008 and continuing through the maturity date of March 1, 2012 when it was repaid in full. The September 2008 loan bore interest at a fixed rate of 6.131% per annum and was repayable in equal monthly installments of $11,000 beginning October 1, 2008 and continuing through the maturity date of September 1, 2012 when it was repaid in full. There is no additional borrowing capacity remaining available to us under the loan agreement.

In April 2002, we received a $500,000 loan from the City of Winston-Salem, North Carolina. Under the terms of the loan, there was no interest accrual or payment due until the fifth anniversary of the loan. Following expiration of the five-year grace period in April 2007, the outstanding principal balance of the loan began to bear interest at an annual interest rate of 5% and became payable in 60 equal monthly installments of $9,000. In December 2010, we repaid in full the remaining outstanding balance under the loan.

*Cash Flows*

| | Year ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | Change |
| | (in thousands) | | |
| Net cash used in operating activities | $(64,239) | $ (83,718) | $ 19,479 |
| Net cash provided by (used in) investing activities | 39,822 | (57,667) | 97,489 |
| Net cash (used in) provided by financing activities | (626) | 82,814 | (83,440) |
| Net decrease in cash and cash equivalents | $(25,043) | $ (58,571) | |

| | Year ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | Change |
| | (in thousands) | | |
| Net cash (used in) provided by operating activities | $(83,718) | $138,298 | $(222,016) |
| Net cash used in investing activities | (57,667) | (62,799) | 5,132 |
| Net cash provided by financing activities | 82,814 | 6,446 | 76,368 |
| Net (decrease) increase in cash and cash equivalents | $(58,571) | $ 81,945 | |

Net cash used in operating activities for the year ended December 31, 2012 decreased by $19.5 million as compared to the year ended December 31, 2011. For 2012, net cash used in operating activities was primarily attributable to aggregate payments of $61.8 million for third-party research and development services in connection with clinical-stage product candidates and preclinical programs and personnel and infrastructure costs, as well as $3.7 million in payments made as a result of two workforce reductions. These cash payments were partially offset by $2.1 million of interest income and related amounts. For 2011, net cash used in operating activities was primarily attributable to aggregate payments of $92.2 million for third-party research and development services in connection with clinical-stage product candidates and preclinical programs and personnel and infrastructure costs, partially offset by $5.5 million received from AstraZeneca in 2011 in connection with events associated with our ongoing Phase 2b clinical trial of TC-1734 as a treatment for mild to moderate Alzheimer's disease and $2.1 million of interest income and related amounts. The decrease of $30.4 million in payments made for third-party research and development services and personnel and infrastructure costs for 2012 as compared to 2011 was principally the result of the wind-down of the development program in major depressive disorder during 2012, our completion of two exploratory studies of TC-6987 during 2012, our plan to focus our resources on our more advanced programs, the closing of our laboratories and the completion of two workforce reductions during 2012 that resulted in decreased personnel and infrastructure costs.

Net cash provided by operating activities for the year ended December 31, 2010 was $138.3 million, a difference of $222.0 million from 2011. For 2010, net cash provided by operating activities was principally the result of our receipt of:

- the $200.0 million upfront payment under our MDD agreement with AstraZeneca in January 2010;
- the $11.0 million payment under an amendment to our ongoing collaboration agreement with AstraZeneca to modify the terms applicable to TC-5619 in April 2010;
- $1.5 million in payments for research services under our preclinical research collaboration with AstraZeneca, which ended in January 2010;
- the $1.5 million grant under the U.S. Government's Qualifying Therapeutic Discovery Project tax credit program; and
- $1.7 million in interest income and related amounts.

These cash inflows were partially offset by:

- our payments in January 2010 of $16.0 million to USFRF based on our receipt of the $200.0 million upfront payment under our MDD agreement with AstraZeneca;
- our payment of $1.5 million to Cornerstone Therapeutics Inc. under a license agreement in August 2010; and
- aggregate payments of $58.7 million for routine operating activities, including third-party research and development services in connection with clinical-stage product candidates and preclinical programs and personnel and infrastructure costs.

We expect payments for operating activities for the year ending December 31, 2013 to decrease as compared to 2012, principally as a result of the completion in 2012 of the development program conducted under the MDD agreement with AstraZeneca and our workforce reductions and closing of laboratory operations that occurred during 2012.

Net cash provided by investing activities for the year ended December 31, 2012 was $39.8 million and net cash used in investing activities for the year ended December 31, 2011 was $57.7 million, a change of $97.5 million. Cash provided by or used in investing activities primarily reflects the portion of our cash that we allocate to, and the timing of purchases and maturities of, our investments in marketable securities. A transfer of funds from an investment in marketable securities to cash generates cash provided by investing activities, while a

transfer of funds from cash or a cash equivalent to investments in marketable securities generates cash used in investing activities. Our net sales of investments in marketable securities for 2012 were $38.6 million and occurred as funds were transferred to cash for working capital. Our net purchases of investments in marketable securities for 2011 were $56.2 million and occurred primarily as a result of our receipt of proceeds from our common stock offering in May and June 2011.

Net cash used in investing activities decreased by $5.1 million for 2011, from $62.8 million for the year ended December 31, 2010. Our net purchases of investments in marketable securities for 2010 were $59.5 million and occurred primarily as a result of our receipt of the upfront payment under our MDD agreement with AstraZeneca.

Net cash used in financing activities for the year ended December 31, 2012 was $626,000 and net cash provided by financing activities for the year ended December 31, 2011 was $82.8 million, a change of $83.4 million. Net cash used in financing activities for 2011 increased by $76.4 million as compared to the year ended December 31, 2010. The differences for 2012 as compared to 2011 and for 2011 as compared to 2010 were primarily attributable to net proceeds of $80.8 million in May and June 2011 from our common stock offering. Net cash provided by financing activities for 2010 also reflects the income tax effect of tax deductions for stock-based compensation in excess of expense recorded for stock options under GAAP of $3.5 million.

*Funding Requirements*

As of December 31, 2012, we had an accumulated deficit of $233.9 million. We may require additional capital in future periods as our product candidates advance into later-stage development and as we progress our programs and invest in additional product opportunities. However, we may generate positive cash flow for any particular reporting period as a result of the timing of milestone events that may be achieved under our ongoing collaboration agreement with AstraZeneca or any potential future collaboration agreement that we enter into and the timing and extent of costs incurred related to development of our product candidates. Our future capital requirements are difficult to forecast and will depend on many factors, including:

- the scope, progress, duration, results and cost of clinical trials, as well as non-clinical studies and assessments, of our product candidates and programs;
- whether we establish additional strategic alliances, collaborations and licensing or other comparable arrangements, or whether we pursue and complete any merger, acquisition or other significant corporate transaction, and, if we do, the associated terms in each case
- whether and to what extent milestone events are achieved for AZD1446 under our ongoing collaboration agreement with AstraZeneca;
- the extent to which we retain development or commercialization rights or responsibilities for our product candidates and incur associated development costs, manufacturing costs or costs to establish sales and marketing functions;
- the number and characteristics of product candidates that we pursue and programs that we conduct;
- the costs to satisfy our obligations under potential future alliances and collaborations;
- the costs of preparing, filing and prosecuting patent applications and maintaining, enforcing and defending patents and other intellectual property rights;
- the costs of manufacturing-related services for our product candidates in development;
- the costs, timing and outcomes of regulatory reviews or other regulatory actions;
- the timing, receipt and amount of sales or royalties, if any, from our potential products;
- the extent of our general and administrative expenses; and
- the rate of technological advancements for the indications that we target.

Our existing capital resources may not 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 through at least the end of 2015, without taking into account any amounts that we would be entitled to receive if milestone events are achieved under our ongoing collaboration agreement with AstraZeneca. 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.

To the extent our capital resources are insufficient to meet future capital requirements or to the extent the conditions for raising capital are favorable, we may seek to finance future cash needs through public or private equity or debt offerings or other financings (whether utilizing our currently effective Registration Statement on Form S-3 or otherwise). Our access in the future to additional equity or debt financing, on acceptable terms or at all, is uncertain. We may also seek to finance future cash needs through alliances, collaborations or licensing or other comparable arrangements. Strategic alliances, collaborations or licensing or other comparable arrangements may not be available on acceptable terms or at all. If adequate funds are not available, we may be required to delay, reduce the scope of or eliminate our development programs 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 significantly dilute the ownership of our stockholders.

We cannot determine precisely the completion dates and related costs of our 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 establish strategic alliances, collaborations or licensing or other arrangements for our product candidates. Our failure, or the failure of any of our present or future licensees or collaborators, to complete research and development programs for our product candidates 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, 2012:

| | Payments Due by Period (in thousands) | | | | |
|---|---|---|---|---|---|
| **Contractual Obligation** | **Total** | **Less Than 1 Year** | **1 - 3 Years** | **3 - 5 Years** | **More Than 5 Years** |
| Long-term debt obligations | $ 2,071 | $ 907 | $1,164 | $— | $ — |
| Operating lease obligations | 1,390 | 556 | 834 | — | — |
| Purchase obligations | 30,137 | 22,523 | 7,607 | 7 | — |
| | $33,598 | $ 23,986 | $9,605 | $ 7 | $ — |

The amounts of purchase obligations reflected in the above table include obligations to purchase drug substance or clinical trial materials, to compensate clinical investigators, clinical trial sites and contract research organizations 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 amounts of purchase obligations also include contractual obligations for insurance and other general and administrative expenses. The amounts of long-term debt obligations for all periods reflected in the above table include principal and interest payments on loan facilities outstanding at December 31, 2012.

**Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements.

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

The primary objectives of our investment activities are to preserve our capital and meet our liquidity needs to fund operations. We also seek to generate competitive rates of return from our investments without assuming significant risk. To achieve our objectives, we maintain a portfolio of cash equivalents and investments in a variety of securities that are of high credit quality based on ratings from commonly relied upon rating agencies. As of December 31, 2012, we had cash, cash equivalents and investments in marketable securities of $184.9 million. Our cash, cash equivalents and investments in marketable securities may be subject to interest rate risk and could fall in value if market interest rates increase. However, because our cash is invested in accounts with market interest rates and are short term in nature and because our cash equivalents and investments in marketable securities are traded in active markets, 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, 2012 would not have a material impact on the total fair value of our portfolio.

We sometimes contract for the conduct of clinical trials or other research and development and manufacturing activities with contract research organizations, clinical trial sites and contract manufacturers in Europe or elsewhere outside of the United States. We may be subject to exposure to fluctuations in foreign currency exchange rates in connection with these agreements. If the average exchange rate between the currency of our payment obligations under any of these agreements and the U.S. dollar were to strengthen or weaken by 10% against the corresponding exchange rate as of December 31, 2012, 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.**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***Report of Independent Registered Public Accounting Firm***

The Board of Directors and Stockholders of
Targacept, Inc.

We have audited the accompanying balance sheets of Targacept, Inc. as of December 31, 2012 and 2011, and the related statements of comprehensive income (loss), stockholders' equity and cash flows for each of the three years in the period ended December 31, 2012. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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, 2012 and 2011, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Targacept, Inc.'s internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 15, 2013 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Raleigh, North Carolina
March 15, 2013

**TARGACEPT, INC.**

**BALANCE SHEETS**
**(in thousands, except share and par value amounts)**

| | December 31, 2012 | December 31, 2011 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 82,240 | $ 107,283 |
| Investments in marketable securities—short term | 42,721 | 87,721 |
| Receivables from collaborations and other | 1,380 | 218 |
| Prepaid expenses | 1,402 | 2,995 |
| Total current assets | 127,743 | 198,217 |
| Investments in marketable securities—long term | 59,966 | 54,266 |
| Property and equipment, net | 1,639 | 5,035 |
| Intangible assets | 115 | 132 |
| Other assets | 116 | 476 |
| Total assets | $ 189,579 | $ 258,126 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 2,056 | $ 3,489 |
| Accrued expenses | 6,085 | 16,167 |
| Current portion of long-term debt | 851 | 1,241 |
| Current portion of deferred revenue | 2,357 | 57,714 |
| Total current liabilities | 11,349 | 78,611 |
| Long-term debt, net of current portion | 1,136 | 1,986 |
| Deferred revenue, net of current portion | 1,179 | 3,241 |
| Total liabilities | 13,664 | 83,838 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock, $0.001 par value, 100,000,000 shares authorized; 33,615,081 and 33,383,403 shares issued and outstanding at December 31, 2012 and December 31 2011, respectively | 34 | 33 |
| Preferred stock, $0.001 par value, 5,000,000 shares authorized; 0 shares issued and outstanding at December 31, 2012 and 2011 | — | — |
| Capital in excess of par value | 409,608 | 401,149 |
| Accumulated other comprehensive income | 201 | 36 |
| Accumulated deficit | (233,928) | (226,930) |
| Total stockholders' equity | 175,915 | 174,288 |
| Total liabilities and stockholders' equity | $ 189,579 | $ 258,126 |

See accompanying notes.

**TARGACEPT, INC.**

**STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**
**(in thousands, except share and per share amounts)**

| | Year ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| Operating revenues: | | | |
| License fees and milestones from collaborations | $ 57,420 | $ 96,979 | $ 83,380 |
| Grant revenue | 440 | 658 | 2,333 |
| Net operating revenues | 57,860 | 97,637 | 85,713 |
| Operating expenses: | | | |
| Research and development (including stock-based compensation of $3,792, $4,885 and $2,768 in 2012, 2011 and 2010, respectively) | 49,087 | 95,215 | 64,546 |
| General and administrative (including stock-based compensation of $3,956, $3,628 and $2,169 in 2012, 2011 and 2010, respectively) | 13,193 | 12,167 | 8,052 |
| Reduction in force (including stock-based compensation of $98 in 2012) | 3,718 | — | — |
| Total operating expenses | 65,998 | 107,382 | 72,598 |
| (Loss) income from operations | (8,138) | (9,745) | 13,115 |
| Other income (expense): | | | |
| Interest income | 1,070 | 1,348 | 1,463 |
| Gain on sale of property and equipment | 55 | — | — |
| Interest expense | (86) | (132) | (153) |
| Total other income (expense) | 1,039 | 1,216 | 1,310 |
| (Loss) income before income taxes | (7,099) | (8,529) | 14,425 |
| Income tax benefit (expense) | 101 | — | (3,526) |
| Net (loss) income | $ (6,998) | $ (8,529) | $ 10,899 |
| Basic net (loss) income per share | $ (0.21) | $ (0.27) | $ 0.38 |
| Diluted net (loss) income per share | $ (0.21) | $ (0.27) | $ 0.36 |
| Weighted average common shares outstanding—basic | 33,476,316 | 31,637,283 | 28,543,408 |
| Weighted average common shares outstanding—diluted | 33,476,316 | 31,637,283 | 30,150,324 |
| | | | |
| Net (loss) income | $ (6,998) | $ (8,529) | $ 10,899 |
| Unrealized gain (loss) on available-for-sale securities, net | 165 | (189) | 225 |
| Comprehensive (loss) income | $ (6,833) | $ (8,718) | $ 11,124 |

See accompanying notes.

**TARGACEPT, INC.**

**STATEMENTS OF STOCKHOLDERS' EQUITY**
**(in thousands, except share amounts)**

| | Common Stock | | Capital in Excess of Par Value | Other Comprehensive Income | Accumulated Deficit | Total Stockholders' Equity |
|---|---|---|---|---|---|---|
| | Shares | Amount | | | | |
| Balances at January 1, 2010 | 28,226,829 | $ 28 | $298,263 | $ — | $ (229,300) | $ 68,991 |
| Issuance of common stock related to exercise of stock options | 643,862 | 1 | 3,291 | — | — | 3,292 |
| Stock-based compensation | — | — | 4,937 | — | — | 4,937 |
| Excess tax deductions from stock-based compensation | — | — | 3,503 | — | — | 3,503 |
| Net change in unrealized holding gain on available-for-sale marketable securities | — | — | — | 225 | — | 225 |
| Net income | — | — | — | — | 10,899 | 10,899 |
| Comprehensive income | — | — | — | — | — | 11,124 |
| Balances at December 31, 2010 | 28,870,691 | 29 | 309,994 | 225 | (218,401) | 91,847 |
| Issuance of common stock related to exercise of stock options | 305,395 | — | 1,802 | — | — | 1,802 |
| Stock-based compensation | — | — | 8,513 | — | — | 8,513 |
| Net proceeds from public stock offering | 4,207,317 | 4 | 80,840 | — | — | 80,844 |
| Net change in unrealized holding gain on available-for-sale marketable securities | — | — | — | (189) | — | (189) |
| Net loss | — | — | — | — | (8,529) | (8,529) |
| Comprehensive loss | — | — | — | — | — | (8,718) |
| Balances at December 31, 2011 | 33,383,403 | 33 | 401,149 | 36 | (226,930) | 174,288 |
| Issuance of common stock related to exercise of stock options | 231,678 | 1 | 613 | — | — | 614 |
| Stock-based compensation | — | — | 7,846 | — | — | 7,846 |
| Net change in unrealized holding gain on available-for-sale marketable securities, net of taxes | — | — | — | 165 | — | 165 |
| Net loss | — | — | — | — | (6,998) | (6,998) |
| Comprehensive loss | — | — | — | — | — | (6,833) |
| Balances at December 31, 2012 | 33,615,081 | $ 34 | $409,608 | $ 201 | $ (233,928) | $ 175,915 |

See accompanying notes.

**TARGACEPT, INC.**

**STATEMENTS OF CASH FLOWS**
**(in thousands)**

| | Year ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| **Operating activities** | | | |
| Net (loss) income | $ (6,998) | $ (8,529) | $ 10,899 |
| Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities: | | | |
| Recognition of deferred revenue | (57,860) | (97,439) | (83,767) |
| Amortization of premium on marketable securities, net | 937 | 911 | 416 |
| Depreciation and amortization | 2,212 | 2,480 | 1,997 |
| Stock-based compensation expense | 7,846 | 8,513 | 4,937 |
| Excess tax benefits from stock-based compensation | — | — | (3,503) |
| Gain on disposal of property and equipment | (55) | — | — |
| Income tax benefit from other comprehensive income | (101) | — | — |
| Changes in operating assets and liabilities: | | | |
| Receivables from collaborations | (1,162) | 620 | 200,963 |
| Other assets | 2,017 | (443) | (1,815) |
| Accounts payable, license fees payable and accrued expenses | (11,515) | 4,419 | (3,802) |
| Deferred license fee revenue | 440 | 5,750 | 11,973 |
| Net cash (used in) provided by operating activities | (64,239) | (83,718) | 138,298 |
| **Investing activities** | | | |
| Purchase of investments in marketable securities | (120,972) | (156,253) | (144,012) |
| Proceeds from sale of investments in marketable securities | 159,538 | 100,012 | 84,481 |
| Purchase of property and equipment | (333) | (1,431) | (3,311) |
| Proceeds from sale of property and equipment | 1,589 | 5 | 43 |
| Net cash provided by (used in) investing activities | 39,822 | (57,667) | (62,799) |
| **Financing activities** | | | |
| Proceeds from issuance of long-term debt | — | 2,132 | 1,228 |
| Principal payments on long-term debt | (1,240) | (1,964) | (1,577) |
| Proceeds from issuance of common stock, net | 614 | 82,646 | 3,292 |
| Excess tax benefits from stock-based compensation | — | — | 3,503 |
| Net cash (used in) provided by financing activities | (626) | 82,814 | 6,446 |
| Net (decrease) increase in cash and cash equivalents | (25,043) | (58,571) | 81,945 |
| Cash and cash equivalents at beginning of year | 107,283 | 165,854 | 83,909 |
| Cash and cash equivalents at end of year | $ 82,240 | $ 107,283 | $ 165,854 |

See accompanying notes.

**TARGACEPT, INC.**

**NOTES TO FINANCIAL STATEMENTS**
**DECEMBER 31, 2012**

## 1. The Company and Nature of Operations

Targacept, Inc., or the Company, is a Delaware corporation formed on March 7, 1997. The Company is a biopharmaceutical company engaged in the development of novel NNR Therapeutics™ for the treatment of various diseases and disorders of the nervous system. The Company's NNR Therapeutics selectively target neuronal nicotinic receptors, which it refers to as NNRs. Its facilities are located in Winston-Salem, North Carolina.

## 2. Summary of Significant Accounting Policies

*Use of Estimates, Reclassifications and Revisions*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles, or GAAP, requires management to make estimates and assumptions that affect the amounts of assets, liabilities, revenues and expenses reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

Certain reclassifications have been made to the financial statements for the years ended December 31, 2011 and 2010 to conform to the presentation in the financial statements for the year ended December 31, 2012. These reclassifications had no impact on previously reported net loss or stockholders' equity.

*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 Marketable Securities*

Consistent with its investment policy, the Company invests its cash allocated to fund its short-term liquidity requirements with prominent financial institutions in bank depository accounts and institutional money market funds and the Company invests the remainder of its cash in U.S. Treasury notes and bonds, U.S. and state government agency-backed securities, corporate debt securities that are rated at least A quality or equivalent, municipal bonds and certificates of deposit.

The Company determines the appropriate classification of marketable securities at the time of purchase and reevaluates its classification as of each balance sheet date. All marketable securities owned during 2012 and 2011 were classified as available-for-sale. The cost of securities sold is based on the specific identification method. Investments in marketable securities are recorded as of each balance sheet date at fair value, with unrealized gains and, to the extent deemed temporary, unrealized losses included in stockholders' equity. Interest and dividend income on investments in marketable securities, accretion of discounts and amortization of premiums and realized gains and losses are included in interest income in the statement of comprehensive income (loss).

An investment in marketable securities is considered to be impaired when a decline in fair value below its cost basis is determined to be other than temporary. The Company evaluates whether a decline in fair value of an investment in marketable securities below its cost basis is other than temporary using available evidence. In the event that the cost basis of the investment exceeds its fair value, the Company evaluates, among other factors, the amount and duration of the period that the fair value is less than the cost basis, the financial health of and business outlook for the issuer, including industry and sector performance and operational and financing cash

**TARGACEPT, INC.**

**NOTES TO FINANCIAL STATEMENTS (continued)**
**DECEMBER 31, 2012**

**2. Summary of Significant Accounting Policies (continued)**

flow factors, overall market conditions and trends, the Company's intent to sell the investment and whether it is more likely than not the Company would be required to sell the investment before its anticipated recovery. If a decline in fair value is determined to be other than temporary, the Company records an impairment charge in the statement of comprehensive income (loss) and establishes a new cost basis in the investment.

*Receivables from Collaborations*

Substantially all of the Company's collaboration revenue is related to the collaboration and alliance agreements discussed in Note 12. A substantial portion of the Company's receivables from collaborations and other at December 31, 2012 and 2011 is related to the Company's two collaboration agreements with AstraZeneca AB, one of which remained in effect as of December 31, 2012.

During 2012, 2011, and 2010, the Company recognized revenue of $57,420,000, $96,979,000, and $83,380,000, respectively, or 99%, 99% and 97% of net operating revenues, respectively, from the collaboration and alliance agreements discussed in Note 12.

*Long-lived Assets*

Property and equipment consists primarily of laboratory equipment, office furniture and fixtures and, prior to December 31, 2012, leasehold improvements and is recorded at historical cost, net of accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets ranging from 3 to 10 years. Laboratory equipment is typically depreciated over 3 to 5 years, office furniture and fixtures are typically depreciated over 5 to 10 years, and leasehold improvements are typically amortized over the lesser of the asset life or the lease term.

The Company capitalizes the costs of intellectual property acquired or licensed from external sources as intangible assets if, at the time of acquisition, the intellectual property has reached technological feasibility. Intellectual property acquired or licensed from external sources that has not reached technological feasibility at the time of acquisition or that has no expected future use is charged to research and development expense as incurred. The Company records all other charges related to the filing, prosecution and maintenance of patents to expense as incurred.

The Company assesses the net realizable value of its long-lived assets and evaluates these assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment charge 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 charge, if recognized, would be based on the excess of the carrying value of the impaired asset over its estimated fair value.

*Research and Development Expense*

Research and development costs are expensed as incurred and include direct costs incurred to third parties related to research or development of the Company's product candidates, salaries of, and stock-based compensation for, personnel involved in research and development activities, contractor fees, administrative expenses and allocations of research and development-related overhead costs. Administrative expenses and research and

**TARGACEPT, INC.**

**NOTES TO FINANCIAL STATEMENTS (continued)**
**DECEMBER 31, 2012**

**2. Summary of Significant Accounting Policies (continued)**

development-related overhead costs included in research and development expense 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 the cost-sharing agreements described in Note 12.

*Accrued Expenses*

The Company records accruals based on estimates of the services received, efforts expended and amounts owed pursuant to contracts with clinical trial sites, 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 other research and development activities in the ongoing development of potential products. The financial terms of these agreements are subject to negotiation, vary from contract to contract and may result in uneven payment flows. Payments under these agreements depend on the performance of services or the achievement of specified events, such as the production of drug substance or clinical trial materials, the recruitment of clinical trial subjects, the completion of portions of a non-clinical study or 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 a particular contract as giving rise to a payment.

*Credit Risk*

Financial instruments that potentially subject the Company to credit risk consist principally of cash, investments in marketable securities and receivables from collaborations. The Company has established guidelines for investment of its cash that are designed to emphasize safety, liquidity and preservation of capital. The Company places its cash and cash equivalents with prominent financial institutions. At December 31, 2012 and 2011, the Company had deposits in excess of federally insured limits of $87,081,000 and $102,412,000, respectively.

*Revenue Recognition*

The Company uses the revenue recognition guidance established by Financial Accounting Standards Board, or FASB, Accounting Standards Codification, or ASC, Topic 605, *Revenue Recognition*, or ASC 605. In determining the accounting for collaboration and alliance agreements, the Company follows the provisions of ASC 605, Subtopic 25, *Multiple Element Arrangements*, or ASC 605-25. ASC 605-25 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 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 separation criteria of ASC 605-25, the consideration received is allocated among the separate units of accounting and the applicable revenue recognition criteria must be applied to each unit. If the arrangement constitutes a single unit of accounting, the revenue recognition policy must be determined for the entire arrangement and the consideration received is recognized over the period of inception through the date on which the last deliverable within the single unit of accounting is expected to be delivered. Revisions to the estimated period of recognition are reflected in revenue prospectively.

Collaboration research and development revenue is earned and recognized as research is performed and related expenses are incurred. Non-refundable upfront fees, which may include, for example, an initial payment upon effectiveness of the contractual relationship, payment representing a common stock purchase premium or

**TARGACEPT, INC.**

**NOTES TO FINANCIAL STATEMENTS (continued)**
**DECEMBER 31, 2012**

**2. Summary of Significant Accounting Policies (continued)**

payment to secure a right for a future license, are recorded as deferred revenue and recognized into revenue as license fees and milestones from collaborations on a straight-line basis over the estimated period of the Company's substantive performance obligations. If the Company does not have substantive performance obligations, it recognizes non-refundable upfront fees into revenue through the date the deliverable is satisfied.

Revenue for non-refundable payments based on the achievement of milestone events under collaboration agreements is recognized in accordance with ASC 605, Subtopic 28, *Milestone Method*, or ASC 605-28, which the Company adopted as of January 1, 2011. Milestone events under the Company's collaboration agreements may include research, development, regulatory, commercialization or sales events. Under ASC 605-28, a milestone payment is recognized as revenue when the applicable event is achieved if the event meets the definition of a milestone and the milestone is determined to be substantive. ASC 605-28 defines a milestone event as an event having all of the following characteristics: (1) there is substantive uncertainty regarding achievement of the milestone event at the inception of the arrangement; (2) the event can only be achieved based, in whole or in part, on either the company's performance or a specific outcome resulting from the company's performance; and (3) if achieved, the event would result in additional payment due to the company. The Company also treats events that can only be achieved based, in whole or in part, on either a third party's performance or a specific outcome resulting from a third party's performance as milestone events if the criteria of ASC 605-28 are otherwise satisfied. A milestone is considered substantive if it meets all of the following criteria: (A) the payment is commensurate with either the Company's performance to achieve the milestone or with the enhancement of the value of the delivered item; (B) the payment relates solely to past performance; and (C) the payment is reasonable relative to all of the deliverables and payment terms within the arrangement. If any of these conditions is not met, the milestone payment is deferred and recognized on a straight-line basis over a period determined as discussed above.

Research and development costs that are reimbursable under collaboration agreements are recorded in accordance with ASC 605, Subtopic 45, *Principal Agent Considerations*. Amounts reimbursed under a cost sharing arrangement are reflected as a reduction of research and development expense.

Grant payments received prior to the Company's performance of work required by the terms of the award are recorded as deferred revenue and recognized as grant revenue as the Company performs the work and incurs qualifying costs.

*Income Taxes*

The Company uses the liability method in accounting for income taxes as required by ASC Topic 740, *Income Taxes*, or ASC 740. Under ASC 740, deferred tax assets and liabilities are recorded 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 of a change in tax rates on deferred tax assets and liabilities 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 the assets will be realized. ASC 740 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. ASC 740 also provides guidance on de-recognition, classification, interest

**TARGACEPT, INC.**

**NOTES TO FINANCIAL STATEMENTS (continued)**
**DECEMBER 31, 2012**

**2. Summary of Significant Accounting Policies (continued)**

and penalties, accounting in interim periods, disclosures and transition. The Company's policy is to classify any interest recognized in accordance with ASC 740 as interest expense and to classify any penalties recognized in accordance with ASC 740 as an expense other than income tax expense.

*Net Income or Loss Per Share*

The Company computes net income or loss per share in accordance with ASC Topic 260, *Earnings Per Share*, or ASC 260. Under the provisions of ASC 260, basic net income or loss per share, or Basic EPS, is computed by dividing net income or loss by the weighted average number of common shares outstanding. Diluted net income or loss per share, or Diluted EPS, is computed by dividing net income or loss by the weighted average number of common shares outstanding plus, in the case of diluted net income per share, dilutive common share equivalents outstanding.

The calculations of Basic EPS and Diluted EPS are set forth in the table below (in thousands, except share and per share amounts):

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| Basic: | | | |
| Net (loss) income | $ (6,998) | $ (8,529) | $ 10,899 |
| Weighted average common shares—basic | 33,476,316 | 31,637,283 | 28,543,408 |
| Basic EPS | $ (0.21) | $ (0.27) | $ 0.38 |
| Diluted: | | | |
| Net (loss) income | $ (6,998) | $ (8,529) | $ 10,899 |
| Weighted average common shares—basic | 33,476,316 | 31,637,283 | 28,543,408 |
| Common share equivalents | — | — | 1,606,916 |
| Weighted average common shares—diluted | 33,476,316 | 31,637,283 | 30,150,324 |
| Diluted EPS | $ (0.21) | $ (0.27) | $ 0.36 |

Common share equivalents consist of the incremental common shares that would be outstanding upon the exercise of stock options, calculated using the treasury stock method. For each of the years ended December 31, 2012 and 2011, the Company excluded all common share equivalents from the calculation of Diluted EPS because the Company had a net loss. As a result, Diluted EPS is identical to Basic EPS for those years. If the Company had been in a net income position for the years ended December 31, 2012 and 2011, 4,250,964 and 3,597,530 shares, respectively, subject to outstanding stock options may have been included in the calculation of common share equivalents using the treasury stock method. For the year ended December 31, 2010, a period in which the Company had net income, shares subject to outstanding stock options that were antidilutive and consequently not included in the calculation of common share equivalents totaled 850,683, calculated on a weighted-average basis.

**TARGACEPT, INC.**

**NOTES TO FINANCIAL STATEMENTS (continued)**
**DECEMBER 31, 2012**

**2. Summary of Significant Accounting Policies (continued)**

*Public Offerings of Common Stock*

In May 2011, the Company completed an underwritten public offering of 3,658,537 shares of its common stock. In June 2011, the Company sold an additional 548,780 shares of its common stock upon the exercise of the over-allotment option granted to the underwriters. The Company's net proceeds from the offering, after deducting underwriters' discounts and commissions and offering expenses paid by the Company, were $80,840,000.

*Stock-Based Compensation*

The Company has two stock-based incentive plans, the 2000 Equity Incentive Plan of Targacept, Inc., as amended and restated through March 15, 2006, or the 2000 Plan, and the Targacept, Inc. 2006 Stock Incentive Plan, as amended and restated through March 9, 2011 and further amended on December 7, 2012, or the 2006 Plan. The 2000 Plan and the 2006 Plan, or the Plans, are described more fully in Note 9.

The Company records stock-based compensation under the fair value recognition provisions of ASC Topic 718, *Compensation—Stock Compensation*, or ASC 718. Under ASC 718, the Company calculates the fair value of each option grant using the Black-Scholes-Merton valuation formula. The fair value of each grant is recorded as expense on a straight-line basis over the option's vesting period.

ASC 718 also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow. This requirement reduces net operating cash flows and increases net financing cash flows for periods after adoption. The Company cannot estimate the future effect of excess tax deductions or shortfalls on cash flows because they depend on, among other things, when employees exercise stock options and the tax deductions available to the Company at those times.

*Prepaid Expenses*

The Company defers and capitalizes non-refundable advance payments for goods or services to be received in the future. The Company then charges the advance payments to expense ratably as the goods are delivered or the services are rendered. The Company may make adjustments to the amount charged to expense each period if expectations change regarding the timing of delivery of goods or rendering of services.

*Fair Value*

The carrying amounts of cash and cash equivalents, investments in marketable securities, receivables from collaborations, accounts payable and accrued expenses are considered to be representative of their respective fair values due to their short-term natures and, in the case of investments in marketable securities, their market interest rates. Likewise, the carrying amounts of the Company's long-term debts are considered to be representative of their fair value due to their respective market interest rates.

The Company follows ASC Topic 820, *Fair Value Measurements and Disclosures*, or ASC 820, for application to financial assets. ASC 820 defines fair value, provides a consistent framework for measuring fair value under GAAP and requires fair value financial statement disclosures. ASC 820 applies only to the measurement and disclosure of financial assets that are required or permitted to be measured and reported at fair value under other ASC topics (except for standards that relate to share-based payments such as ASC Topic 718, *Compensation—Stock Compensation*).

**TARGACEPT, INC.**

**NOTES TO FINANCIAL STATEMENTS (continued)**
**DECEMBER 31, 2012**

**2. Summary of Significant Accounting Policies (continued)**

The valuation techniques required by ASC 820 may be based on either observable or unobservable inputs. Observable inputs reflect readily obtainable data from independent sources, and unobservable inputs reflect the Company's market assumptions. These inputs are classified into the following hierarchy:

*Level 1 Inputs*—quoted prices (unadjusted) in active markets for identical assets that the reporting entity has the ability to access at the measurement date;

*Level 2 Inputs*—inputs other than quoted prices included within Level 1 that are observable for the asset, either directly or indirectly; and

*Level 3 Inputs*—unobservable inputs for the assets.

The following tables present the Company's investments in marketable securities (including those classified on the Company's balance sheet as cash equivalents) that are measured at fair value on a recurring basis as of December 31, 2012 and 2011, respectively:

| December 31, 2012 | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|
| | | (in thousands) | |
| U.S. Treasury and U.S. or state government agency-backed securities | $46,371 | $ — | $ — |
| Corporate debt securities | — | 47,173 | — |
| Municipal bonds | — | 2,700 | — |
| Certificates of deposit | 10,000 | — | — |
| Accrued interest | 443 | — | — |
| Total cash equivalents and marketable securities | $56,814 | $ 49,873 | $ — |

| December 31, 2011 | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|
| | | (in thousands) | |
| U.S. Treasury and U.S. or state government agency-backed securities | $69,474 | $ — | $ — |
| Corporate debt securities | — | 75,007 | — |
| Certificates of deposit | 13,000 | — | — |
| Accrued interest | 506 | — | — |
| Total cash equivalents and marketable securities | $82,980 | $ 75,007 | $ — |

Corporate debt securities and municipal bonds are valued based on various observable inputs such as benchmark yields, reported trades, broker/dealer quotes, benchmark securities and bids.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2012

**2. Summary of Significant Accounting Policies (continued)**

*Accumulated Other Comprehensive Income or Loss*

Accumulated other comprehensive income or loss, as presented in stockholders' equity on the Company's balance sheet, reflects the cumulative net unrealized gains or losses on available-for-sale securities for all periods. The table below reflects changes in accumulated other comprehensive income for the year ended December 31, 2012, in thousands.

| | |
|---|---|
| Accumulated other comprehensive income, January 1, 2012 | $ 36 |
| Unrealized gain on available-for-sale securities, net | 344 |
| Net realized gains on available-for sale securities reclassified out of other comprehensive income | (78) |
| Income taxes | (101) |
| Accumulated other comprehensive income, December 31, 2012 | $ 201 |

**3. Investments in Marketable Securities**

The following is a reconciliation of amortized cost to fair value of available-for-sale marketable securities (including those classified on the Company's balance sheet as cash equivalents) held at December 31, 2012 and 2011:

| December 31, 2012 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | | (in thousands) | | |
| *Security type* | | | | |
| *Cash Equivalents* | | | | |
| Corporate debt securities | $ 4,000 | $ — | $ — | $ 4,000 |
| *Marketable Securities—Short term* | | | | |
| U.S. Treasury and U.S. or state government agency-backed securities | 25,412 | 27 | — | 25,439 |
| Corporate debt securities | 7,193 | 16 | — | 7,209 |
| Certificates of deposit | 10,000 | — | — | 10,000 |
| Accrued interest | 73 | — | — | 73 |
| *Marketable Securities—Long term* | | | | |
| U.S. Treasury and U.S. or state government agency-backed securities | 20,846 | 86 | — | 20,932 |
| Corporate debt securities—long term | 35,802 | 177 | (15) | 35,964 |
| Municipal Bonds | 2,689 | 11 | — | 2,700 |
| Accrued interest | 370 | — | — | 370 |
| Total available-for-sale marketable securities | $106,385 | $ 317 | $ (15) | $106,687 |

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2012

**3. Investments in Marketable Securities (continued)**

| December 31, 2011 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | | (in thousands) | | |
| *Security type* | | | | |
| *Cash Equivalents* | | | | |
| Corporate debt securities | $ 16,000 | $ — | $ — | $ 16,000 |
| *Marketable Securities—Short term* | | | | |
| U.S. Treasury and U.S. or state government agency-backed securities | 35,908 | 32 | — | 35,940 |
| Corporate debt securities | 38,531 | 37 | (34) | 38,534 |
| Certificates of deposit | 13,000 | — | — | 13,000 |
| Accrued interest | 247 | — | — | 247 |
| *Marketable Securities—Long term* | | | | |
| U.S. Treasury and U.S. or state government agency-backed securities | 33,466 | 75 | (7) | 33,534 |
| Corporate debt securities—long term | 20,540 | 39 | (106) | 20,473 |
| Accrued interest | 259 | — | — | 259 |
| Total available-for-sale marketable securities | $157,951 | $ 183 | $ (147) | $157,987 |

As of December 31, 2012, the Company held investments in marketable securities with unrealized gains of $317,000 and unrealized losses of $15,000. For the investments in an unrealized loss position, the duration of the loss was less than 12 months, and the investments are not considered to be other-than-temporarily impaired.

As of December 31, 2012, the Company's investments in marketable securities including those classified on its balance sheet as cash equivalents, reach maturity between January 10, 2013 and December 7, 2015, with a weighted average maturity date of approximately April 23, 2014.

**4. Property and Equipment**

As of the respective dates shown, property and equipment consisted of the following:

| | December 31, | |
|---|---|---|
| | 2012 | 2011 |
| | (in thousands) | |
| Laboratory equipment | $ 2,628 | $ 12,218 |
| Office furniture and fixtures | 2,880 | 4,254 |
| Leasehold improvements | — | 1,395 |
| | 5,508 | 17,867 |
| Less: accumulated depreciation | (3,869) | (12,832) |
| Property and equipment, net | $ 1,639 | $ 5,035 |

The Company recorded $2,195,000, $2,463,000, and $1,979,000 of depreciation expense for the years ended December 31, 2012, 2011 and 2010, respectively. During the year ended December 31, 2012, the Company closed its laboratory operations and completed two reductions in force (see Note 13), which resulted in the sale of laboratory equipment and office furniture and fixtures with a book value of $1,534,000 and a cumulative gain on the sales of $55,000.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2012

**5. Intangible Assets**

As of the respective dates shown, intangible assets consisted of the following:

| | December 31, | |
|---|---|---|
| | 2012 | 2011 |
| | (in thousands) | |
| Patents | $ 296 | $ 296 |
| Less: accumulated amortization | (181) | (164) |
| Total | $ 115 | $ 132 |

Intangible assets consist of licensed patent rights assigned to the Company by Layton Bioscience, Inc. in 2002, which had an original value to the Company of $296,000.

The Company's prospective amortization of its intangible assets is $17,000 per year to research and development expense on a straight-line basis over the remaining useful life of the patents, a period of 17 years from the date of acquisition.

**6. Accrued Expenses**

As of the respective dates shown, accrued expenses consisted of the following:

| | December 31, | |
|---|---|---|
| | 2012 | 2011 |
| | (in thousands) | |
| Clinical trial and preclinical study costs | $5,232 | $14,859 |
| Employee compensation | 797 | 1,178 |
| Other | 56 | 130 |
| Total | $6,085 | $16,167 |

**7. Long-term Debt**

In July 2010, the Company entered into a loan agreement with a bank that provides aggregate borrowing capacity of $4,000,000 to be provided in up to three individual term loans on or prior to June 30, 2011 to fund the purchase of equipment, furnishings, software and other fixed assets. The Company borrowed $1,228,000 under the loan agreement in September 2010 and borrowed an additional $2,132,000 in June 2011. The Company's September 2010 borrowing bears interest at a fixed rate of 3.40% per annum and is repayable in equal monthly installments of $28,000 beginning January 1, 2011 through the maturity date of December 1, 2014. The Company's June 2011 borrowing bears interest at a fixed rate of 3.471% per annum and is repayable in equal monthly installments of $48,000 beginning July 1, 2011 through the maturity date of June 1, 2015. Pursuant to the loan agreement, the Company granted a first priority security interest in favor of the bank in the assets acquired with the proceeds of the loan.

In March 2008, the Company entered into a loan agreement with a bank that provided borrowing capacity of $5,300,000 to fund the purchase of equipment, furnishings, software and other fixed assets and enable the refinancing of an existing loan facility with another lender. The Company borrowed $4,811,000 upon entering into the loan agreement and borrowed the remaining $489,000 in September 2008. The Company's March 2008

**TARGACEPT, INC.**

**NOTES TO FINANCIAL STATEMENTS (continued)**
**DECEMBER 31, 2012**

**7. Long-term Debt (continued)**

borrowing bore interest at a fixed rate of 5.231% per annum and was repayable in equal monthly installments of $112,000 beginning April 1, 2008 through the maturity date of March 1, 2012. The March 2008 borrowing was paid and satisfied in full on March 1, 2012. The Company used $1,679,000 of the proceeds from the March 2008 borrowing to pay and satisfy in full the principal and interest outstanding on two tranches of the existing loan facility with another lender and granted a first priority security interest in favor of the bank in assets previously acquired with the proceeds of those tranches. The Company's September 2008 borrowing bears interest at a fixed rate of 6.131% per annum and is repayable in equal monthly installments of $11,000 beginning October 1, 2008 through the maturity date of September 1, 2012. The September 2008 borrowing was paid and satisfied in full on August 31, 2012.

During 2002, the Company borrowed $500,000 from the City of Winston-Salem. No payments were due on the City of Winston-Salem note until April 2007, when the Company began making monthly payments of $9,000 on the loan based on an interest rate of 5%. The note payable to the City of Winston-Salem was scheduled to mature on April 19, 2012. In December 2010, the Company repaid the remaining $135,000 balance of the note payable.

The Company paid $91,000, $134,000 and $156,000 in interest under notes payable during the years ended December 31, 2012, 2011 and 2010, respectively. Future scheduled maturities of long-term debt were as follows at December 31, 2012 (in thousands):

| | |
|---|---|
| 2013 | $ 851 |
| 2014 | 853 |
| 2015 | 283 |
| 2016 and thereafter | — |
| | $1,987 |

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2012

**8. Income Taxes**

For the year ended December 31, 2012, the Company recognized $101,000 of income tax benefit as a result of the application of intraperiod tax allocation provisions of ASC 740, under which the Company is required to consider all items (including items recorded in other comprehensive income) in determining the amount of tax benefit that should be allocated to net loss. The non-cash income tax benefit was offset in full by income tax expense recorded in other comprehensive income. For the year ended December 31, 2011, the Company did not recognize any income tax expense or benefit. For the year ended December 31, 2010, the Company recognized $3,526,000 of income tax expense primarily as a result of the application of ASC 740 to stock-based compensation. Exercises of stock options during year ended December 31, 2010 resulted in tax deductions for stock-based compensation in excess of expense recorded for the stock options under GAAP, resulting in an income tax benefit of $3,503,000. The Company recognized the income tax benefit related to the excess tax deductions as an increase to capital in excess of par value, which based on ASC 740 resulted in an offsetting charge in the same amount to income tax expense. The Company has incurred cumulative net operating losses since inception. For the years shown, components of the Company's income tax expense (benefit) were as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| | (in thousands) | | |
| Current: | | | |
| Federal | $ — | $ — | $ 3,086 |
| State | — | — | 440 |
| Net current income tax (benefit) expense | — | — | 3,526 |
| Deferred: | | | |
| Federal | (1,128) | (6,147) | 1,519 |
| State | (718) | (1,095) | (1,321) |
| Valuation allowance | 1,745 | 7,242 | (198) |
| Net deferred income tax expense (benefit) | (101) | — | — |
| Net income tax (benefit) expense | $ (101) | $ — | $ 3,526 |

The following is a reconciliation from the federal income tax rate to the Company's effective tax rate.

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| Expected federal income tax benefit/expense at statutory rate | 35% | 35% | 35% |
| Increase (decrease) resulting from: | | | |
| Research and development credits | — | 19 | (12) |
| Stock-based compensation | (15) | (13) | 4 |
| State income tax expense, net of federal benefit | 2 | 3 | 3 |
| Qualifying Therapeutic Drug Project grant | — | — | (3) |
| Change in unrecognized tax benefit reserves | — | — | (3) |
| Change in valuation allowance | (25) | (85) | (1) |
| Other | 4 | 41 | 1 |
| | 1% | — % | 24% |

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2012

**8. Income Taxes (continued)**

At December 31, 2012, 2011 and 2010, the Company had net operating loss carryforwards for federal income tax purposes of $187,752,000, $135,860,000, and $39,011,000, respectively, and for state income tax purposes of $176,296,000, $134,470,000 and $76,178,000, respectively. At December 31, 2012, 2011 and 2010, the Company had research and development income tax credit carryforwards for federal income tax purposes of $10,762,000, $10,778,000 and $9,556,000, respectively. The Company had research and development income tax credit carryforwards for state income tax purposes of $587,000 at December 31, 2012, 2011 and 2010. The federal net operating loss carryforwards begin to expire in 2024. The state net operating loss carryforwards begin to expire in 2019. The federal and state 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. A series of stock issuances gave rise to such an ownership change in December 2004. As a result, 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 Company's net deferred tax assets relate principally to its recognition of deferred license fees from collaborations, research and development tax credits and net operating loss carryforwards. A valuation allowance has been recognized to offset the deferred tax assets. If and when recognized, the tax benefit for those items will be reflected in the period in which the benefit is recorded as a reduction of income tax expense. However, in the event the Company has excess tax deductions related to the exercise of stock options, the tax benefit will be reflected as an increase to capital in excess of par value. 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. The valuation allowance increased by $1,745,000 and $7,242,000 for the years ended December 31, 2012 and 2011, respectively. For the year ended December 31, 2010, the valuation allowance decreased by $198,000.

As of the respective dates shown, significant components of the Company's deferred tax assets (liabilities) were as follows:

| | December 31, | |
|---|---|---|
| | 2012 | 2011 |
| | (in thousands) | |
| Deferred tax assets: | | |
| Collaboration revenue | $ 1,341 | $ 21,193 |
| Research and development tax credit | 10,033 | 10,049 |
| Net operating loss carryforward | 65,935 | 45,901 |
| Patents | 1,798 | 1,968 |
| Stock-based compensation | 5,260 | 3,509 |
| Other | 94 | 48 |
| Total gross deferred tax assets | 84,461 | 82,668 |
| Valuation allowance | (84,101) | (82,356) |
| Net deferred tax asset | 360 | 312 |
| Deferred tax liabilities | | |
| Equipment and other | (360) | (312) |
| Net deferred tax asset | $ — | $ — |

**TARGACEPT, INC.**

**NOTES TO FINANCIAL STATEMENTS (continued)**
**DECEMBER 31, 2012**

**8. Income Taxes (continued)**

As of December 31, 2012, the Company had cumulative tax deductions from exercises of stock options in excess of expense recorded for the stock options under GAAP. The $7,540,000 benefit of these excess tax deductions had not begun to be realized as of December 31, 2012 because the Company incurred operating losses in the years the respective stock options were exercised and has incurred cumulative net operating losses since inception. Accordingly, the tax benefit will not be recognized as an increase to capital in excess of par value unless and until the excess deductions reduce income taxes payable.

The Company follows the provisions of ASC 740, which prescribes a 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 and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods and disclosures. There was no cumulative effect adjustment upon adoption.

A reconciliation of beginning and ending unrecognized tax benefits is as follows (in thousands).

| | |
|---|---|
| Balance at January 1, 2010 | $ 1,886 |
| Decreases based on tax positions related to prior years | (412) |
| Balance at December 31, 2010 | 1,474 |
| Additions (decreases) based on tax positions related to current and prior years | — |
| Balance at December 31, 2011 | 1,474 |
| Additions (decreases) based on tax positions related to current and prior years | — |
| Balance at December 31, 2012 | $ 1,474 |

None of the unrecognized tax benefits would, if recognized, affect the effective tax rate because the Company has recorded a valuation allowance to fully offset federal and state deferred tax assets. The Company has no tax positions for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease during 2013. No interest or penalties with respect to unrecognized tax positions are recognized in the statement of comprehensive income (loss) for any of the years ended December 31, 2012, 2011 or 2010.

Because the Company has incurred cumulative net operating losses since inception, all tax years remain open to examination by U.S. federal, North Carolina and Massachusetts tax authorities. An examination of the Company’s 2006 federal income tax return was completed in 2009 with no adjustments. An examination of the Company’s 2009, 2008, 2007, and 2006 North Carolina income tax returns was completed in 2012 with no material adjustments.

In November 2010, the Internal Revenue Service notified the Company that it had approved cumulative grants of $1,467,000 to the Company under the Qualifying Therapeutic Discovery Project tax credit program enacted as part of the Patient Protection and Affordable Care Act of 2010. In the fourth quarter of 2010, the Company recorded the cumulative grants as grant revenue in its financial statements.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2012

**9. Stock-Based Incentive Plans**

The 2000 Plan became effective in August 2000. 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. As of December 31, 2012, the number of shares authorized for issuance under the Plans was 7,282,078, of which 854,557 shares remained available for grant.

Awards may be made with respect to the 2006 Plan, or may have been made with respect to both Plans, 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 stock 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.

In addition to awards made under the Plans, on December 3, 2012, the Company granted a nonqualified option to purchase 400,000 shares of its common stock pursuant to an employment agreement entered into by the Company in connection with the hire of its president and chief executive officer. The option, which was not granted pursuant to a Plan, has similar terms to nonqualified stock options granted under the 2006 Plan.

Under ASC 718, the Company recognizes the grant date fair value of stock options issued to employees and non-employee directors over the requisite service periods, which are typically the vesting periods. 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 primarily based on the Company's implied volatility, the calculated historical volatility of twelve to sixteen benchmark companies in the Company's industry that have been identified as comparable public entities, the Company's historical volatility and the implied volatility of the same benchmark companies. The expected term for stock options granted during 2012, 2011 and 2010 is based on historical analysis. 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 stock options granted as of the respective dates shown:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| Dividend yield | — | — | — |
| Risk-free interest rate | 1.0% | 2.5% | 2.9% |
| Volatility | 69% | 67% | 75% |
| Expected term | 6.16 years | 6.00 years | 6.27 years |

During 2012, the Company partially accelerated the vesting of, and/or extended the permitted period for exercise for, some outstanding stock options held by several executive and non-executive employees who departed the Company. These modifications resulted in incremental compensation cost recorded by the Company for the year ended December 31, 2012 of $1,397,000.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2012

**9. Stock-Based Incentive Plans (continued)**

A summary of option activity and changes during the year ended December 31, 2012 appears below.

| | Shares Subject to Options | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Outstanding at January 1, 2012 | 3,779,866 | $ 14.51 | | |
| Granted | 1,713,835 | 4.54 | | |
| Forfeited | (892,219) | 16.38 | | |
| Exercised | (231,678) | 2.65 | | |
| Outstanding at December 31, 2012 | 4,369,804 | $ 10.84 | 6.3 years | $ 624,538 |
| Vested and exercisable at December 31, 2012 | 2,802,294 | $ 11.80 | 4.7 years | $ 608,091 |

The weighted average grant date fair value of options granted during the years ended December 31, 2012, 2011, and 2010 was $2.98, $15.87 and $13.46, respectively. The total intrinsic value of options exercised during the years ended December 31, 2012, 2011, and 2010 was $471,680, $6,082,000, and $11,527,000, respectively.

A summary of the status of non-vested stock options outstanding as of December 31, 2012 and changes during the year ended December 31, 2012 appears below.

| | Shares Subject to Options | Weighted Average Grant-Date Fair Value Per Share |
|---|---|---|
| Non-vested at January 1, 2012 | 1,376,081 | $ 13.28 |
| Granted | 1,713,835 | 2.98 |
| Vested | (891,443) | 8.80 |
| Forfeited | (630,963) | 10.15 |
| Non-vested at December 31, 2012 | 1,567,510 | $ 5.84 |

As of December 31, 2012, there was $9,153,000 of total unrecognized compensation expense related to non-vested stock-based compensation arrangements, before considering forfeitures. That cost is expected to be recorded over a weighted average period of 3.14 years. The total fair value of shares subject to stock-based compensation arrangements that vested during the years ended December 31, 2012, 2011, and 2010 was $7,836,000, $8,481,000 and $4,396,000, respectively.

The Company had 4,369,804 and 3,779,866 shares of common stock reserved for future issuance upon the exercise of outstanding stock options at December 31, 2012 and 2011, respectively.

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2012

**10. Commitments and Contingencies**

*Leases*

On March 1, 2002, the Company entered into an agreement with Wake Forest University Health Sciences (WFUHS) to lease an office and research facility in Winston-Salem, North Carolina with an initial term that extended through July 31, 2007. The lease contained a renewal option for up to one additional five-year term, with a rental rate for the renewal term similar to the initial term. From 2005 to 2012, the terms of the lease were amended to, among other things, adjust and readjust the amount of rental space and include a second renewal term, exercisable at the Company's option, at the then-existing market rate for similar space in the Piedmont Triad in North Carolina. The Company exercised its first renewal option in January 2007 and, as a result, the lease extended until July 31, 2012. Effective July 31, 2012, the Company and WFUHS further amended the lease to extend the lease term until the end of 2012, reduce the space leased by the Company from approximately 79,000 square feet to 48,318 square feet and reduce the monthly rent payable by the Company by approximately 37% to $131,141. The Company's lease with WFUHS expired on December 31, 2012.

On December 4, 2012, the Company entered into an agreement with B/E Aerospace, Inc. to sublease approximately 18,282 square feet of office space in Winston-Salem, North Carolina. The term of the sublease began on January 1, 2013 and ends on December 30, 2015. The monthly rent payable by the Company under the sublease is approximately $22,000 for the first year, subject to escalation of approximately 3% for each subsequent year of the term. The sublease is subject to the terms and conditions of the prime lease covering the subleased space between B/E Aerospace and its landlord, SL Winston-Salem LLC.

The Company has entered into various other lease agreements, primarily for storage space and equipment. Rent expense incurred by the Company under the office lease and other operating leases was $2,819,000, $2,575,000 and $2,003,000 for the years ended December 31, 2012, 2011 and 2010, respectively.

The following table illustrates expected future lease payments under all operating leases (in thousands):

| | |
|---|---|
| 2013 | 556 |
| 2014 | 507 |
| 2015 | 327 |
| 2016 | |
| 2017 and thereafter | — |
| | $1,390 |

*Employment Arrangements*

The Company has entered into employment agreements with some 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 from up to nine to 18 months following termination, depending on the executive and the circumstances of termination. 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.

Under an employment agreement with the Company's former chief executive officer, the Company has agreed to pay severance equal to the departing executive's regular base salary as of May 31, 2012 and continue

**10. Commitments and Contingencies (continued)**

the departing executive's health and life insurance benefits coverage provided to him as of May 31, 2012 for twelve months, representing an aggregate estimated amount of $506,000 that the Company recorded as general and administrative expense for the year ended December 31, 2012.

**11. Retirement Savings Plan**

The Company has a 401(k) retirement plan in which all of its employees are eligible to participate. The Company contributed $454,000, $535,000, and $487,000 to the plan for the years ended December 31, 2012, 2011 and 2010, respectively. The Company matched employee contributions to the plan, on a per employee basis, up to 4% of each employee's wages for the years ended December 31, 2012, 2011 and 2010.

**12. Strategic Alliance and Collaboration Agreements**

***AstraZeneca AB***

In December 2005, the Company entered into a collaborative research and license agreement with AstraZeneca AB that was initially focused in cognitive disorders. In March 2013, the Company and AstraZeneca amended the agreement. As amended, the agreement permits AstraZeneca to pursue development and commercialization of compounds that it has licensed from the Company in any therapeutic area.

The Company is eligible to receive license fees and milestone payments under the agreement. The amount of license fees and milestone payments depends on the timing and achievement of specified milestone events.

AstraZeneca paid the Company an initial fee of $10,000,000 in February 2006. Based on the agreement terms, the Company allocated $5,000,000 of the initial fee to the research collaboration, which the Company recognized as revenue on a straight-line basis 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 grants of licenses to develop and commercialize the Company's product candidate TC-1734 (also known as AZD3480), until December 2006, when AstraZeneca made a determination to proceed with further development of TC-1734. As a result, in the first quarter of 2007, the Company began recognizing the $5,000,000 of the initial fee that it had previously deferred as revenue on a straight-line basis over the estimated development period for TC-1734. In July 2009, based on feedback received from AstraZeneca regarding its development plans for TC-1734 as a treatment for attention deficit/hyperactivity disorder, or ADHD, the Company extended its estimate of the development period for TC-1734 to continue through 2013 and began recognizing the part of the $5,000,000 portion of the initial fee not yet recognized as of April 1, 2009 into revenue on a straight-line basis over the remaining estimated development period. In September 2010, the Company and AstraZeneca amended the agreement to enable the Company to conduct a clinical trial of TC-1734 in mild to moderate Alzheimer's disease and to provide for respective roles and responsibilities and associated financial terms for such a study. Under the 2010 amendment, the Company received from AstraZeneca $500,000 in October 2010, $2,000,000 in September 2011 and $3,500,000 in December 2011.

As of December 31, 2012, the Company was recognizing both the portion of the $5,000,000 of the initial fee attributable to TC-1734 license grants not yet recognized and the payments received under the amendment into revenue on a straight-line basis over the period of the Company's substantive performance obligations under the agreement, as amended. In March 2013, AstraZeneca exercised its right to terminate TC-1734 from the collaboration. As a result, the Company expects to recognize into revenue in 2013 the portion of these amounts not yet recognized as of the date of AstraZeneca's action, totaling $3,536,000. The Company recognized an aggregate of $2,946,000, $1,192,000, and $641,000 of the initial fee and the payments received under the amendment as revenue for the years ended December 31, 2012, 2011, and 2010, respectively.

**12. Strategic Alliance and Collaboration Agreements (continued)**

The Company is eligible to receive additional payments from AstraZeneca if specified milestone events under the agreement are achieved for the Company's product candidate AZD1446. The amounts of the contingent milestone payments vary depending on the applicable indication pursued and range from an additional $7,000,000 to $14,000,000 if development milestone events are achieved, an additional $8,000,000 to $10,000,000 if a regulatory milestone event is achieved, up to an additional $12,000,000 to $49,000,000 if first commercial sale milestone events are achieved and, in specified circumstances, up to an additional $30,000,000 if sales-related milestone events are achieved. If regulatory approval is achieved for AZD1446 for any indication, the Company is also eligible to receive stepped royalties on any sales of AZD1446 for that indication or any other indication. If AZD1446 is subsequently developed under the agreement for other indications, the Company would also be eligible to receive contingent milestone payments of up to $35,000,000 for each successive indication, if development, regulatory and first detail milestone events are achieved. Based solely on projected activities and timelines, the Company expects that the maximum amount of contingent milestone payments that could conceivably be earned during 2013 with respect to AZD1446 is $2,000,000, if a development milestone event is achieved. The likelihood that the Company will earn that milestone amount or achieve any particular milestone event with respect to AZD1446 in 2013 or in any future period is uncertain, and the Company may not earn any milestone amount or achieve any milestone event with respect to AZD1446 in 2013 or ever.

The Company considers that each of the potential milestone events under the agreement with respect to AZD1446 would be substantive because the applicable criteria of its revenue recognition policy (see Note 2) would be satisfied.

The Company and AstraZeneca conducted a multi-year preclinical research collaboration under the agreement. The term of the research collaboration expired in January 2010 and, as a result, the Company did not recognize any collaboration research and development revenue for the years ended December 31, 2012, 2011 or 2010.

In October 2007, the Company provided notice under the agreement offering AstraZeneca the right to license its product candidate TC-5619 for specified conditions characterized by cognitive impairment. Based on a subsequent election by AstraZeneca made under the terms of the agreement, AstraZeneca paid the Company $2,000,000 and the Company agreed to develop TC-5619 independently through completion of Phase 1 clinical development and a Phase 2 clinical proof of concept clinical trial in accordance with a mutually acceptable development plan, following which AstraZeneca would have the right to license TC-5619 on terms specified in the agreement (as it was amended in April 2010 as described below). The Company recognized the $2,000,000 payment as revenue on a straight-line basis over the period estimated from time to time for the Company's research and development obligations for TC-5619 under the agreement. In April 2010, the Company and AstraZeneca amended the agreement to modify the terms applicable to TC-5619. In conjunction with the amendment, the Company and AstraZeneca agreed to an expanded development program for TC-5619 and the Company received a payment of $11,000,000 to maintain AstraZeneca's option to license TC-5619. The Company recorded the $11,000,000 payment as deferred revenue and recognized it as revenue on a straight-line basis over the period estimated from time to time for the Company's research and development obligations for TC-5619 under the agreement. The Company completed its research and development obligations for TC-5619 under the agreement in the second quarter of 2011. Accordingly, the Company recognized all of the $2,000,000 and $11,000,000 payments related to TC-5619 received from AstraZeneca into revenue by June 30, 2011. The Company recognized $4,801,000 and $6,564,000 of the payments as revenue for the years ended December 31, 2011 and 2010, respectively. In late April 2011, the Company received notice from AstraZeneca that it had determined not to exercise its license option.

**TARGACEPT, INC.**

**NOTES TO FINANCIAL STATEMENTS (continued)**
**DECEMBER 31, 2012**

**12. Strategic Alliance and Collaboration Agreements (continued)**

The Company has received payments upon achievement of milestone events under the agreement that it recognized in full as revenue upon achievement because the event met each of the conditions required for immediate recognition under its revenue recognition policy (see Note 2). In particular, the Company received a $10,000,000 payment from AstraZeneca in July 2009 based on achievement of the objective in a completed Phase 2 clinical trial of TC-1734 in adults with ADHD, a milestone event under an amendment to the agreement. Under the terms of an existing sponsored research agreement and subsequent license agreement between the Company and University of Kentucky Research Foundation, or UKRF, the Company made a payment of $350,000 to UKRF in January 2010 as a result of the $10,000,000 payment received from AstraZeneca. The Company has also received cumulative payments from AstraZeneca of $2,600,000 based on the achievement of milestone events related to the development of product candidates arising under the parties' completed preclinical research collaboration, including AZD1446.

AstraZeneca has paid the Company an aggregate of $88,120,000 under the agreement since its inception. As of December 31, 2012, $3,536,000 of the amounts received remained to be recognized into revenue in future periods.

*Prior Collaboration Agreement*

In December 2009, the Company entered into a collaboration and license agreement with AstraZeneca AB for the global development and commercialization of TC-5214 as a treatment for major depressive disorder. Under the agreement, AstraZeneca made an upfront payment to the Company of $200,000,000. The Company recorded the upfront payment made by AstraZeneca as deferred revenue and began recognizing the payment as revenue on a straight-line basis over the estimated period of the Company's substantive performance obligations under the agreement, or approximately 33 months after the agreement date. The Company recognized $54,473,000 of the upfront payment as revenue for the year ended December 31, 2012 and $72,565,000 for each of the years ended December 31, 2011 and 2010. Under the terms of an existing license agreement, the Company paid $16,000,000 to University of South Florida Research Foundation, in February 2011 based on the Company's receipt of the upfront payment from AstraZeneca

The Company and AstraZeneca jointly designed a program for the global development of TC-5214 as an adjunct therapy and as a "switch" monotherapy, in each case in patients with major depressive disorder who do not respond adequately to initial antidepressant treatment. AstraZeneca was responsible for 80% and the Company was responsible for 20% of the costs of this program, except that AstraZeneca was responsible for 100% of development costs that were required only for countries outside the United States and the European Union. In addition, for each of the Company and AstraZeneca, costs that were not contemplated at execution to be part of the program were in some cases excluded from the cost-sharing arrangement.

The Company's portion of the costs of the TC-5214 development program was $2,175,000, $32,046,000 and $10,771,000 for the years ended December 31, 2012, 2011 and 2010, respectively. AstraZeneca's allocable portion of the program costs paid by the Company was $127,000, $336,000 and $2,023,000 for the years ended December 31, 2012, 2011 and 2010, respectively. AstraZeneca's allocable portion of the program costs paid by the Company is reflected in the Company's financial statements as a reduction to research and development expense.

In the first quarter of 2012, the Company and AstraZeneca announced that, based on the totality of the results of the Phase 3 development program for TC-5214, a regulatory filing for TC-5214 as an adjunct therapy for major depressive disorder would not be pursued. Also in the first quarter of 2012, the Company reported that the Company and AstraZeneca determined to discontinue a Phase 2b clinical trial of TC-5214 as a "switch" monotherapy. The determinations to not pursue a regulatory filing for TC-5214 as an adjunct therapy for major

**12. Strategic Alliance and Collaboration Agreements (continued)**

depressive disorder and to discontinue the Phase 2b clinical trial of TC-5214 as a "switch" monotherapy resulted in a change in the estimated period of the Company's substantive performance obligations under the agreement, and the Company revised the revenue recognition period for the upfront payment accordingly.

In April 2012, the Company received notice of termination of the agreement from AstraZeneca. By the terms of the agreement, the termination became effective in late May 2012. As a result, the Company recognized into revenue the portion of the upfront payment previously received and not yet recognized as of the notice of termination date and the entire upfront payment was recognized into revenue by June 30, 2012. Final activities in the TC-5214 program in major depressive disorder wound down after termination and were completed during the fourth quarter of 2012.

***GlaxoSmithKline***

On July 27, 2007, the Company entered into a product development and commercialization agreement with SmithKline Beecham Corporation, doing business as GlaxoSmithKline, and Glaxo Group Limited, which are referred to together as GlaxoSmithKline, that set forth the terms of an alliance designed to discover, develop and market product candidates that selectively target specified NNR subtypes for specified therapeutic focus areas. In February 2011, the Company received notice of termination of the agreement from GlaxoSmithKline. By the terms of the agreement, the termination became effective in May 2011.

Under the agreement and a related stock purchase agreement, GlaxoSmithKline made an initial payment to the Company of $20,000,000 and purchased 1,275,502 shares of the Company's common stock for an aggregate purchase price of $15,000,000 on July 27, 2007. The purchase price paid by GlaxoSmithKline reflected an aggregate deemed premium of $3,521,000, based on the closing price of the Company's common stock on the trading day immediately preceding the date that the agreements were signed and announced. The Company deferred recognition of both the initial payment made by GlaxoSmithKline and the deemed premium paid for the shares of the Company's common stock purchased by GlaxoSmithKline and began recognizing both amounts into revenue on a straight-line basis over the nine-year period of the Company's research and early development obligations estimated at inception of the agreement. The Company recognized $2,613,000 of the initial payment and deemed premium as revenue for the year ended December 31, 2010.

In December 2007, the Company received a $6,000,000 payment from GlaxoSmithKline upon the achievement of a specified milestone event under the agreement. The Company determined the payment did not meet each of the conditions of its revenue recognition policy (see Note 2) required for recognition of the full amount into revenue upon achievement of the milestone. Specifically, based on the progress as of inception of the agreement of the product candidate to which the payment related, there was not substantive uncertainty regarding achievement of the milestone event within the meaning of the Company's revenue recognition policy. Accordingly, the Company recorded the payment as deferred revenue and began recognizing it into revenue on a straight-line basis over the remaining portion of the nine-year period of the Company's research and early development obligations estimated at inception of the agreement. The Company recognized $692,000 of the payment as revenue for the year ended December 31, 2010.

As a result of its receipt in February 2011 of notice of termination of the agreement, the Company recognized the remaining $18,421,000 of the payments discussed above that had not previously been recognized into revenue for the first quarter of 2011 in accordance with its revenue recognition policy (see Note 2).

TARGACEPT, INC.

NOTES TO FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2012

**13. Reductions In Force**

On April 25, 2012, the Company announced a reduction in force as part of a plan to focus its resources on its clinical programs and select preclinical opportunities. The restructuring was completed in the second quarter of 2012. The Company recorded as expense and paid $2,312,000 in severance and other charges related to the reduction in force for the year ended December 31, 2012. Upon the completion of the restructuring, the Company's workforce was reduced by 65 employees, or approximately 46%.

On October 8, 2012, the Company announced a further reduction in force and the closing of its laboratory operations. Both of these actions were completed in the fourth quarter of 2012. The Company recorded as expense and paid $1,406,000 in severance and other charges related to the reduction in force for the year ended December 31, 2012. Upon the completion of the restructuring, the Company's workforce was further reduced by 27 employees, or approximately 38%.

**14. Selected Quarterly Financial Data (unaudited)**

| | 2012 Quarter | | | |
|---|---|---|---|---|
| | First | Second | Third | Fourth |
| | (in thousands, except share and per share amounts) | | | |
| Net operating revenues | $ 22,857 | $ 33,645 | $ 768 | $ 590 |
| Income (loss) from operations | 1,986 | 14,234 | (8,098) | (16,260) |
| Net income (loss) | 2,259 | 14,492 | (7,879) | (15,870) |
| Basic net income (loss) per share(1) | $ 0.07 | $ 0.43 | $ (0.24) | $ (0.47) |
| Diluted net income (loss) per share(1) | $ 0.07 | $ 0.43 | $ (0.24) | $ (0.47) |
| Weighted average common shares outstanding—basic | 33,390,286 | 33,409,341 | 33,494,106 | 33,609,867 |
| Weighted average common shares outstanding—diluted | 33,822,010 | 33,638,629 | 33,494,106 | 33,609,867 |

| | 2011 Quarter | | | |
|---|---|---|---|---|
| | First | Second | Third | Fourth |
| | (in thousands, except share and per share amounts) | | | |
| Net operating revenues | $ 38,994 | $ 20,743 | $ 18,955 | $ 18,945 |
| Income (loss) from operations | 12,302 | (2,571) | (9,331) | (10,145) |
| Net income (loss) | 12,587 | (2,257) | (9,054) | (9,805) |
| Basic net income (loss) per share(1) | $ 0.43 | $ (0.07) | $ (0.27) | $ (0.29) |
| Diluted net income (loss) per share(1) | $ 0.41 | $ (0.07) | $ (0.27) | $ (0.29) |
| Weighted average common shares outstanding—basic | 28,996,060 | 30,725,227 | 33,377,874 | 33,382,640 |
| Weighted average common shares outstanding—diluted | 30,399,750 | 30,725,227 | 33,377,874 | 33,382,640 |

(1) Per common share amounts for the quarters and full years have been calculated separately. Accordingly, the sum of quarterly amounts may not equal the annual amount because of differences in the weighted average common shares outstanding during each period, principally due to the effect of share issuances by the Company during the year.

(2) Diluted weighted average common shares outstanding are identical to basic weighted average common shares outstanding and Diluted EPS is identical to Basic EPS for the third and fourth quarters of 2012 and for the second, third and fourth quarter of 2011 because common share equivalents are excluded from the calculations of diluted weighted average common shares outstanding for those quarters, as their effect is antidilutive.

**15. Subsequent Event**

In March 2013, the Company and AstraZeneca amended their collaborative research and license agreement as discussed in Note 12.

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

None.

**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(b) 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) *Management's Report on Internal Control Over Financial Reporting*. Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or Rule 15d-15(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, the principal executive and principal financial officers and effected by the board of directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may lessen. Our management, including our chief executive officer and chief financial officer, assessed the effectiveness of our internal control over financial reporting as of December 31, 2012 using the criteria established in a report entitled "Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission" and in accordance with the interpretive guidance issued by the SEC in Release No. 34-55929. Based on its assessment, our management concluded that, as of December 31, 2012, our internal control over financial reporting was effective.

Our independent registered public accounting firm has issued an audit report on the effectiveness of our internal control over financial reporting as of December 31, 2012. The report appears below.

***Report of Independent Registered Public Accounting Firm***

The Board of Directors and Stockholders of
Targacept, Inc.

We have audited Targacept, Inc.'s internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Targacept, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Targacept, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheets of Targacept, Inc. as of December 31, 2012 and 2011, and the related statements of comprehensive income (loss), stockholders' equity and cash flows for each of the three years in the period ended December 31, 2012 and our report dated March 15, 2013 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Raleigh, North Carolina
March 15, 2013

(c) *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, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information.**

None.

## 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 2013 Annual Meeting of Stockholders to be filed with the SEC under the captions “Board of Directors and Management,” “Corporate Governance” and “Section 16(a) Beneficial Ownership Reporting Compliance” and is incorporated by reference in this Item 10.

*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. To the extent permissible under applicable law, the rules of the SEC and NASDAQ listing standards, 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 2013 Annual Meeting of Stockholders to be filed with the SEC under the captions “Executive Compensation” and “Corporate Governance” and is incorporated by reference in this Item 11.

### 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 2013 Annual Meeting of Stockholders to be filed with the SEC under the captions “Security Ownership of Certain Beneficial Owners and Management” and “Equity Compensation Plan Information” and is incorporated by reference in this Item 12.

### 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 2013 Annual Meeting of Stockholders to be filed with the SEC under the captions “Certain Relationships and Related Person Transactions” and “Corporate Governance” and is incorporated by reference in this Item 13.

### 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 2013 Annual Meeting of Stockholders to be filed with the SEC under the caption “Independent Registered Public Accounting Firm Fee Information and Audit Committee Pre-Approval Policy” and is incorporated by reference in this Item 14.

## PART IV

**Item 15. Exhibits, Financial Statement Schedules.**

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

(a)(2) *Financial Statement Schedules.* All schedules are omitted because they are not applicable or because 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 by reference in this Item 15(a)(3).

(b) *Exhibits*. See Exhibit Index.

(c) *Separate Financial Statements and Schedules*. None.

## 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 15, 2013

**Targacept, Inc.**

By: /S/ STEPHEN A. HILL
**Stephen A. Hill**
**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 and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /S/ STEPHEN A. HILL<br>**Stephen A. Hill** | Chief Executive Officer, President and Director (principal executive officer) | March 15, 2013 |
| /S/ ALAN A. MUSSO<br>**Alan A. Musso** | Senior Vice President, Finance and Administration, Chief Financial Officer and Treasurer (principal financial officer and principal accounting officer) | March 15, 2013 |
| /S/ MARK SKALETSKY<br>**Mark Skaletsky** | Chairman of the Board of Directors | March 15, 2013 |
| /S/ M. JAMES BARRETT<br>**M. James Barrett** | Director | March 15, 2013 |
| /S/ CHARLES A. BLIXT<br>**Charles A. Blixt** | Director | March 15, 2013 |
| /S/ JULIA R. BROWN<br>**Julia R. Brown** | Director | March 15, 2013 |
| **G. Steven Burrill** | Director | |
| /S/ ERROL B. DE SOUZA<br>**Errol B. De Souza** | Director | March 15, 2013 |
| /S/ ALAN W. DUNTON<br>**Alan W. Dunton** | Director | March 15, 2013 |
| /S/ JOHN P. RICHARD<br>**John P. Richard** | Director | March 15, 2013 |
| /S/ RALPH SNYDERMAN<br>**Ralph Snyderman** | Director | March 15, 2013 |

## 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, as amended and restated January 9, 2009 and further amended effective as of August 6, 2009 (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K, as filed with the SEC on August 11, 2009) |
| 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, 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, 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 members of executive management (incorporated by reference to Exhibit 10.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1, as filed with the SEC on March 16, 2006 (Registration No. 333-131050)) |
| 10.2 | Sublease, dated December 4, 2012, by and between the Company and B/E Aerospace, Inc. |
| 10.3(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)) |
| 10.3(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)) |
| 10.3(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)) |
| 10.3(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)) |
| 10.4(a)* | Targacept, Inc. 2006 Stock Incentive Plan, as amended and restated through March 9, 2011 and further amended on December 7, 2012 |
| 10.4(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, as filed with the SEC on March 16, 2006 (Registration No. 333-131050)) |

| Exhibit Number | Description |
|---|---|
| 10.4(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, as filed with the SEC on March 16, 2006 (Registration No. 333-131050)) |
| 10.4(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, as filed with the SEC on March 16, 2006 (Registration No. 333-131050)) |
| 10.4(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, as filed with the SEC on March 16, 2006 (Registration No. 333-131050)) |
| 10.5(a)* | 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)) |
| 10.5(b)* | Amendment No. 1, dated March 13, 2008, to Employment Agreement, dated as of August 22, 2000, by and between the Company and J. Donald deBethizy (incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the Quarter Ended March 31, 2008) |
| 10.5(c)* | Separation Agreement and Release, dated June 21, 2012, by and between the Company and J. Donald deBethizy (incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the Quarter Ended June 30, 2012) |
| 10.6(a)* | 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)) |
| 10.6(b)* | Amendment No. 1, dated March 13, 2008, to Employment Agreement, dated as of February 8, 2002, by and between the Company and Alan A. Musso (incorporated by reference to Exhibit 10.7 to the Company's Quarterly Report on Form 10-Q for the Quarter Ended March 31, 2008) |
| 10.7(a)* | Employment Agreement, dated as of September 1, 2003, by and between the Company and Jeffrey P. Brennan (incorporated by reference to Exhibit 10.12 to the Company's Registration Statement on Form S-1, as filed with the SEC on January 17, 2006 (Registration No. 333-131050)) |
| 10.7(b)* | Amendment No. 1, dated December 3, 2007, to Employment Agreement, dated as of September 1, 2003, by and between the Company and Jeffrey P. Brennan (incorporated by reference to Exhibit 10.12(b) to the Company's Annual Report on Form 10-K for the Year Ended December 31, 2007) |
| 10.7(c)* | Amendment No. 2, dated March 13, 2008, to Employment Agreement, dated as of September 1, 2003, by and between the Company and Jeffrey P. Brennan (incorporated by reference to Exhibit 10.4 to the Company's Quarterly Report on Form 10-Q for the Quarter Ended March 31, 2008) |
| 10.8* | Employment Agreement, dated as of March 13, 2008, by and between the Company and Peter A. Zorn (incorporated by reference to Exhibit 10.8 to the Company's Quarterly Report on Form 10-Q for the Quarter Ended March 31, 2008) |
| 10.9* | Employment Agreement, effective as of November 14, 2012, by and between the Company and Stephen A. Hill (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, as filed with the SEC on November 16, 2012) |
| 10.10* | Nonqualified Stock Option Agreement, dated December 3, 2012, by and between the Company and Stephen A. Hill (incorporated by reference to Exhibit 99.1 to the Company's Registration Statement on Form S-8, as filed with the SEC on January 4, 2013 (Registration No. 333-185888)) |

| Exhibit Number | Description |
|---|---|
| 10.11* | Form of Retention Award Agreement by and between the Company and its executive officers and certain other personnel. |
| 10.12(a)+ | Amended and Restated License Agreement, dated as of March 9, 2004, by and between the Company and 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)) |
| 10.12(b)+ | Amendment No. 1, effective September 21, 2009, to Amended and Restated License Agreement dated March 9, 2004, by and between the Company and University of South Florida Research Foundation, Inc. (incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2009) |
| 10.13(a)+ | License Agreement, dated May 26, 1999, by and between the Company and 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)) |
| 10.13(b)+ | Amendment No. 1, dated August 16, 2005, to License Agreement, dated May 26, 1999, by and between the Company and 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, as filed with the SEC on April 6, 2006 (Registration No. 333-131050)) |
| 10.14(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) |
| 10.14(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) |
| 10.14(c)+ | Amendment No. 2 dated July 8, 2009 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, 2009) |
| 10.14(d)+ | Amendment No. 3, effective as of April 30, 2010, 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 June 30, 2010) |
| 10.14(e)+ | Amendment No. 4, effective as of September 28, 2010, 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, 2010) |
| 10.15+ | Amended and Restated Supply Agreement, effective December 3, 2009, by and among the Company, Interchem Corporation and Euticals S.p.A. (as successor to Poli Industria Chimica, SPA) (incorporated by reference to Exhibit 10.19 to the Company's Annual Report on Form 10-K for the Year Ended December 31, 2009) |
| 10.16* | Description of Annual Cash Incentive Program |
| 10.17* | 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 |

| Exhibit Number | Description |
|---|---|
| 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 |
| 101** | The following materials from the Company's Annual Report on Form 10-K for the year ended December 31, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) the Balance Sheets, (ii) the Statements of Operations, (iii) the Statements of Stockholders' Equity, (iv) the Statements of Cash Flows, and (v) Notes to Financial Statements, tagged as blocks of text. |

+ 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.

* Denotes management contract, compensatory plan or arrangement.

** Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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

**Exhibit 10.2**

**SUBLEASE**

Between

B/E AEROSPACE, INC., a Delaware corporation

**Sublandlord,**

and

TARGACEPT, INC., a Delaware corporation,

**Subtenant.**

Dated: December 4, 2012

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**SUBLEASE**

THIS SUBLEASE (the "**Sublease**") is made and entered into as of the 4th day of December 2012, by and between B/E AEROSPACE, INC., a Delaware corporation ("**Sublandlord**"), and TARGACEPT, INC, a Delaware corporation ("**Subtenant**").

**R E C I T A L S**:

A. Sublandlord and First States Investors 3300, LLC (predecessor in interest to SL Winston-Salem LLC, a Delaware limited liability company ("**Landlord**")), entered into a certain Office Lease Agreement dated as of July 16, 2007, as amended by that certain First Amendment to Lease dated as of October 8, 2010, and that certain Second Amendment to Lease dated as of February 7, 2011 (such lease and amendments are collectively referred to as the "**Prime Lease**" and are attached to this Sublease as Exhibit A), pursuant to which Sublandlord currently leases from Landlord approximately 18,282 rentable square feet of space on the 15th floor (the "**Sublease Premises**") of the building commonly known as 100 North Main Street, Winston-Salem, North Carolina (the "**Building**") and depicted on Exhibit B attached to this Sublease, for a term ending on December 30, 2015.

B. Subject to the consent of Landlord, Sublandlord desires to sublet the Sublease Premises to Subtenant and Subtenant desires to sublet the Sublease Premises from Sublandlord, all upon the terms and subject to the conditions and provisions set forth below.

In consideration of the foregoing and of the mutual covenants and promises contained in this Sublease, and for other good and valuable consideration, the receipt and legal sufficiency of which are mutually acknowledged, Sublandlord and Subtenant agree as follows:

**1. Demise; Use**. Sublandlord sublets to Subtenant and Subtenant sublets from Sublandlord the Sublease Premises, together with all of Sublandlord's parking rights set forth in the Parking Lot Rider attached to the Prime Lease, including, but not limited to, the right to use the Spaces and the right to sublet additional spaces as set forth in Section 19 of the First Amendment to Lease dated October 8, 2010 (collectively, the "**Parking Rights**"), for the term and rental and upon the other terms and conditions set forth below, to be used and occupied by Subtenant solely for the purpose of general office use for no other purpose.

**2. Term**. Subject to obtaining Landlord's consent in the form of the Consent Agreement (as defined below), the term of this Sublease shall commence on January 1, 2013 (the "**Commencement Date**") and shall terminate on December 30, 2015 (the "**Termination Date**"). Notwithstanding anything to the contrary set forth herein, if later than January 1, 2013, the Commencement Date shall not occur until the date that Sublandlord delivers full and exclusive possession of the Sublease Premises to Subtenant together with a copy of the Consent of Landlord, in the form of **Schedule 1** attached hereto and incorporated herein by reference (the "**Consent Agreement**"), fully executed by Sublandlord and Landlord. For purposes of this Sublease, the phrase "**Lease Year**" shall mean the twelve calendar month period commencing on each January 1 and ending on each December 31 (December 30 for the last Lease Year) during the term of this Sublease. For purposes of this Sublease, the phrase "**Term**" shall mean the period commencing on the Commencement Date and ending on the Termination Date.

**3. Possession**. Subject to obtaining Landlord's consent in the form of the Consent Agreement, Sublandlord will use commercially reasonable and diligent efforts to deliver the

Sublease Premises to Subtenant not later than December 15, 2012 to enable Subtenant to make certain tenant improvements. If Subtenant shall occupy the Sublease Premises prior to the Commencement Date with Sublandlord's consent, all of the provisions of this Sublease shall be in full force and effect commencing at such occupancy; such occupancy shall be on the basis of a month-to-month tenancy; provided, however, no rent shall be payable for such period. Such early occupancy by Subtenant shall not affect the Commencement Date, the Termination Date or any Lease Year.

**4. Gross Rent**.

(a) Beginning on the Commencement Date, Subtenant shall pay to Sublandlord gross annual rental ("**Gross Rent**") for the Sublease Premises as follows:

| Time Period | Annual Gross Rent Rate Per Rentable Square Foot | Annual Gross Rent | Monthly Gross Rent |
|---|---|---|---|
| 1/1/13-12/31/13 | $ 14.50 | $265,089.00 | $ 22,090.75 |
| 1/1/14-12/31/14 | $ 14.94 | $273,133.08 | $ 22,761.09 |
| 1/1/15-12/31/15 | $ 15.39 | $281,359.98 | $ 23,446.67 |

Annual Gross Rent shall be due and payable in equal monthly installments, in advance, on the first day of each calendar month during the term of this Sublease. If the term of this Sublease commences on a day other than the first day of a calendar month or ends on any day other than the last day of a calendar month, Gross Rent for such month shall be prorated accordingly.

(b) All Gross Rent and other amounts due to Sublandlord pursuant to the terms of this Sublease (i) shall be due and payable on or before the first day of each month of the term of this Sublease, (ii) shall be paid without setoff or deduction whatsoever, except as otherwise set forth herein, and (iii) shall be paid to Sublandlord at the office of B/E Aerospace, Inc. at 88269 Expedite Way, Chicago, IL 60695-0001 or via wire transfer to B/E Aerospace, Inc., Account #304192856, JPMorgan Chase Bank New York, SWIFT: CHASUS33, ABA #021000021, CHIP UID: 002 or at such other place as Sublandlord may designate by notice to Subtenant.

(c) If any installment of Gross Rent or other amount due to Sublandlord pursuant to the terms of this Sublease is not paid within five (5) business days of the date when due, an administrative fee equal to the Late Charge (as defined in the Prime Lease) multiplied by such past due amount may, in Sublandlord's sole discretion, be charged to Subtenant.

(d) All past due installments of Gross Rent and other amounts due to Sublandlord pursuant to the terms of this Sublease and more than thirty (30) days past due shall bear interest from the date due until paid at the Default Rate (as defined in the Prime Lease).

(e) Subtenant shall pay directly to Landlord on the due dates for services requested by Subtenant which are billed by Landlord directly to Subtenant rather than by Sublandlord.

**5. Condition of Premises and Construction of Improvements**.

(a) Subject to Sublandlord's obligations set forth herein, Subtenant's taking possession of the Sublease Premises shall be conclusive evidence against Subtenant that the Sublease Premises were in good order and satisfactory condition when Subtenant took possession. No promise of Sublandlord to alter, remodel or improve the Sublease Premises and no representation respecting the condition of the Sublease Premises or the Building have been made by Sublandlord to Subtenant, except that on or before December 15, 2012, Sublandlord shall (i) deliver the Sublease Premises in broom clean condition, (ii) remove all of Sublandlord's personal property not being acquired from Sublandlord by Subtenant by separate arrangement, (iii) clean the carpets, and (iv) leave in place all wiring and card readers. Upon the expiration of the term of this Sublease, Subtenant shall surrender the Sublease Premises in at least as good condition as of the Commencement Date, ordinary wear and tear and damage from casualty excepted.

(b) Subtenant shall not, without the prior written consent of Landlord and Sublandlord, which, with respect to Sublandlord, shall not be unreasonably withheld, conditioned or delayed, make any alterations, additions or improvements to the Sublease Premises. Subtenant shall also comply with any additional requirements imposed pursuant to the Prime Lease by Landlord and Sublandlord regarding such alterations, additions or improvements to the Sublease Premises.

**6. The Prime Lease**.

(a) This Sublease and all of the rights of Subtenant with respect to the Sublease Premises are subject to the terms, conditions and provisions of the Prime Lease. Subtenant assumes and agrees to perform faithfully and be bound by, with respect to the Sublease Premises, all of Sublandlord's obligations, covenants, agreements and liabilities under the Prime Lease, and all of the terms, conditions, provisions and restrictions contained in the Prime Lease, in each case to the extent arising from and after the Commencement Date until the termination of this Sublease, except that Subtenant shall not be liable or have any obligation for the payment of any "Base Rent" or "Operating Expenses" (as such terms are defined in the Prime Lease).

(b) Without limitation of the foregoing:

(i) Subtenant shall not make any changes, alterations or additions in or to the Sublease Premises except as otherwise expressly permitted under this Sublease;

(ii) If Subtenant desires to take any other action and the Prime Lease would require that Sublandlord obtain the consent of Landlord before undertaking any action of the same kind, Subtenant shall not undertake the same without obtaining the prior written consent of Sublandlord, which consent shall not be unreasonably withheld, conditioned or delayed. Sublandlord may condition its consent on obtaining the consent of Landlord and may permit Subtenant to contact Landlord directly for such consent. Sublandlord agrees to cooperate with Subtenant to take reasonable actions to obtain such consent from Landlord and to sign requests for such consent from Landlord;

(iii) All rights given to Landlord and its agents and representatives under the Prime Lease to enter the Sublease Premises shall inure to the benefit of Sublandlord and its respective agents and representatives with respect to the Sublease Premises;

(iv) Sublandlord shall also have all other rights, privileges, options, reservations and remedies granted or allowed to or held by Landlord under the Prime Lease;

(v) Subtenant shall maintain insurance of the kinds and in the amounts required to be maintained by Sublandlord under the Prime Lease with respect to the Sublease Premises. All insurance policies shall name Landlord, Sublandlord and their respective officers and/or directors, as the case may be, and the respective agents and employees of each of them, as additional insureds;

(vi) Subtenant shall not do anything or suffer or permit anything to be done which could result in a default under the Prime Lease or permit the Prime Lease to be canceled or terminated; and

(vii) Sublandlord shall timely pay all Base Rent and all Operating Expenses required under the Prime Lease. During the Term, Sublandlord shall not provide any consent or approval requested of Sublandlord by Landlord under the Prime Lease without first obtaining the prior written consent of Subtenant, which consent shall not be unreasonably withheld, conditioned or delayed. Sublandlord shall not do anything or suffer or permit anything to be done which could result in a default under the Prime Lease or permit the Prime Lease to be canceled or terminated. Upon written request by Subtenant, Sublandlord shall use commercially reasonable and diligent efforts to cause Landlord to provide any and all services required under the Prime Lease to be provided by Landlord or to provide consent or approval regarding a requested action, when such consent or approval is required under the Prime Lease.

(c) Notwithstanding anything contained in this Sublease or in the Prime Lease to the contrary, Sublandlord and Subtenant agree as follows:

(i) Subtenant shall not assign, mortgage, pledge, hypothecate or otherwise transfer or permit the transfer of this Sublease or any interest of Subtenant in this Sublease, by operation of law or otherwise, nor permit the use of all or any part of the Sublease Premises by any persons or entities other than Subtenant and Subtenant's employees, nor sublet the Sublease Premises, without the prior written consent of Landlord and Sublandlord, which, with respect to Sublandlord, shall not be unreasonably withheld, conditioned or delayed. Notwithstanding anything herein to the contrary, with respect to Sublandlord's consent requirements in the immediately preceding sentence, any merger of Subtenant with or into another entity or the sale of all or substantially all of the stock or assets of Subtenant (a **"Permitted Transfer"**) shall not be considered an assignment or transfer by Subtenant of this Sublease or otherwise subject to the restrictions of this clause (c)(i) so long as (A) not less than thirty (30) days prior to the occurrence of the Permitted Transfer, Subtenant notifies Sublandlord of the Proposed Permitted Transfer, and (B) along with such notice, Subtenant furnishes Sublandlord with documentation evidencing that the successor to Subtenant immediately following the Permitted Transfer will have a tangible net worth (as determined according to generally accepted principles of accounting consistently applied) not less than the tangible net worth of Subtenant as of the Commencement Date. Subtenant acknowledges that no Permitted Transfer will become effective unless and until consented to by Landlord.

(ii) Neither rental nor other payments under this Sublease shall abate by reason of any damage to, destruction of or interruption of services to all or any part of the Sublease Premises or the Building unless, and then only to the extent that, rental and such other payments actually abate under the Prime Lease with respect to the Sublease Premises on account of such event;

(iii) Subtenant shall not have any right to any portion of the proceeds of any award for a condemnation or other taking, or a conveyance in lieu of condemnation, of all or any portion of the Building or the Sublease Premises;

(iv) Subtenant shall not have any right to exercise or have Sublandlord exercise any option under the Prime Lease, including, without limitation, any option to extend the term of the Prime Lease or lease additional space; and

(v) In the event of any conflict between the terms, conditions and provisions of the Prime Lease and the terms, conditions and provisions of this Sublease, the terms, conditions and provisions of this Sublease shall in all instances govern and control.

(d) It is expressly understood and agreed that Sublandlord does not assume and shall not have any of the obligations or liabilities of Landlord under the Prime Lease and that Sublandlord is not making the representations or warranties, if any, made by Landlord in the Prime Lease. With respect to work, services, repairs and restoration or the performance of other obligations required of Landlord under the Prime Lease, Sublandlord's sole obligation shall be to request the same, upon written request from Subtenant, and to use commercially reasonable and diligent efforts to obtain the same from Landlord and to allow Subtenant to proceed directly against Landlord. Sublandlord shall not be liable in damages, nor shall rent abate, for or on account of any failure by Landlord to perform the obligations and duties imposed on it under the Prime Lease (except Subtenant shall receive a pro rata share of any rent abatement which Sublandlord may receive with respect to the Sublease Premises on account of such failure by Landlord).

**7. Default**.

(a) The occurrence of any of the following shall be deemed a "**Default**" by Subtenant:

(i) Subtenant fails to pay any Gross Rent on or before the date it is due and such failure continues for three (3) business days after notice has been given to Subtenant that payment is delinquent (however, Sublandlord shall not be obligated to send notice of such failure to pay more than two (2) times within any consecutive twelve (12) month period);

(ii) Subtenant fails to pay any other amount due from Subtenant under this Sublease and such failure continues for five (5) days after notice from Sublandlord to Subtenant;

(iii) Subtenant fails to perform or observe any other covenant or agreement set forth in this Sublease and such failure continues for thirty (30) days after notice from Sublandlord to Subtenant; or

(iv) any other event occurs which involves Subtenant or the Sublease Premises and which would constitute a default under the Prime Lease if it involved Sublandlord or the Sublease Premises;

Upon a Default by Subtenant under this Sublease, Sublandlord may, without limitation of any other rights and remedies available to it under this Sublease or at law or in equity, exercise any and all rights and remedies of Landlord set forth in the Prime Lease in the event of a default by Sublandlord under the Prime Lease.

(b) In the event Subtenant fails or refuses to make any payment or perform any covenant or agreement under this Sublease, Sublandlord may make such payment or undertake to perform such covenant or agreement (but shall not have any obligation to do so). In such event, amounts so paid and amounts expended in undertaking such performance, together with all costs, expenses and attorneys' fees incurred by Sublandlord in such connection, shall be due from Subtenant upon demand from Sublandlord.

(c) The occurrence of any of the following shall be deemed a "**Default**" by Sublandlord:

(i) Sublandlord fails to pay any Base Rent or other payment required under the Prime Lease and, if such failure is subject to a notice and cure period pursuant to the terms of the Prime Lease, such failure is not cured by Sublandlord within such period;

(ii) Sublandlord fails to observe or perform any of the other covenants, conditions, or provisions of the Prime Lease to be observed or performed by Sublandlord which are not to be performed by Subtenant pursuant to the express terms of this Sublease and, if such failure is subject to a notice and cure period pursuant to the terms of the Prime Lease, such failure is not cured by Sublandlord within such period; or

(iii) Sublandlord fails to perform or observe any other covenant or agreement set forth in this Sublease and such failure continues for (A) thirty (30) days after notice from Subtenant to Sublandlord, unless clause (B) applies, or (B) ninety (90) days after notice from Subtenant to Sublandlord, if such failure is curable but not within thirty (30) days and Sublandlord is diligently pursuing such cure.

Upon a Default by Sublandlord under this Sublease, Subtenant may, without limitation of any other rights and remedies available to it under this Sublease or at law or in equity, exercise any of the following remedies:

(A) in the case of Sublandlord's failure to timely pay, through expiration of all applicable notice and cure periods (if any), any Base Rent or other payment required under the Prime Lease pursuant to the terms of the Prime Lease, Subtenant may, but shall not be obligated to, pay Gross Rent directly to Landlord, pay Base Rent to Landlord and make other payments required under the Prime Lease directly to Landlord, in which event, Subtenant shall have the right to offset and deduct all such payments against Subtenant's obligations to pay Gross Rent and any other sums due hereunder to Sublandlord; or

(B) in the case of any other default by Sublandlord under the Prime Lease, Subtenant may, but shall not be obligated to, exercise self-help and cure such default, in which event, Subtenant shall have the right to offset and deduct the costs of such cure, together

with interest thereon at the Default Rate (as such term is defined in the Prime Lease), from the date of such expenditure against Subtenant's obligations to pay Gross Rent and any other sums due hereunder to Sublandlord.

**8. Nonwaiver**. Any failure by Sublandlord or Subtenant to declare any default or delay in taking any action in connection with any default by Sublandlord or Subtenant shall not be deemed a waiver of such default by the non-defaulting party. No receipt of monies by Sublandlord from Subtenant after the termination in any way of the term or of Subtenant's right of possession under this Sublease or after the giving of any notice shall reinstate, continue or extend the term of this Sublease or affect any notice given to Subtenant or any suit commenced or judgment entered prior to receipt of such monies.

**9. Cumulative Rights and Remedies**. All rights and remedies of either party under this Sublease shall be cumulative and none shall exclude any other rights or remedies allowed by law.

**10. Indemnity**.

(a) Subtenant agrees to indemnify, defend and save Landlord and Sublandlord, and their respective partners, officers, directors, members, employees, agents, lenders, contractors and each of their respective successors and assigns (collectively, including Landlord and Sublandlord, the "**Sublandlord Indemnified Parties**") harmless from and against any and all actual losses, liabilities, fines, penalties and damages to persons or property (including without limitation, amounts paid in settlement, reasonable cost of investigation, reasonable attorneys' fees and other legal expenses and reasonable fees of other necessary professionals) (collectively "**Losses**") in any manner directly arising out of or in connection with: (a) Subtenant's possession, occupancy and use of the Sublease Premises; (b) performance of any labor or services or the furnishing of any materials or other property in respect of space occupies by Subtenant in the Building; (c) the breach or default on the part of Subtenant in the performance of any covenant or agreement contained in this Sublease; and (d) any negligence or willful act of Subtenant, its employees or agents. Sublandlord will promptly notify Subtenant of any actions, proceedings, claims, or demands for which Sublandlord or any Sublandlord Indemnified Parties request indemnification from Subtenant. Subtenant has the right to assume the entire control of the defense thereof, and Sublandlord will cooperate fully with Subtenant in such defense at Subtenant's costs. Subtenant's obligations pursuant to this subparagraph shall survive the termination or expiration of the Sublease.

(b) Sublandlord agrees to indemnify, defend and save Subtenant, its affiliates and each of its and their respective partners, directors, officers, stockholders, members, employees and agents, and their respective personal representatives, heirs, successors and assigns (collectively, including Subtenant, the "**Subtenant Indemnified Parties**"), harmless from and against any and all Losses directly arising out of or in connection with: (a) the breach or default on the part of Sublandlord in the performance of any covenant or agreement contained in this Sublease for which written notice (if the breach or default relates to a condition within the Sublease Premises) has been received by Sublandlord; and (b) any negligence or willful act of Sublandlord, its agents or employees. Subtenant will promptly notify Sublandlord of any actions, proceedings, claims, or demands for which Subtenant requests indemnification from Sublandlord. Sublandlord has the right to assume the entire control of the defense thereof, and Subtenant will cooperate fully with Sublandlord in such defense at Sublandlord's cost. Sublandlord's obligations pursuant to this subparagraph shall survive the termination or expiration of the Sublease.

**11. Waiver of Subrogation**. Anything in this Sublease to the contrary notwithstanding, Sublandlord and Subtenant each waive any and all rights of recovery, claims, actions or causes of action against the other and the officers, directors, agents and employees of each of them, and Subtenant waives any and all rights of recovery, claims, actions or causes of action against Landlord, its agents and employees (provided Landlord waives such rights against Subtenant) for any loss or damage that may occur to the Sublease Premises or any improvements or any personal property in the Building, by reason of fire, the elements or any other cause insured against under valid and collectible fire and extended coverage insurance policies, regardless of the cause or origin, including negligence, except in any case which would render this waiver void under law, to the extent that such loss or damage is actually recovered under such insurance policies.

**12. Brokerage Commissions**. Each party represents and warrants to the other that it (i) has had no dealings with any real estate broker or agent in connection with this Sublease other than Cassidy Turley and CB Richard Ellis, whose commissions will be paid by Sublandlord pursuant to separate agreements, and (ii) knows of no other real estate broker or agent who is or might be entitled to a commission in connection with this Sublease. Each party agrees to protect, defend, indemnify and hold the other harmless from and against any and all claims inconsistent with the foregoing representations and warranties for any brokerage, finder's or similar fee or commission in connection with this Sublease if such claims are based on or relate to any act of the indemnifying party which is contrary to the foregoing representations and warranties.

**13. Successors and Assigns**. This Sublease shall be binding upon and inure to the benefit of the successors and assigns of both Sublandlord and Subtenant and, to the extent any such assignment may be approved, Subtenant's assigns.

**14. Entire Agreement**. This Sublease contains all the terms, covenants, conditions and agreements between Sublandlord and Subtenant relating in any manner to the rental, use and occupancy of the Sublease Premises. No prior agreement or understanding pertaining to the same shall be valid or of any force or effect. The terms, covenants and conditions of this Sublease cannot be altered, changed, modified or added to except by a written instrument signed by both Sublandlord and Subtenant.

**15. Notices**.

(a) In the event any notice from Landlord or otherwise relating to the Prime Lease or this Sublease is delivered to the Sublease Premises or is otherwise received by Subtenant, Subtenant shall, as soon as possible but in any event within one (1) business day, deliver such notice to Sublandlord if such notice is in writing or advise Sublandlord by telephone if such notice is oral. In the event any notice from Landlord or otherwise relating to the Prime Lease or this Sublease is received by Sublandlord, Sublandlord shall, as soon as possible but in any event within one (1) business day, deliver such notice to Subtenant if such notice is in writing or advise Subtenant by telephone if such notice is oral.

(b) Notices and demands required or permitted to be given by either party to the other with respect to this Sublease or to the Sublease Premises shall be in writing and shall not be effective for any purpose unless the same shall be served either by personal delivery with a receipt requested, by overnight air courier service, by facsimile with evidence of successful transmission and accompanied by a copy sent by United States certified or registered mail, postage prepaid, return receipt requested; provided, however, all notices of default shall be served either by personal delivery with a receipt requested or by overnight air courier service, addressed as follows:

If to Sublandlord:

B/E Aerospace Inc.
190 Oak Plaza Boulevard
Winston-Salem, NC 27105
Attn: Ken Rusterholz
Telephone: (336) 744-1044
Facsimile: (336) 744-3283

With a copy to:

B/E Aerospace, Inc.
1400 Corporate Center Way
Wellington, FL 33414
Attention: General Counsel
Telephone: (561) 791-5000
Facsimile: (561) 791-3966

With a copy to:

Glen D. Taxman
Much Shelist
2 Park Plaza, Suite 1075
Irvine, CA 92614
Telephone: (949) 385-5353
Facsimile: (312) 521-2000

If to Subtenant:

Targacept, Inc.
100 North Main Street, Suite 1510
Winston-Salem, North Carolina 27101
Attention: Controller
Telephone: (336) 480-2100
Facsimile: (336) 480-2103

With copy to:

Targacept, Inc.
100 North Main Street, Suite 1510
Winston-Salem, North Carolina 27101
Attention: General Counsel
Telephone: (336) 480-2100
Facsimile: (336) 480-2103

All notices and demands shall be deemed to have been given when actually received or, if earlier, (i) four (4) days after mailing, if mailed, or (ii) if made by personal delivery, overnight air courier service or facsimile, then upon such delivery. Either party may change its address for receipt of notices by giving notice to the other party as provided in this Section 15.

**16. Authority**. Subtenant represents and warrants to Sublandlord that this Sublease has been duly authorized, executed and delivered by and on behalf of Subtenant and constitutes the valid, enforceable and binding agreement of Subtenant enforceable in accordance with the terms of this Sublease. Sublandlord represents and warrants to Subtenant that this Sublease has been duly authorized, executed and delivered by and on behalf of Sublandlord and constitutes the valid, enforceable and binding agreement of Sublandlord enforceable in accordance with the terms of this Sublease.

**17. Consent of Landlord**. The obligations of Sublandlord and Subtenant, respectively, under this Sublease are conditioned and contingent upon obtaining Landlord's consent to this Sublease as evidenced by Landlord's full execution and irrevocable delivery to Sublandlord and Subtenant of the Consent Agreement.

**18. Examination**. No lease, sublease or obligation on Sublandlord or Subtenant shall arise until this instrument is signed and delivered by Sublandlord and Subtenant and the fully executed Consent Agreement is obtained as described in Section 17 above.

**19. Covenant of Quiet Enjoyment**. Sublandlord covenants that Subtenant, on paying the Gross Rent and charges for services and other payments required under this Sublease, and on keeping, observing and performing all of the other terms, covenants, conditions, provisions and agreements contained in this Sublease, shall, during the term of this Sublease, be entitled to have, hold, and quietly enjoy the Sublease Premises subject to the terms, covenants, provisions and agreements of this Sublease.

**20. Counterparts/Facsimile/Electronic Signature**. Signatures transmitted and received via facsimile or electronic mail will be treated for all purposes under this Sublease as original signatures and will be deemed valid, binding and enforceable by and against the all parties. Transmitted copies (reproduced documents that are transmitted via photocopy, facsimile, electronically or any other process that accurately transmits the original) will be considered documents equivalent to the original documents. This Sublease may be executed in multiple counterparts, each of which shall be deemed an original, but all of which, together, shall constitute but one and the same instrument.

**21. Costs of Enforcement**. If either Sublandlord or Subtenant brings an action to enforce the terms of this Sublease or declare rights under this Sublease, the prevailing party in any such action, or appeal, shall be entitled to its reasonable attorneys' fees and court costs to be paid by the losing party as fixed by the court in the same or separate suit and whether or not such action is pursued to decision or judgment. The attorneys' fee award shall not be computed in accordance with any court fee schedule, but shall be such as to fully reimburse all attorneys' fees and court costs reasonably incurred.

**22. Time of Essence**. Time is of the essence of this Sublease.

**23. Severability and Governing Law**. If any term, covenant or condition of this Sublease or the application thereof to any person, entity or circumstance shall, to any extent, be invalid or unenforceable, the remainder of this Sublease, or the application of such term, covenant, or condition to persons, entities or circumstances other than those to which it is invalid or unenforceable, shall not be affected thereby, and each term, covenant or condition of this

Sublease shall be valid and enforced to the fullest extent permitted by law. This Sublease shall be governed by and construed in accordance with the law of the State of North Carolina, without regard to the principles of conflict of laws.

**24. Entire Agreement**. This Sublease contains the entire agreement of the parties regarding the Sublease Premises, and no representations, inducements, promises or agreements, oral or otherwise, between the parties, not embodied herein, will be of any force or effect.

**25. Recitals, Schedules and Exhibits**. All Recitals set forth above and all Schedules and Exhibits attached hereto are incorporated herein as matters of contract.

**[signature pages to follow]**

Sublandlord and Subtenant have caused this Sublease to be executed as of the date first above written.

**SUBLANDLORD:**

B/E AEROSPACE, INC.,
a Delaware corporation

By: /s/ Eric J. Wesch
Eric J. Wesch, Vice President - Finance and Treasurer

**SUBTENANT:**

TARGACEPT, INC.,
a Delaware corporation

By: /s/ Alan A. Musso
Alan A. Musso, Senior Vice President, Finance and Administration and Chief Financial Officer

**SCHEDULE 1**

**Consent Agreement**

13

**LANDLORD'S CONSENT TO SUBLEASE**

The undersigned, SL Winston-Salem LLC, a Delaware limited liability company, hereby: (i) acknowledges receipt of a copy of, and consents to and approves, that certain Sublease dated November , 2012 by and between B/E Aerospace, Inc., a Delaware corporation, as sublandlord, and Targacept, Inc., a Delaware corporation, as subtenant (the "Sublease"), for that certain space comprising approximately 18,282 rentable square feet on the 15th floor of the building located at 100 Main Street, Winston- Salem N.C., including, but not limited to, all parking rights and all signage rights of B/E Aerospace, Inc., contained in that certain Office Lease Agreement dated as of July 16, 2007 by and between B/E Aerospace, Inc., as Tenant, and First States Investors 3300, LLC, as Landlord, as amended by that certain First Amendment to Lease dated as of October 8, 2010, and by that certain Second Amendment to Lease dated as of February 7, 2011 (collectively, the Prime Lease"); (ii) agrees that no exercise by Targacept, Inc., as subtenant under the Sublease, of any of the rights, remedies and options contained therein shall constitute a default or event of default under the Prime Lease; and (iii) agrees that each of B/E Aerospace, Inc. and Targacept, Inc. shall have the right to rely upon this Landlord's Consent to Sublease.

Dated this day of November, 2012.

SL Winston-Salem LLC

By: _____

Its: _____

**EXHIBIT A**

Prime Lease

PROPERTY: WBBD-3360 Wachovia Center Tower
PREPARED BY: Peter W. Hilton-Kingdon

# OFFICE LEASE AGREEMENT

This Office Lease Agreement ("Lease") is entered into as of July 16, 2007 ("Effective Date") by and between First States Investors 3300, LLC, a Delaware limited liability company, with an address at 610 Old York Road, Suite 300, Jenkintown, Pennsylvania 19046 ("Landlord"), and B/E Aerospace, Inc., a Delaware corporation with an address at 1455 Fairchild Road, Winston-Salem, North Carolina 27105 ("Tenant"). Landlord and Tenant, each intending to be legally bound, hereby mutually covenant and agree as follows:

## ARTICLE 1 - FUNDAMENTAL LEASE PROVISIONS

The following terms shall have the meanings set forth below, subject to further definition and elaboration elsewhere in this Lease.

"Base Rent"

| Beginning | Ending | Rent/SF | Monthly | Annual |
|---|---|---|---|---|
| Commencement Date | Month 12 | $15.00 | $ 9,853.75 | $118,245.00 |
| Month 13 | Month 24 | $15.50 | $10,182.21 | $122,186.50 |
| Month 25 | Month 36 | $16.00 | $10,510.67 | $126,128.00 |

"Base Year" 2007

"Building" Wachovia Center Tower
100 North Main Street
Winston-Salem, North Carolina 27101, containing a total of 546,020 rentable square feet

"Claims" Any and all claims, losses, costs, injuries, damages, expenses, liabilities, liens, actions, causes of action (whether in tort or contract, law or equity, or otherwise), charges, assessments, fines, and penalties of any kind (including consultant and expert expenses, court costs, and attorneys' fees actually incurred).

"Commencement Date" July 15, 2007

"Common Areas" All areas in the Property (defined below) except those areas occupied by Landlord or leased to tenants or held for lease to tenants, including, without limitation, parking areas, streets, driveways, aisles, sidewalks, curbs, delivery passages, loading areas, lighting facilities, mechanical rooms, elevator areas, common areas (such as corridors, bathrooms and similar areas) on multi-tenant floors, other Building common areas and all other areas situated on or in the Property which are designated by Landlord, from time to time, for use by, or for benefit of, all tenants and occupants of the Property in common.

"Default Rate" The lesser of the maximum annual rate of interest permitted by applicable law or 12% per annum

"Expiration Date" The last day of the thirty-sixth (36th) month following the Commencement Date, unless extended or sooner terminated as provided for herein.

"Hazardous Material" Any substance that is toxic, ignitable, reactive, or corrosive and that is now or hereafter regulated by any local government, the state where the Property is located, or the United States Government, including without limitation, asbestos, polychlorobiphenyls ("PCB's"), petroleum products or distillates, any and all material or substances that are defined as "hazardous waste," "extremely hazardous waste," or a "hazardous substance" pursuant to state, federal, or local governmental law.

"Landlord Broker" Cindy Christopher (Meridian Realty)
318 Indera Mills Court
Winston-Salem, North Carolina 27101

| | |
|---|---|
| "Landlord Notice Address" | First States Investors 3300, LLC<br>610 Old York Road, Suite 300<br>Jenkintown, PA 19046<br>Attn: Lease Administration<br><br>With a copy to:<br><br>First States Management Corp., LP.<br>680 Old York Road<br>Suite 200<br>Jenkintown, PA 19046<br>Attn: Vice President – Property Management |
| "Landlord Related Party" | Landlord's members and their directors and officers, employees, Landlord's property real estate management companies and lenders or land lessors if applicable |
| "Late Charge" | 5% |
| "Leasehold Improvements" | Improvements to the Premises made to meet the needs of Tenant whether installed prior to or during the Term and whether paid for by Landlord, a prior tenant, Tenant, or any combination thereof. Leasehold Improvements shall include, but are not limited to carpeting, wall coverings and draperies. |
| "Permitted Use" | General office use and for no other purpose; provided, however, that Tenant shall not under any circumstances be permitted to use the Premises for "retail banking purposes", which shall include, but not be limited to, the accepting of deposits from, or the making of loans to, the general public, whether by a national bank, credit union, state bank, savings bank or other entity or person. |
| "Premises" | That portion of the 26th floor of the Building, as indicated on the floor plan attached hereto as Exhibit "A", known as Suite 2600, containing an aggregate of approximately 7,883 rentable square feet. |
| "Property" | The Building and real property upon which the Building is situated |
| "Proportionate Share" | 1.4437% |
| "Rent Commencement Date" | August 1, 2007, subject to Section 2.2 below. |
| "Riders" | The following Riders, if any, are attached to and form a part of this Lease. In the event of a conflict between the terms of the Rider and the terms of this Lease, the terms of the particular Rider shall control:<br><br>Exhibit "B" Renewal Option Rider<br>Exhibit "C" Parking Lot Rider<br>Exhibit "D" Right of First Refusal (Lease) Rider<br>Exhibit "E" Leasehold Improvement Rider |
| "Security Deposit" | N/A |
| "Tenant Broker" | N/A |
| "Tenant Notice Address" | B/E Aerospace, Inc.<br>1455 Fairchild Road<br>Winston-Salem, NC 27105<br>Attn: Evan Stewart |
| "Tenant Related Parties" | Including but not limited to Tenant's customers, employees, agents, guests, contractors, subtenants, licensees, concessionaires, invitees or their related parties. |
| "Term" | The period commencing on the Commencement Date and ending on the Expiration Date. |

## ARTICLE 2 - GRANTING CLAUSE AND RENT PROVISIONS

**2.1 Grant of Premises**. In consideration of the obligation of Tenant to pay the rent and other charges as provided in this Lease and in consideration of the other terms and provisions of this Lease, Landlord hereby leases the Premises to Tenant during the Term, subject to the terms and provisions of this Lease.

**2.2 Term**. The Term shall commence on the Commencement Date and end on the Expiration Date. The Commencement Date shall constitute the commencement of the Term for all purposes, whether or not Tenant has actually taken possession. If for any reason the Premises are not ready for occupancy by the Rent Commencement Date, Landlord shall not be liable for any claims or damages by reason thereof, but in such event the Expiration Date shall be extended by the number of days between the Rent Commencement Date and the actual Rent Commencement Date. Within ten (10) days of the date the Commencement Date or Rent Commencement Date are determined by Landlord, in Landlord's reasonable discretion, Landlord shall confirm the Commencement Date, Rent Commencement Date and Expiration Date with Tenant. The foregoing notwithstanding, Tenant shall have a right of access to the Premises beginning as of the Effective Date to allow into the Premises, provided that Tenant has all applicable insurance coverage pursuant to Section 7.6 in effect as of the Effective Date and that Tenant shall not commence the conduct of its business at the Premises prior to the stated Commencement Date, and in any event the Rent Commencement Date shall remain the date specified in Article 1 as an accommodation to Tenant to allow time between the Commencement Date and the Rent Commencement Date for Tenant to perform and complete such work within the Premises.

**2.3 Base Rent; Late Payment**. Tenant agrees to pay the Base Rent to Landlord in equal monthly installments in advance, commencing on the Rent Commencement Date and continuing during the Term, without demand, offset or reduction. One (1) monthly installment of Base Rent shall be due and payable on the date of execution of this Lease by Tenant for the first month's rent and a like monthly installment shall be due and payable on or before the first day of each calendar month succeeding the Rent Commencement Date during the Term. If the Rent Commencement Date should be a date other than the first day of a calendar month, the monthly rent for the first partial month shall be prorated on a per diem basis. Any increases in Base Rent during the Term shall occur on the first day of the calendar month in which such increase is scheduled to occur. Tenant shall pay, as additional rent, all other sums due under this Lease. Base Rent and additional rent are sometimes collectively called "rent". All rent due under the terms of this Lease shall be payable to Landlord and forwarded to Landlord at the address section forth in Article 1, or to such other address as Landlord may designate by written notice to Tenant

**2.4 Operating Expenses**. If the Operating Expenses for the Property, in any calendar year during the Term, exceed the Operating Expenses for the Base Year, Tenant agrees to pay as additional monthly rent the Proportionate Share of such excess Operating Expenses, as estimated by Landlord from time to time. During any partial calendar year of the Term, Tenant's Proportionate Share of Operating Expenses shall be adjusted based upon the actual number of days contained within the Term during such partial calendar year. By April 30th of each calendar year, Landlord will provide Tenant an itemized statement showing in reasonable detail all additional rent due (or any overpayments made) under this Section and Tenant (or Landlord, as the case may be) shall pay such amount within thirty (30) days after receipt of such statement; provided, however, in no event shall Tenant be released of its obligation for such additional rent if Landlord fails to send Tenant a statement within the time specified above. In no event shall the Base Rent or other sums due under this Lease ever be reduced due to the operation of this Section 2.4 or to Operating Expenses being less for the Property than the Operating Expenses for the Base Year. The term "Operating Expenses" includes all expenses of Landlord with respect to the ownership, maintenance, servicing, repairing and operation of the Property, including, but not limited to: maintenance, repair and replacement costs (including the repairs specified in Section 5.1 below); electricity, water, sewer, gas and other utility charges; window washing and janitorial services; trash and snow and ice removal; landscaping and pest control; management fees (not to exceed 5% of total revenue from the Building)

payable to third parties; wages and benefits payable to employees of Landlord's property management company whose duties are directly connected with the operation and maintenance of the Property; all services, supplies, repairs, replacement or other expenses for maintaining and operating the Property including parking and Common Areas; the cost of repairing and replacing all building standard lighting fixtures in the Property, including, without limitation, bulbs and ballasts therefore; the cost of installation of any device or other equipment which is installed to improve the operating efficiency of any system and reduce Operating Expenses; all real property taxes and installments of special assessments which accrue against the Property during the Term; governmental levies or charges of any kind or nature assessed or imposed on the Property, whether by state, county, city of any political subdivision thereof; all insurance premiums Landlord is required to pay or deems necessary to pay, including hazard insurance and public liability insurance, with respect to the Property; all amounts paid for liability and casualty loss pursuant to insurance deductible amounts; and any amounts considered an operating, maintenance or management expense under generally accepted accounting principles.

The term "Operating Expenses" does not include: expenses for repairs, restoration or other work occasioned by fire, wind, the elements or other casualty that are paid by insurance; income and franchise taxes of Landlord; expenses incurred in leasing to or procuring of tenants, leasing commissions, advertising expenses and expenses for the renovating of space for Landlord or for new tenants; interest or principal payments on any mortgage encumbering the Property; expenses for repairs or other work occasioned by condemnation, to the extent reimbursed by condemnation proceeds; any expense required to be fully reimbursed to Landlord by Tenant or any other tenant of the Property (whether or not actually paid), or any expenses billed to and required to be paid directly by same (whether or not actually paid) for their own account or on Landlord's behalf; or legal expenses incurred in connection with leasing the Property or enforcement of Property leases. Tenant's obligations under this Section shall survive the expiration or earlier termination of the Lease.

**2.5 Late Payment Charge**. Other remedies for nonpayment notwithstanding, if any monthly rental payment is not received by Landlord on or before the fifth (5th) day of the month for which the rent is due, or if any other payment hereunder due Landlord by Tenant is not received by Landlord within five (5) days of the date such amount became due, Tenant shall pay the Late Charge multiplied by such past due amount, which shall become due and payable in addition to such amounts owed under this Lease. All amounts more than thirty (30) days past due shall accrue interest at the Default Rate.

**2.6 Security Deposit**. The Security Deposit shall be paid concurrent with Tenant's execution of this Lease and held by Landlord for the performance of Tenant's covenants and obligations under this Lease, it being expressly understood that the Security Deposit shall not be considered an advance payment of rental or a measure of Landlord's damage in case of default hereunder by Tenant, and shall be held by Landlord without payment of any interest thereon. Upon the occurrence of any event of default by Tenant under this Lease, Landlord may, from time to time, without prejudice to any other remedy, use the Security Deposit to the extent necessary to make good any arrears of rent, or to repair any damage or injury, or pay any expense or liability incurred by Landlord as a result of the event of default or breach of covenant, and any remaining balance of the Security Deposit shall be returned by Landlord to Tenant upon the expiration or earlier termination of this Lease. If any portion of the Security Deposit is so used or applied, Tenant shall upon ten (10) days written notice from Landlord, deposit with Landlord by cash or cashier's check an amount sufficient to restore the Security Deposit to its original amount. The Security Deposit may be assigned and transferred by Landlord to the successor in interest of Landlord and, upon acknowledgment by such successor of receipt of such security and its assumption of the obligation to account to Tenant for such security in accordance with the terms of this Lease, Landlord shall thereby be discharged of any further obligation relating thereto.

**2.7 Holding Over**. If Tenant does not vacate the Premises upon the expiration or earlier termination of this Lease, Tenant shall be a tenant at sufferance for the holdover period and all of the terms and provisions of this Lease shall be applicable during that period, except that Tenant shall pay Landlord (in addition to any other sums payable under this Lease) as Base Rent for the period of such holdover an amount equal to one and one-half times the Base Rent which would have been payable by Tenant had the holdover period been a part of the immediately preceding year of the Term (without waiver of Landlord's right to recover damages as permitted by law). The rent

payable during the holdover period shall be payable to Landlord on demand. No holding over by Tenant, whether with or without the consent of Landlord, shall operate to extend the Term. Tenant shall indemnify Landlord against all claims made by any tenant or prospective tenant against Landlord resulting from delay by Landlord in delivering possession of the Premises to such other tenant or prospective tenant.

**2.8 Utility Charges**. From and after the Commencement Date, Tenant shall pay, before any interest or penalty shall accrue thereon, all water and sewer rentals and charges and all charges for gas, electricity, telephone and communication services and other utility services used, rendered or consumed upon the Premises during the Term hereof. If any such services are not separately metered to the Premises, Tenant shall pay a reasonable proportion, to be determined by Landlord, of all charges jointly metered with other premises. Tenant has the right, upon notice to Landlord and at Tenant's sole cost and expense, to install and pay for all separate utility meters necessary to permit the Premises to be separately billed for utilities.

## ARTICLE 3 - OCCUPANCY, USE AND OPERATIONS

**3.1 Use**. Tenant warrants and represents to the Landlord that the Premises shall be used and occupied only for the Permitted Use. Tenant shall occupy the Premises, conduct its business and control its agents, employees, invitees and visitors in such a manner as is lawful, reputable and will not create a nuisance to other occupants or tenants in the Building. Tenant shall not solicit business, distribute handbills or display merchandise within the Common Areas, or take any action which would interfere with the rights of other persons to use the Common Areas. Tenant shall not permit any operation which emits any odor or matter which intrudes into other portions of the Property, use any apparatus or machine which makes undue noise or causes vibration in any portion of the Property or otherwise interfere with, annoy or disturb any other tenant in its normal business operations or Landlord in its management of the Property. Tenant shall neither permit any waste on the Premises nor allow the Premises to be used in any way which would, in the reasonable opinion of Landlord, be extra hazardous on account of fire or which would in any way increase or render void the fire insurance on the Property. Tenant has inspected the Premises and the Building and accepts them in their present "AS-IS" condition, except for the work to be performed by Landlord under Section 6.1 of the Lease.

**3.2 Signs**. Except as set forth herein, no signs of any type or description shall be erected, placed or painted in or about the Premises or Building except those signs submitted to Landlord in writing and approved by Landlord in writing, and which signs are in conformity with all laws, ordinances, regulations, and restrictions, of any kind or nature relating to such signage. Landlord reserves the right to remove, at Tenant's expense, all signs other than signs approved in writing by Landlord under this Section 3.2, without notice to Tenant and without liability to Tenant for any damages sustained by Tenant as a result thereof and Tenant shall repair any damage caused by such removal. All such permitted signs shall, at the sole cost and expense of Tenant, be maintained and repaired in first-class condition by Tenant throughout the Term. Upon expiration or termination of this Lease, all signs installed by Tenant shall be removed and any damage resulting therefrom shall be promptly repaired, or such removal and repair may be done by Landlord and the cost charged to Tenant as additional rent.

**3.3 Compliance with Laws, Rules and Regulations**. Tenant, at Tenant's sole cost and expense, shall comply with all laws, ordinances, orders, rules and regulations of state, federal, municipal or other agencies or bodies having jurisdiction over the use, condition or occupancy of the Premises. Tenant shall procure at its own expense all permits and licenses required for the transaction of its business in the Premises. Tenant will comply with the rules and regulations of the Property adopted from time to time by Landlord, a copy of which rules and regulations will be delivered to Tenant and which shall not materially or adversely affect the terms of this Lease. Tenant shall reimburse Landlord on demand for any expenses which Landlord may incur in effecting compliance with Tenant's obligations and agrees that Landlord shall not be liable for any damages resulting to Tenant from such action. Landlord shall apply the rules in a non-discriminatory manner to Tenant and have the right at all times to change and amend the rules and regulations in any reasonable manner as it may deem advisable for the safety, care, cleanliness, preservation of good order and operation or use of the Property or the Premises. All changes and amendments to the rules and regulations of the Property will be forwarded by Landlord to Tenant in writing and shall thereafter be carried out and observed by Tenant. With respect to any

alteration or installation of improvements, fixtures or facilities required by any legal requirement (including the Americans with Disabilities Act of 1990), Tenant shall be responsible for compliance at its expense to the extent such requirement is applicable to the Premises. Landlord will, at its expense comply with any such requirement to the extent applicable to the Common Areas; provided, however, that to the extent that the requirement would not have applied but for this Lease or Tenant's specific use of the Premises or an act or omission of Tenant, its employees, agents or invitees; or in the event Tenant occupies a full floor in the Building, then Tenant shall pay the cost of such compliance to Landlord on demand.

**3.4 Environmental Matters**.

(a) Tenant shall not cause or permit any Hazardous Material to be used, stored, generated, or disposed of on or in the Premises or the Property by Tenant, Tenant's agents, employees, contractors, or invitees. If Hazardous Materials are used, stored, generated, or disposed of on or in the Premises or the Property, or if the Premises or the Property become contaminated in any manner for which Tenant is legally liable, Tenant shall indemnify, defend and hold harmless the Landlord, its officers, directors, trustees, shareholders, members, partners, employees and agents from any and all claims, demands, causes of action, damages, fines, judgments, penalties, costs, liabilities, expenses or losses (including, without limitation, a decrease in value of the Premises or the Property, damages caused by loss or restriction of rentable or usable space, or any damages caused by adverse impact on marketing of the space, and any and all sums paid for settlement of claims, litigation expenses, attorneys' fees, court costs, consultant, and expert fees) of whatever kind or nature, known or unknown, contingent or otherwise, arising during or after the Term and arising as a result of that contamination by Tenant. This indemnification includes, without limitation, any and all costs incurred because of any investigation of the site or any cleanup, removal, or restoration mandated by a federal, state, or local agency or political subdivision. Without limitation of the foregoing, if Tenant causes or permits the presence of any Hazardous Material on the Premises or the Property and that results in contamination, Tenant shall promptly, at its sole expense, take any and all necessary actions to return the Premises or the Property to the condition existing prior to the presence of any such Hazardous Material on the Premises or the Property. Tenant shall first obtain Landlord's approval for any such remedial action. The provisions of this paragraph shall be in addition to any other obligations and liabilities Tenant may have to Landlord at law or equity and shall survive the transactions contemplated herein and shall survive the termination of this Lease. Notwithstanding the foregoing, Tenant may use nominal amounts of Hazardous Materials as are normal and customary for general office use, provided that Tenant complies with all applicable laws relating thereto.

(b) Tenant shall not discharge, leak, or emit, or permit to be discharged, leaked, or emitted, any material into the atmosphere, ground, sewer system, or any body of water, if that material (as is reasonably determined by the Landlord, or any governmental authority) does or may pollute or contaminate the same, or may adversely affect (i) the health, welfare, or safety of persons, whether located on the Premises or elsewhere, or (ii) the condition, use or enjoyment of the Building or any other real or personal property. Tenant shall immediately notify Landlord of any release of any Hazardous Material on or near the Premises or the Property whether or not such release is in a quantity that would otherwise be reportable to a public agency and shall also comply with the notification requirements of any applicable state, local, or federal law or regulation.

**3.5 Warranty of Possession**. Landlord and Tenant each warrants that it has the right and authority to execute this Lease, and Landlord warrants to Tenant, that upon payment of the required rents by Tenant and subject to the terms, conditions, covenants and agreements contained in this Lease, Tenant shall have possession of the Premises during the Term, without hindrance from Landlord or any person or persons lawfully claiming the Premises by, through or under Landlord (but not otherwise); subject, however, to all mortgages, deeds of trust, leases and agreements to which this Lease is subordinate and to all laws, ordinances, orders, rules and regulations of any governmental authority.

**3.6 Inspection**. Landlord or its authorized agents shall at any and all reasonable times and upon twenty-four (24) hours prior notice (except in the event of an emergency or to provide any service or repair required hereunder) have the right to enter the Premises to inspect the same, to show the Premises to prospective

mortgages, purchasers or prospective tenants, and to alter or improve or repair the Premises or any other portion of the Property. Tenant hereby waives any claim for abatement or reduction of rent or for any damages for injury or inconvenience to or interference with Tenant's business, for any loss of occupancy or use of the Premises, and for any other loss occasioned thereby, unless caused by the gross negligence or willful misconduct of Landlord or Landlord's agents or employees. Landlord shall at all times have and retain a key with which to unlock all of the doors in, upon and about the Premises. Tenant shall not change Landlord's lock system or in any other manner prohibit Landlord from entering the Premises. Landlord shall have the right at all times to enter the Premises by any means in the event of an emergency without liability therefor.

**3.7 Personal Property Taxes**. Tenant shall be liable for all taxes levied against leasehold improvements, merchandise, personal property, trade fixtures and all other taxable property located in the Premises. If any such taxes for which Tenant is liable are levied against Landlord or Landlord's property and if Landlord elects to pay the same or if the assessed value of Landlord's property is increased by inclusion of personal property and trade fixtures placed by Tenant in the Premises and Landlord elects to pay the taxes based on such increase, Tenant shall pay to Landlord, upon demand, that part of such taxes for which Tenant is primarily liable pursuant to the terms of this Section. Tenant shall pay when due any and all taxes related to Tenant's use and operation of its business in the Premises.

## ARTICLE 4 - BUILDING SERVICES

**4.1 Building Services**. During the Term, Landlord shall provide (a) water at those points of supply provided for general use of other tenants in the Building and electricity for use in the Premises, (b) central heating and air conditioning in season, and at temperatures and in amounts as are considered by Landlord to be standard or in compliance with any governmental regulations, such service at times other than regular hours to be furnished upon not less than twenty-four (24) hours advance notice from Tenant, who shall bear the entire cost thereof at the rate established by Landlord, (c) self-operated passenger elevator service, if applicable, and (d) janitorial service for the Premises, Building and Common Areas which shall only include, however, the sweeping and cleaning of floors, the cleaning of lavatories and toilets located in the Common Areas, the washing of exterior windows, the dusting of light fixtures and air grills, and the disposal of trash from the Premises, Building and Common Areas. Tenant shall pay all utility, telephone and telecommunications charges and shall provide all services not enumerated in this Section. Landlord may, in its sole discretion, provide additional services not enumerated herein. Failure by Landlord to any extent to provide these defined services or any other services not enumerated, or any cessation thereof, shall not render Landlord liable in any respect for damages to either person or property, be construed as an eviction of Tenant, work an abatement of rent or relieve Tenant from fulfillment of any covenant in this Lease, provided such services are restored within ten (10) business days after Tenant delivers written notice to Landlord of the failure of such services to be provided to the Premises. If any essential building service is not restored within such ten (10) business days and, as a result, such failure to restore such services interferes with Tenant's use and occupancy of all or any portion of the Premises, Tenant shall be entitled to abatement of rent for the portion (or all) of the Premises it is unable to use from the date of such cessation until the date such services are restored or the date Tenant recommences its use of the Premises (or the portion thereof affected by the cessation); provided, that if such essential building services are not restored within 30 days following the delivery of such notice and the interruption is not due to an event described in Sections 7.1 or 7.2, then Tenant, at its sole option and sole remedy, may terminate the Lease upon delivery of written notice to Landlord prior to restoration of the services. If any of the equipment or machinery useful or necessary for provision of utility services, and for which Landlord is responsible, breaks down, or for any cause ceases to function properly, Landlord shall use reasonable diligence to repair the same promptly, but Tenant shall have no claim for rebate of rent or damages on account of any interruption in service occasioned from the repairs. Landlord reserves the right from time to time to make changes in the utilities and services provided by Landlord to the Property.

For purposes of this Section 4.1, the term "regular hours" means 8:00 a.m. to 6:00 p.m. on weekdays and 8:00 a.m. to 1:00 p.m. on Saturday; and "holidays" means New Year's Day, Martin Luther King Day, President's Day, Memorial Day, Fourth of July, Labor Day, Columbus Day, Thanksgiving and Christmas, together with such other holidays designated by Landlord consistent with those holidays designated by national banks located in the county in which the Building is located.

**4.2 Theft or Burglary**. Landlord shall not be liable to Tenant for losses to Tenant's property or personal injury caused by criminal acts or entry by any person into the Premises or the Property, except to the extent that same results from the gross negligence or willful act of Landlord or its agents or employees.

## ARTICLE 5 - REPAIRS AND MAINTENANCE

**5.1 Landlord Repairs**. Landlord shall not be required to make any improvements, replacements or repairs of any kind or character to the Premises during the Term except as are set forth in this Section. Landlord shall maintain in a first-class working condition and in a good state of repair (and replace as necessary) only the roof, foundation, parking and Common Areas, the exterior walls, doors, corridors, windows and other structures or equipment serving the Premises, including the plumbing, electrical system and HVAC systems. Landlord shall not be liable to Tenants, except as expressly provided in this Lease, for any damage or inconvenience, and Tenant shall not be entitled to any damages nor to any abatement or reduction of rent by reason of any maintenance, repairs, replacements, alterations or additions made by Landlord under this Lease. All requests for repairs or maintenance that are the responsibility of Landlord pursuant to this Lease must be made in writing to Landlord. Landlord shall use reasonable efforts not to disturb Tenant's conduct of business within the Premises in the course of performing such repairs.

**5.2 Tenant Repairs**. Tenant, at its own cost and expense, shall perform such maintenance, repairs and replacements as are required in order to keep the Premises in a first-class condition (except only for those items that are the responsibility of Landlord under Section 5.1) and shall repair or replace any damage or injury to all or any part of the Premises and/or the Property, caused by any act or omission of Tenant or Tenant's agents, employees, invitees, licensees or visitors.

**5.3 Tenant Damages**. Tenant shall not allow any damage to be committed on any portion of the Premises or Property, and at the termination of this Lease, by lapse of time or otherwise, Tenant shall deliver the Premises to Landlord in as good condition as existed at the Commencement Date of this Lease, ordinary wear and tear excepted. The cost and expense of any repairs necessary to restore the condition of the Premises shall be borne by Tenant.

## ARTICLE 6 - ALTERATIONS AND IMPROVEMENTS

**6.1 Construction**. Tenant acknowledges and agrees that, except as provided in the Leasehold Improvement Rider attached as Exhibit "E", Landlord has not undertaken to perform any modification, alteration or improvements to the Premises, and Tenant further waives any existing (but not latent) defects in the Premises and accepts (1) the Premises as suitable for the purpose for which they are leased and (2) the Property and every part and appurtenance thereof as being in good and satisfactory condition.

**6.2 Tenant Improvements**. Tenant shall not make or allow to be made any alterations, physical additions or improvements in or to the Premises without first obtaining the written consent of Landlord, which consent may in the sole and absolute discretion of Landlord be denied. Landlord's failure to respond in writing to Tenant's request for any alterations, physical additions or improvements within fifteen (15) days of receipt thereof shall be deemed Landlord's disapproval of such request. Any alterations, physical additions or improvements to the Premises made by or installed by either party hereto shall remain upon and be surrendered with the Premises and become the property of Landlord upon the expiration or earlier termination of this Lease without credit to Tenant; provided, however, Landlord, at its option, may require Tenant to remove any physical improvements or additions and/or repair any alterations in order to restore the Premises to the condition existing at the time Tenant took possession, all costs of removal and/or alterations to be home by Tenant. This clause shall not apply to moveable equipment, furniture or moveable trade fixtures owned by Tenant, which may be removed by Tenant at the end of the Term if Tenant is not then in default and if such equipment and furniture are

not then subject to any other rights, liens and interests of Landlord. Tenant shall have no authority or power, express or implied, to create or cause any mechanic's or materialman's lien, charge or encumbrance of any kind against the Premises, the Property or any portion thereof. Tenant shall promptly cause any such liens that have arisen by reason of any work claimed to have been undertaken by or through Tenant to be released by payment, bonding or otherwise within ten (10) days after Tenant first has notice thereof, and shall indemnify and defend Landlord against liability or loss arising out of any such claim (including, without limitation, legal fees and court costs). Landlord specifically approves the installation of carpeting and the painting of walls within the Premises by Tenant at Tenant's expense, which alterations shall not be required to be removed by Tenant upon any termination of the Lease Term.

**6.3 Common and Service Area Alterations**. Landlord shall have the right to decorate and to make repairs, alterations, additions, changes or improvements, whether structural or otherwise, in, about or on the Property or any part thereof, and to change, alter, relocate, remove or replace service areas and/or Common Areas, to place, inspect, repair and replace in the Premises (below floors, above ceilings or next to columns) utility lines, pipes and the like to serve other areas of the Property outside the Premises and to otherwise alter or modify the Property, and for such purposes to enter upon the Premises and, during the continuance of any such work, to take such measures for safety or for the expediting of such work as may be required, in Landlord's judgment, all without affecting any of Tenant's obligations hereunder. Landlord shall use reasonable efforts not to disturb Tenant's conduct of business within the Premises in the course of performing such rights under this Section.

## ARTICLE 7 - CASUALTY AND INSURANCE

**7.1 Lease Termination Due to Casualty**. If the Premises should be totally destroyed by fire or other casualty, or if in the determination of Landlord the Premises should be damaged so that rebuilding cannot reasonably be completed substantially within one hundred eighty (180) days after Landlord's receipt of written notification by Tenant of the destruction, or if the Premises are damaged or destroyed by casualty not covered by the standard broad form of fire and extended coverage insurance then in common use in the state where the Premises are located, or (unless Landlord has elected to self-insure) if the insurance proceeds received by Landlord from its insurance are not sufficient to completely restore the damage or destruction, or if all or any portion of such insurance proceeds are required by its lender to be applied against debt owed to such lender, or if the damage occurs during the last twelve (12) months of the Term, then, at Landlord's sole option, this Lease may be terminated and, in such event, the rent shall be abated (and any pre-paid rent returned to Tenant, as applicable) for the unexpired portion of the Lease, effective as of the date of the damage.

**7.2 Lease Continuation After Casualty**. If following damage or destruction to the Premises by fire or other casualty, this Lease is not terminated pursuant to Section 7.1 hereof, Landlord shall proceed with reasonable diligence to rebuild or repair the Building or other improvements to substantially the same conditions in which they existed prior to the damage. If the Premises are to be rebuilt or repaired and are untenantable in whole or in part following the damage, and the damage or destruction was insured under Landlord's Property Insurance, the Base Rent payable under this Lease during the period for which the Premises are untenantable shall be reduced (and any pre-paid rent returned or credited to Tenant, as applicable) to an amount determined by multiplying the Base Rent that would otherwise be payable but for this provision by the ratio that the portion of the Premises not rendered untenantable bears to the total area of the Premises prior to the casualty, Landlord's obligation to rebuild or restore under this Section shall be limited to restoring to substantially the condition in which the same existed prior to the casualty, and Tenant shall, promptly after the completion of such work by Landlord, proceed with reasonable diligence and at Tenant's sole cost and expense to otherwise make the Premises suitable for Tenant's Permitted Use. If the damage or destruction occurs during a free-rent period, then the portion of the free-rent period affected by the casualty will begin to run after the end of the rent abatement period. In the event of any damage or destruction by fire or other casualty to any portion of the Building that may not result in direct damage or destruction to the Premises but that results in any restriction or limitation on access to or use of the Premises, then the Base Rent payable under this Lease during the period for which such access to or use of the Premises is restricted or limited shall be reduced in the same ratio as provided above in the event of damage or destruction that directly impacts the Premises.

**7.3 Landlord Insurance**. Landlord shall at all times during the Term insure the Property against special perils of direct physical loss in an amount and with such deductibles as Landlord considers appropriate, as commercially available and generally acceptable for similar exposures; provided however, Landlord shall have the right to self-insure against the above-described risks and Landlord shall not in any way or manner insure any personal property (including, but not limited to, any furniture, machinery, goods or supplies) of Tenant upon or within the Premises, any fixtures installed or paid for by Tenant upon or within the Premises, or any Leasehold Improvements on the Premises. Tenant shall have no right in or claim to the proceeds of any policy of insurance maintained by Landlord even if the cost of such insurance is borne by Tenant.

**7.4 Waiver of Subrogation or Recovery**. NOTWITHSTANDING ANYTHING IN THIS LEASE TO THE CONTRARY, LANDLORD (INCLUDING LANDLORD RELATED PARTIES) AND TENANT HEREBY WAIVE AND RELEASE EACH OTHER (FOR THEMSELVES AND THEIR RESPECTIVE INSURERS) OF AND FROM ANY AND ALL RIGHT OF RECOVERY, CLAIM, ACTION OR CAUSE OF ACTION, AGAINST EACH OTHER, FOR ANY LOSS OR DAMAGE THAT MAY OCCUR TO THE PREMISES, IMPROVEMENTS TO THE PROPERTY, OR TENANT'S PERSONAL PROPERTY INCLUDING BUT NOT LIMITED TO TENANT'S TRADE FIXTURES, FURNISHINGS, TENANT IMPROVEMENTS, EQUIPMENT, ELECTRONIC EQUIPMENT AND MEDIA WITHIN THE PROPERTY, BY REASON OF FIRE OR THE ELEMENTS OR ANY CAUSE THAT IS INSURED AGAINST, IS INSURABLE AGAINST AT REGULAR RATES, OR IS REQUIRED BY THE TERMS OF THIS LEASE TO BE INSURED AGAINST (WHETHER OR NOT ACTUALLY INSURED) REGARDLESS OF CAUSE OR ORIGIN, INCLUDING NEGLIGENCE OF LANDLORD OR TENANT AND THEIR RELATED PARTIES AND STRICT LIABILITY OF ANY KIND, REGARDLESS OF THE AMOUNT OF THE PROCEEDS, IF ANY, PAYABLE UNDER SUCH INSURANCE. LANDLORD AND TENANT AGREE IMMEDIATELY TO HAVE THE INSURANCE POLICIES PROVIDE SUCH WAIVERS OF SUBROGATION TO EFFECTUATE THE FOREGOING.

**7.5 Release and Hold Harmless**. Except to the extent arising from Landlord's gross negligence or intentional misconduct (or that of any Landlord Related Parties), Tenant releases and will indemnify and hold harmless Landlord and Landlord Related Parties from all Claims arising from or in connection with: (i) the conduct, operation or management of the Premises or of any business therein, or any work or thing whatsoever done, or any condition created in or about the Premises during the Term; (ii) the use of the Premises or the Property by Tenant or Tenant Related Parties; (iii) any act, omission or negligence of Tenant or any of Tenant Related Parties; (iv) any breach or default on the part of Tenant in the observance or performance of any of its agreements or obligations hereunder; and (v) any accident, injury or damage whatsoever occurring in or at the Premises. Tenant hereby expressly releases and holds Landlord and Landlord Related Parties harmless from the consequences of any act or omission of Landlord or Landlord Related Parties (including but not limited to the failure or cessation of any service or utility provided by Landlord or Landlord Related Parties unless such act or omission constitute gross negligence or intentional misconduct by the Landlord or Landlord Related Parties). With respect to Tenant's indemnification obligations, Tenant will indemnify and defend with counsel reasonably satisfactory to Landlord, and shall not settle any claim without Landlord's reasonable prior approval. Landlord shall indemnify, protect, defend, and hold Tenant and Tenant Related Parties harmless from and against any and all claims, actions, damages, liabilities, demands, costs and expenses of every kind and nature (including attorneys' fees and court costs) in connection with injury (including death) or damage to any person, property or business that occurs in or about the Building and that results from the gross negligence or willful misconduct of Landlord, Landlord Related Parties, its agents or contractors or that results from the Landlord's breach of this Lease.

**7.6 Tenant's Insurance**.

(1) **Liability Insurance**. Tenant at all times during the Term shall, at its own expense, keep in full force and effect commercial general liability (CGL) insurance and, if necessary, commercial umbrella insurance with a limit of not less than $2,000,000 each occurrence. If such insurance contains a general aggregate limit, it shall apply separately to this location. CGL insurance shall be written on ISO occurrence form CG 00 01 12 04 (or a substitute form providing equivalent coverage) and shall cover liability arising from premises, operations, independent contractors, products-completed operations, personal injury and advertising injury, and liability assumed under an insured contract. Landlord and Landlord Related Parties shall be included as additional insureds under the CGL, using ISO additional insured endorsement CG 20 10 11 85 or a substitute providing equivalent coverage, and under the commercial umbrella, if any. This insurance shall apply as primary insurance with respect to any other insurance or self-insurance programs afforded to Landlord. There shall be no endorsement or modification of the CGL to make it excess over other available insurance; alternatively, if the CGL states that it is excess or pro rata, the policy shall be endorsed to be primary with respect to the additional insured. Tenant waives all rights against Landlord for recovery of damages to the extent these damages are covered by the commercial general liability or commercial umbrella liability insurance. Tenant, shall continue at not less than the aforesaid limit until required to be changed by Landlord in writing by reason of changed economic conditions making such protection inadequate. Tenant shall carry Worker's Compensation coverage with minimum limits as required by applicable law and Employer's Liability coverage with minimum limits of $1,000,000. Tenant may carry a portion of Tenant's insurance as an umbrella policy of insurance. Tenant waives all rights against Landlord for recovery of damages to the extent these damages are covered by the workers compensation and employers liability or commercial umbrella liability insurance obtained by Tenant. Where permitted by law, Tenant shall obtain an endorsement equivalent to WC 00 03 13 to affect this waiver.

(2) **Property Insurance**. Tenant shall also carry insurance against fire and such other risks as are from time to time included in Standard Special Form Insurance (including coverage against vandalism and malicious mischief) for the full replacement cost of Tenant's trade fixtures, furnishings, Tenant Improvements, equipment and all items of personal property of Tenant located on or in the Premises and provide loss of rent coverage for a minimum period of 12 months.

(3) **Other Insurance**: Tenant shall provide any other insurance that would be reasonably requested by Landlord from time to time.

(4) **Notifications**. Upon the occurrence of any accident, injury or personal property casualty in or about the Premises or Property, Tenant shall give immediate notice thereof to Landlord, and shall provide Landlord with evidence that such liability of Landlord relating thereto is covered by the insurance which Tenant is required by this Lease to carry. If the Improvements, or any part thereof, are destroyed or damaged by any cause, Tenant shall give immediate notice thereof to Landlord.

(5) **General Provisions**.

a. All insurance required to be carried by Tenant under this Lease shall be in form and content, and written by insurers acceptable to Landlord, in its sole discretion, subject to a minimum A.M. Best's rating of A, Financial Strength X.

b. Any deductibles or self-insured retentions must be disclosed in writing and are subject to Landlord approval.

c. All policies of insurance shall contain clauses or endorsement to the effect that 30 days written notice will be given to Landlord if canceled or non-renewed.

d. Duly executed certificates of insurance providing evidence of compliance with the requirements of this Lease together with satisfactory evidence of the payment of the premium thereof, shall be deposited with Landlord on the date Tenant first occupies the Premises and upon renewals of such policies not less than thirty (30) days prior to the expiration of the term of such coverage. Acceptance of insurance certificate

by Landlord shall in no way limit or relieve Tenant of its duties and responsibilities under this Lease. Failure of Landlord to demand such certificate or other evidence of full compliance with these insurance requirements or failure of Landlord to identify a deficiency from evidence that is provided shall not be construed as a waiver of Tenant's obligation to maintain such insurance. At Landlord's discretion, copies of the insurance policies must be provided.

e. If Tenant has obtained insurance coverage in amounts in excess of those listed above, such additional insurance coverage shall also inure to the benefit of the Landlord. If Tenant shall fail to comply with any of the requirements contained relating to insurance, Landlord has the right but not the obligation, to obtain such insurance and Tenant shall pay to Landlord, on demand as additional rent hereunder, the premium cost thereof.

## ARTICLE 8 - CONDEMNATION

**8.1 Substantial Taking**. If in the determination of Landlord all or a substantial part of the Premises are taken for any public or quasi-public use under any governmental law, ordinance or regulation, or by right of eminent domain or by purchase in lieu thereof, and in the determination of Landlord or Tenant the taking would prevent or materially interfere with the use of the Premises for the purpose for which it is then being used, this Lease shall, at the option of either Landlord or Tenant, terminate and the rent shall be abated (or any pre-paid rent returned to Tenant, as applicable) during the unexpired portion of this Lease effective on the date physical possession is taken by the condemning authority.

**8.2 Partial Taking**. If a portion of the Premises shall be taken for any public or quasi-public use under any governmental law, ordinance or regulation, or by right of eminent domain or by purchase in lieu thereof, and this Lease is not terminated as provided in Section 8.1 above, Landlord shall restore and reconstruct, to the extent of condemnation proceeds (excluding any proceeds for land) actually received after the exercise by any mortgagee of the Property of an option to apply such proceeds against Landlord's debt to such mortgagee, the Property and other improvements on the Premises to the extent necessary to make it reasonably tenantable. Effective as of the date of such taking, the rent payable under this Lease during the unexpired portion of the term shall be reduced (and any pre-paid rent returned or credited to Tenant, as applicable) to an amount determined by multiplying the Base Rent that would otherwise be payable but for this provision by the ratio that the portion of the Premises not rendered untenantable due to such taking bears to the total area of the Premises prior to the taking. If Landlord fails to substantially complete such restoration and reconstruction within one hundred eighty (180) days of the date of physical possession by the condemning authority, Tenant may at its option terminate this Lease by delivering written notice of termination to Landlord, whereupon all rights and obligations of this Lease shall cease to exist. However, if the portion of the Premises remaining after the taking contemplated by this Section renders the remainder of the Premises unsuitable, in Tenant's reasonable business judgment, for the conduct of Tenant's business, Tenant may terminate this Lease by written notice to Landlord within fifteen (15) days after the date possession is taken by the condemning authority, and rent shall be abated (and any pre-paid rent returned or credited to Tenant, as applicable), for the remaining term of this Lease effective as of the date of such taking.

**8.3 Condemnation Proceeds**. All compensation awarded for any taking (or the proceeds of private sale in lieu thereof), whether for the whole or a part of the Premises, shall be the property of Landlord (whether such award is compensation for damages to Landlord's or Tenant's interest in the Premises), and Tenant hereby assigns all of its interest in any such award to Landlord; provided, however, Landlord shall have no interest in any award made to Tenant for loss of business or for taking of Tenant's fixtures and other property within the Premises if a separate award for such items is made to Tenant.

## ARTICLE 9 - ASSIGNMENT OR SUBLEASE

**9.1 Tenant Assignment/Sublease**. Tenant shall not assign or sublease, in whole or in part, this Lease, or allow it to be assigned or subleased, in whole or in part, by operation of law (except that merger shall not be subject to this restriction) or otherwise (including, without limitation, by dissolution or transfer of a controlling interest in any partnership or corporate Tenant, which dissolution or transfer shall be deemed an assignment) or mortgage or pledge the same, or sublet the Premises, in whole or in part, without the prior written consent of Landlord, which consent shall not be unreasonably withheld. In no event shall any such assignment or sublease ever release Tenant or any guarantor from any obligation or liability hereunder. No assignee or sublessee of the Premises of any portion thereof may further assign or sublet the Premises or any portion thereof. However, if Tenant is not then in default and if the Tenant then in possession of the Premises is BE Aerospace, Inc., Tenant shall have the right to assign this Lease or sublease all or any portion of the Premises to an affiliate of Tenant without requiring the prior consent of Landlord by giving notice thereof to Landlord at least ten (10) days prior to the effective date of such assignment or sublease, provided that such assignment or sublease shall be subject to all other provisions of this Lease and shall not effect a release of Tenant from any liability under this Lease. The term "affiliate" as used in this Section shall mean any corporation or other entity controlling, controlled by or under common control with (directly or indirectly) Tenant, including without limitation any parent corporation controlling Tenant or subsidiary that Tenant controls. The term "control" as used in this Section shall mean the power to direct or cause the direction of the management and policies of the controlled entity through the ownership of at least fifty percent (50%) of the vote of management or of equity owners of such controlled entity.

**9.2 Landlord Assignment**. Landlord shall have the right to sell, transfer or assign, in whole or in part, its rights and obligations under this Lease and in the Property. Any such sale, transfer or assignment shall operate to release Landlord from any and all liabilities under this Lease arising after the date of such sale, assignment or transfer.

**9.3 Rights of Mortgagee**. Subject to the terms of any non-disturbance agreement with any Lender, Tenant accepts this Lease subject and subordinate to any recorded lease, mortgage, deed to secure debt or deed of trust lien presently existing, if any, or hereafter encumbering the Property and any renewals, modifications, extensions or replacements thereof and to all existing ordinances and recorded restrictions, covenants, easements, and agreements with respect to the Property. Landlord hereby is irrevocably vested with full power and authority to subordinate Tenant's interest under this Lease to any mortgage, deed to secure debt or deed of trust lien hereafter placed on the Property, and Tenant agrees upon demand to execute additional instruments subordinating this Lease as Landlord may require. Upon any foreclosure, or any other transfer of Landlord's interest in the Property, whether or not in connection with a mortgage, Tenant hereby does, and hereafter agrees to attorn to the purchaser at such foreclosure sale or to the grantee under any deed in lieu of foreclosure or to any other transferee of Landlord's interest, and shall recognize such purchaser, grantee, or other transferee as Landlord under this Lease, and no further attornment or other agreement shall be required to effect or evidence Tenant's attornment to and recognition of such purchaser or grantee as Landlord hereunder. Such agreement of Tenant to attorn shall survive any such foreclosure sale, trustee's sale, conveyance in lieu thereof, or any other transfer of Landlord's interest in the Property. Tenant, upon demand, at any time, before or after any such foreclosure sale, trustee's sale, conveyance in lieu thereof, or other transfer shall execute, acknowledge and deliver to the mortgagee any written instruments and certificates evidencing such attornment as the mortgagee or other prospective transferee may reasonably require, and Tenant hereby irrevocably appoints Landlord as Tenant's agent and attorney-in-fact for the purpose of executing, acknowledging, and delivering any such instruments and certificates. Notwithstanding anything to the contrary implied in this Section, any mortgagee under any mortgage shall have the right at any time to subordinate any such mortgage to this Lease on such terms and subject to such conditions as the mortgagee in its discretion may consider appropriate. Landlord agrees that it shall exercise reasonable efforts to obtain a non-disturbance and attornment agreement ("SNDA") for Tenant from any grantee or transferee, at Tenant's sole cost and expense, upon written request from Tenant; provided, however, Tenant shall submit to Landlord with any such request a check in the amount of two thousand dollars ($2,000.00) for Landlord to hold in escrow to apply towards the costs of such SNDA.

**9.4 Estoppel Certificates**. Tenant agrees to furnish, from time to time, within ten (10) days after receipt of a request from Landlord or Landlord's mortgagee, a statement certifying to the extent requested such matters as may be reasonably required by Landlord or Landlord's mortgagee. Any statement delivered pursuant to this Article may be relied upon by any mortgagee, beneficiary, purchaser or prospective purchaser of the Building or any interest therein.

## ARTICLE 10 - LIENS

Tenant shall not suffer or permit the interest of Landlord in either the Premises or the Property to be subject to any construction, mechanics', materialman's liens or liens of any kind. All parties with whom Tenant may deal are put on notice that Tenant has no power to subject Landlord's interest to any claim or lien of any kind or character, and all such persons so dealing with Tenant must look solely to the credit of Tenant, and not to Landlord's assets or interest. Tenant shall put all such parties with whom Tenant may deal on notice of the terms of this Section. If at any time a lien or encumbrance is filed against either the Premises or the Property as a result of Tenant's work, materials, or obligations, Tenant shall promptly discharge said lien or encumbrance by payment or bond.

## ARTICLE 11 - DEFAULT AND REMEDIES

**11.1 Default by Tenant**. The following shall be deemed to be events of default by Tenant under this Lease: (1) Tenant shall fail to pay when due my installment of rent or any other payment required pursuant to this Lease within five (5) days after notice has been given to Tenant that payment is delinquent (however Landlord shall not be obligated to send notice of such failure to pay more than, two (2) times within a consecutive twelve (12) month period); (2) Tenant or any guarantor of Tenant's obligations hereunder shall file a petition or be adjudged bankrupt or insolvent under any applicable federal or state bankruptcy or insolvency law or admit that it cannot meet its financial obligations as they become due, or a receiver or trustee shall be appointed for all or substantially all of the assets of Tenant or any guarantor of Tenant's obligations hereunder; (3) Tenant or any guarantor of Tenant's obligations hereunder shall make a transfer in favor of creditors or shall make an assignment for the benefit of creditors; (4) Tenant shall do or permit to be done any act which results in a lien being filed against the Premises or the Property; (5) the liquidation, termination, dissolution or (if the Tenant is a natural person) the death of any Tenant or any guarantor of Tenant's obligations hereunder; or (6) Tenant shall be in default of any other term, provision or covenant of this Lease, other than those specified in subparts (1) through (5), above, and such default is not cured within thirty (30) days after written notice thereof to Tenant (provided that, if Tenant has exercised reasonable diligence to cure such default and such default cannot be cured within such thirty (30) day period despite reasonable diligence, Tenant shall not be in default under this provision unless Tenant fails thereafter diligently and continuously to prosecute the cure to completion, not to exceed thirty (30) additional days).

**11.2 Remedies for Tenant's Default**. Upon the occurrence of any event of default set forth in this Lease, Landlord shall have the option to pursue any one or more of the remedies set forth in this Section 11.2 without any additional notice or demand:

(1) Without declaring the Lease terminated, Landlord may enter upon and take possession of the Premises, by legal process, and lock out, expel or remove Tenant and any other person who may be occupying all or any part of the Premises without being liable for any claim for damages, and relet the Premises on behalf of Tenant and receive the rent directly by reason of the reletting. Tenant agrees to pay Landlord on demand any deficiency that may arise by reason of any reletting of the Premises; further, Tenant agrees to reimburse Landlord for any expenditures made by it in order to relet the Premises, including, but not limited to, remodeling and repair costs.

(2) Without declaring the Lease terminated, Landlord may enter upon the Premises, by legal process, without being liable for any claim for damages, and do whatever Tenant is obligated to do under the terms of this Lease. Tenant agrees to reimburse Landlord on demand for any expenses, including

without limitation reasonable attorney's fees and expenses, which Landlord may incur in effecting compliance with Tenant's obligations under this Lease; further, Tenant agrees that Landlord shall not be liable for any damages resulting to Tenant from effecting compliance with Tenant's obligations under this Lease unless caused by the negligence or willful misconduct of Landlord.

(3) Landlord may terminate this Lease, in which event Tenant shall immediately surrender the Premises to Landlord, and if Tenant fails to surrender the Premises, Landlord may, without prejudice to any other remedy which it may have for possession or arrearages in rent, enter upon and take possession of the Premises, by legal process, and lock out, expel or remove Tenant and any other person who may be occupying all or any part of the Premises without being liable for any claim for damages. Tenant agrees to pay on demand the amount of all loss and damage which Landlord may suffer for any reason due to the termination of this Lease under this Section 11.2, including (without limitation) loss and damage due to the failure of Tenant to maintain and/or repair the Premises as required hereunder and/or due to the inability of Landlord to relet the Premises on satisfactory terms or otherwise.

(4) Landlord may accelerate and sue for the entire balance of the unpaid rent for the remainder of the Term less the fair rental value of the Premises for the remainder of the Term, such result being reduced to its present value using a discount rate of five percent (5%), whereupon, Tenant shall immediately become liable for and pay on demand to Landlord said amount of accelerated damages, in addition to all past due Base Rent and other charges unpaid by Tenant.

(5) Landlord may exercise all rights and remedies that are available under the laws of the state where the Property is located and applicable federal law and at equity.

In addition to any other remedy set forth in this Lease, if Landlord has made rent concessions of any type or character, or waived any Base Rent, and Tenant fails to take possession of the Premises on the Commencement Date or otherwise defaults at any time during the Term, the rent concessions, including any waived Base Rent, shall be cancelled, and the amount of the waived Base Rent or other rent concessions shall be due and payable immediately as if no rent concessions or waiver of any Base Rent had ever been granted. A rent concession or waiver of the Base Rent shall not relieve Tenant of any obligation to pay any other charge due and payable under this Lease, including, without limitation, any sum due under Section 2.4 of this Lease. Notwithstanding anything contained in this Lease to the contrary, this Lease may be terminated by Landlord only by written notice of such termination to Tenant given in accordance with this Lease, and no other act or omission of Landlord shall be construed as a termination of this Lease. If Tenant defaults under this Lease at anytime during the Term, in addition to any other remedies to which Landlord is entitled, Tenant shall reimburse Landlord, within five (5) days of demand, the unamortized amount of the leasing commission paid to any broker in connection with this Lease.

**11.3 Remedies Cumulative**. All rights and remedies of Landlord herein or existing at law or in equity are cumulative and the exercise of one or more rights or remedies shall not be taken to exclude or waive the right to the exercise of any other.

**11.4 Accord and Satisfaction**. No payment by Tenant or receipt by Landlord or its employee or agent of a lesser amount than the Rent payable hereunder shall be deemed to be other than a payment on account to be credited against monies owed Landlord hereunder, in such order as Landlord may reasonably determine, nor shall any restrictive endorsement, statement or name on any check or any letter accompanying any check or payment delivered to Landlord or its employee or agent be deemed, declared or interpreted an accord and satisfaction; and Landlord or its agent may accept and deposit such check or payment without notice to Tenant, without same operating as a satisfaction or an acceptance of satisfaction by Landlord or its employee or agent, and without prejudice to Landlord's right to recover the balance of any monies due hereunder, or to pursue any other remedy provided herein or by law.

**11.5 Landlord Default**. The following shall be deemed to be events of default by Landlord under this Lease: (a) Landlord fails to observe or perform any of the covenants, conditions, or provisions of this Lease to be observed or performed by Landlord, where such failure continues for a period of ninety (90) days after written notice thereof from Tenant to Landlord; provided, however, that if the nature of the default requires more than ninety (90) days to effect the cure, then Landlord shall not be deemed to be in default if Landlord commences the cure within the thirty (90) day period and thereafter diligently prosecutes the cure to completion; or (b) Landlord makes any general arrangement or assignment for the benefit of creditors, or if Landlord becomes a "debtor" as defined in 11 U.S.C. section 101 or any successor statute thereto (unless, in the case of a petition filed against Landlord, the petition is dismissed within sixty (60) days), or the appointment of a trustee or receiver to take possession of the Premises where possession is not restored to Landlord within thirty (30) days, or the attachment, execution, or other judicial seizure or lien against the Premises, where such lien is not discharged within thirty (30) days. If Landlord commits an event of default under this Lease and Landlord does not remedy the event of default within the cure period provided in this Lease, Tenant may terminate this Lease by providing Landlord with ten (10) days prior written notice, in which case Tenant shall be relieved of its obligations hereunder from the date of termination in said notice, or Tenant shall be entitled to correct such default and to either (i) bring suit for the collection of any amounts for which Landlord may be in default, together with interest thereon at the Default Rate from the date of such expenditure; or (ii) to abate its rental obligations during the months following such default by an amount equal to any amounts for which Landlord is in default, together with interest thereon at the Default Rate from the date of such expenditure. Except as the context of the above sections indicates or expressly provides, Tenant's rights and remedies are not intended to be exclusive, but shall be in addition to all other rights and remedies available to Tenant by statute, under the law, or in equity.

## ARTICLE 12 - MISCELLANEOUS

**12.1 Waiver**. Failure of Landlord to declare an event of default immediately upon its occurrence, or delay in taking any action in connection with an event of default, shall not constitute a waiver of the default, but Landlord shall have the right to declare the default at any time and take such action as is lawful or authorized under this Lease. Pursuit of any one or more of the remedies set forth in Article 11 above shall not preclude pursuit of any remedy hereunder or at law constitute forfeiture or waiver of any rent or damages accruing to Landlord by reason of the violation of any of the terms, provisions or covenants of this Lease. Failure by Landlord to enforce one or more of the remedies provided hereunder or at law upon any event of default shall not be deemed or construed to constitute a waiver of the default or of any other violation or breach of any of the terms, provisions and covenants contained in this Lease. Landlord may collect and receive rent due from Tenant without waiving or affecting any rights or remedies that Landlord may have at law or in equity or by virtue of this Lease at the time of such payment. Institution of a forcible detainer action to re-enter the Promises shall not be construed to be an election by Landlord to terminate this Lease.

**12.2 Successors**. This Lease shall be binding upon and inure to the benefit of Landlord and Tenant and their respective heirs, personal representatives, successors and assigns.

**12.3 Notices**. Whenever this Lease requires or permits any consent, approval, notice, request or demand from one party to the other (collectively, "Notice"), such Notice must be in writing and shall be effective on the date of actual receipt of such Notice by the addressee or when the attempted initial delivery is refused or when it cannot be made because of a change in address of which the sending party has not been notified. The following shall, without limitation, be prima facia evidence of actual receipt of Notice by the addressee: (a) if mailed, by a United States certified mail return receipt, signed by the addressee or the addressee's agent or representative, (b) if by a nationally-recognized overnight courier, by a receipt from the courier evidencing delivery, or (c) if hand delivered, by a delivery receipt signed by the addressee or the addressee's agent or representative. The parties' respective addresses for delivery of any Notice shall be as set forth on page 1 of this Lease, or to such other address as any party may have designated by Notice to the other.

**12.4 Corporate Authority**. If Tenant executes this Lease as a corporation, or a partnership (general or limited) or other entity, Tenant and each person executing this Lease on behalf of Tenant hereby personally

represents and warrants that: Tenant is a duly authorized and existing corporation or partnership (general or limited) or other entity as provided herein; Tenant is qualified to do business in the state in which the Premises are located, the corporation or partnership (general or limited) or other entity as provided herein has full right and authority to enter into this Lease; each person signing on behalf of the corporation or partnership (general or limited) or other entity as provided herein is authorized to do so; and the execution and delivery of the Lease by Tenant will not result in any breach of, or constitute a default under any mortgage, deed of trust, lease, loan, credit agreement, partnership agreement, or other contract or instrument to which Tenant is a party or by which Tenant may be bound.

**12.5 Multiple Tenants**. If this Lease is executed by more than one person or entity as "Tenant", each such person or entity shall be jointly and severally liable hereunder. It is expressly understood that any one of the named Tenants shall be empowered to execute any modification, amendment, exhibit, floor plan, or other document herein referred to and bind all of the named Tenants thereto; and Landlord shall be entitled to rely on same to the extent as if all of the named Tenants had executed same.

**12.6 Broker Indemnification**. Landlord represents and warrants to Tenant that no broker or agent engaged or contacted by Landlord either negotiated or was instrumental in negotiating or consummating this Lease other than the Landlord Broker, who shall be paid pursuant to a separate written agreement between Landlord and Landlord Broker, and Landlord agrees to indemnify Tenant against any loss, expense (including reasonable attorneys' fees and costs), cost or liability incurred by Tenant as a result of Claims by any broker or finder other than the Landlord Broker. Tenant represents and warrants to the Landlord that no broker or agent engaged or contacted by Tenant either negotiated or was instrumental in negotiating or consummating this Lease other than the Tenant Broker, and Tenant agrees to indemnify Landlord against any loss, expense (including reasonable attorneys' fees and costs), cost or liability incurred by Landlord as a result of Claims by any broker or finder other than the Tenant Broker contracted by or attributed to Tenant. Tenant Broker shall be paid by Landlord Broker and Tenant Broker shall look solely to Tenant or Landlord Broker for compensation and Landlord shall have no liability to Tenant Broker for any commission, finder's fee or other compensation resulting from the negotiation or consummation of this Lease.

**12.7 Interpretation**. The captions appearing in this Lease are for convenience only and in no way define, limit, construe or describe the scope of intent of any Section. Grammatical changes required to make the provisions of this Lease apply (a) in the plural sense where there is more than one tenant, and (b) to either corporations, associations, partnerships or individuals, males or females, shall in all instances be assumed as though in each case fully expressed. The laws of the state where the property is located shall govern the validity, performance and enforcement of this Lease. This Lease shall not be construed more or less favorably with respect to either party as a consequence of the Lease or various provisions hereof having been drafted by one of the parties hereto.

**12.8 Rent Tax**. Tenant shall pay and be liable for all rental, sales and use taxes or other similar taxes (not including income tax levied against Landlord as a result of the receipt of payments under this Lease), if any, levied or imposed by any city, state, county or other governmental body having authority, such payments to be in addition to all other payments required to be paid to Landlord by Tenant under the terms of this Lease. Any such payment shall be paid concurrently with the payment of the rent, additional rent, or other charge upon which the tax is based as set forth above.

**12.9 Severability**. If any provision of this Lease or the application thereof to any person or circumstances shall be invalid or unenforceable to any extent, the remainder of this Lease and the application of such provisions to other persons or circumstances shall not be affected thereby and shall be enforced to the greatest extent permitted by law. Each covenant and agreement contained in this Lease shall be construed to be a separate and independent covenant and agreement, and the breach of any such covenant or agreement by Landlord shall not discharge or relieve Tenant from Tenant's obligation to perform each and every covenant and agreement of this Lease to be performed by Tenant.

**12.10 Landlord's Liability**. The liability of Landlord for any breach or default by Landlord under the terms of this Lease, or otherwise for whatever reason regarding this Lease or the Property, whether such liability is in contract, tort or otherwise, shall, in each instance, be limited to the interest of Landlord in the Property, and Tenant agrees to look solely to Landlord's interest in the Property as the same may then be encumbered, for the recovery of any judgment against Landlord, it being intended and agreed that neither Landlord nor, in any event, any person or entity comprising, owning or affiliated with Landlord, or any of the partners, shareholders, directors, officers, employees and representatives of Landlord or any such person or entity, shall ever be personally liable for any judgment or deficiency.

**12.11 Sale of Property**. Upon any conveyance, sale or exchange of the Premises or assignment of this Lease and provided the successor Landlord becomes liable for the obligations of "Landlord" herein, Landlord shall be and is hereby entirely free and relieved of all liability under any and all of its covenants and obligations contained in or derived from this Lease arising out of any act, occurrence, or omission relating to the Premises or this Lease occurring after the consummation of such sale or exchange and assignment.

**12.12 Time is of the Essence**. The timely performance of all of the covenants, conditions and agreements of this Lease is of the essence.

**12.13 Security**. Tenant acknowledges that one or more tenants in the Property, because such tenant(s) is a national bank, has or may have guards or other security personnel or security systems. Such guards, security personnel and security systems are for such tenant's sole benefit. Landlord has no obligation to continue providing same and Landlord may make such changes in the provision thereof from time to time, as Landlord may desire. Tenant acknowledges that Tenant has no right to the benefit of such security personnel, guards or security systems, and Tenant waives all claims against Landlord, its agents and/or employees based on or related to any failure to furnish security services, failure to furnish protection from crime or related matters.

**12.14 Exhibits/Riders**. All exhibits/riders to this Lease are attached hereto and incorporated herein by this reference.

**12.15 Waiver of Jury Trial**. The parties waive trial by jury in any action or proceeding to which they may be parties arising out of, in connection with, or in any way pertaining to this Lease. It is agreed and understood that this waiver constitutes a waiver of trial by jury of all claims against all parties to such actions or proceedings, including, claims against parties who are not parties to this Lease. This waiver is knowingly, willingly and voluntarily made by Tenant and Tenant hereby represents that no representations of fact or opinion have been made by any individual to induce this waiver of trial by jury or to in any way modify or nullify its effect. Tenant further represents that it has been represented in the signing of this Lease and in the making of this waiver by independent legal counsel, or has had the opportunity to be represented by independent legal counsel selected of its own free will, and that it has had the opportunity to discuss this waiver with counsel.

**12.16 Relocation**. Landlord may take possession of the Premises and require Tenant to move therefrom to other comparable space (which shall contain no less rentable square footage than the Premises and which shall not result in an increase in Base Rent or in Tenant's Proportionate Share even if such comparable space is larger than the Premises) in the Building by giving written notice to the Tenant at least three (3) months in advance of the date on which Landlord intends to relocate Tenant; provided, however, that Landlord shall pay for all reasonable costs of relocating Tenant to such other space, including costs incurred to rewire computers and telecommunications equipment and costs incurred to change Tenant's address. Landlord and Tenant will execute a modification of or supplement to this Lease with respect to and identifying such relocated premises, to be otherwise on terms identical to the terms hereof. The failure of Tenant to relocate in accordance with this Section shall constitute an Event of Default under this Lease and Tenant shall be additionally liable to Landlord for all consequential damages suffered by Landlord as a result thereof.

**12.17 Surrender**. Tenant shall, on the Expiration Date of the Term, or upon any earlier termination of this Lease, or upon any termination of Tenant's right to possess the Premises pursuant to the provisions of this

Lease, well and truly surrender and deliver up the Premises into the possession and use of Landlord, without fraud or delay and in the condition in which Tenant has herein agreed to maintain them, broom clean and free and clear of all lettings, occupancies, liens and encumbrances, other than those existing immediately prior to the commencement of the Term. Any personal property which shall remain on the Premises for ten (10) days after the expiration of the Term or earlier termination of this Lease or Tenant's right to possess the Premises may, at the option of Landlord, be deemed to have been abandoned by Tenant and may be retained by Landlord as Landlord's property or be disposed of, without liability of Landlord, in such manner as Landlord may see fit, or Landlord, at its option, may require Tenant to remove the same at Tenant's expense. In case of such removal, all costs of removal and of repairing any damage to the Premises arising from such removal shall be paid by Tenant upon Landlord's demand. Tenant shall pay to Landlord on demand (a) a reasonable fee for storing and disposing of any such personal property, and (b) all costs and expenses incurred by Landlord in storing and disposing of any such personal property (including, without limitation, counsel fees relating to claims against Landlord by any and all parties claiming interests in such personal property).

**12.18 Confidentiality Clause**. Tenant represents and warrants to Landlord that Tenant shall keep the terms set forth in this Lease in confidence (the "Information") and specifically, Tenant shall not discuss or disclose the Information with any other tenants or persons located in the Building or the Property; however, Tenant may disclose the Information to its officers, directors, shareholders, employees, accountants, attorneys, lenders, prospective subtenants or assignees, and others who may be legally entitled to such Information or to whom Tenant maybe legally required to disclose such Information.

**12.19 Nondiscrimination**. Tenant herein covenants by and for itself, its heirs, executors, administrators, personal representatives, successors and assigns, and all persons claiming under or through it, and this Lease is made and accepted upon and subject to the condition that there shall be no discrimination against or segregation of any person or group of persons on account of race, color, creed, sex, national origin, or ancestry in the leasing, subletting, transferring, use or occupancy of the Premises. Neither Tenant nor any person claiming under or through Tenant shall establish or permit any such practice or practices of discrimination or segregation with reference to the selection, location, number, use, or occupancy of tenants, lessees, subtenants, sublessees, or vendees in or on the Premises.

**12.20 Entire Agreement**. IT IS EXPRESSLY AGREED BY TENANT, AS A MATERIAL CONSIDERATION FOR THE EXECUTION OF THIS LEASE, THAT THIS LEASE, WITH THE SPECIFIC REFERENCES TO EXTRINSIC DOCUMENTS, IS THE ENTIRE AGREEMENT OF THE PARTIES; THAT THERE ARE, AND WERE, NO VERBAL REPRESENTATIONS, WARRANTIES, UNDERSTANDINGS, STIPULATIONS, AGREEMENTS OR PROMISES PERTAINING TO THE SUBJECT MATTER OF THIS LEASE OR OF ANY EXPRESSLY MENTIONED EXTRINSIC DOCUMENTS THAT ARE NOT INCORPORATED IN WRITING IN THIS LEASE. ALL EXHIBITS/RIDERS TO THIS LEASE ARE ATTACHED HERETO AND INCORPORATED HEREIN BY THIS REFERENCE.

**12.21 Amendment**. THIS LEASE MAY NOT BE ALTERED, WAIVED, AMENDED OR EXTENDED EXCEPT BY AN INSTRUMENT IN WRITING SIGNED BY LANDLORD AND TENANT.

**12.22 Limitation of Warranties**. LANDLORD AND TENANT EXPRESSLY AGREE THAT THERE ARE AND SHALL BE NO IMPLIED WARRANTIES OF MERCHANTABILITY, HABITABILITY, FITNESS FOR A PARTICULAR PURPOSE OR OF ANY OTHER KIND ARISING OUT OF THIS LEASE, AND THERE ARE NO WARRANTIES WHICH EXTEND BEYOND THOSE EXPRESSLY SET FORTH IN THIS LEASE. WITHOUT LIMITING THE GENERALITY OF THE FOREGOING, TENANT EXPRESSLY ACKNOWLEDGES THAT LANDLORD HAS MADE NO WARRANTIES OR REPRESENTATIONS CONCERING ANY HAZARDOUS MATERIALS OR OTHER ENVIRONMENTAL MATTERS AFFECTING ANY PART OF THE PROPERTY, AND LANDLORD HEREBY EXPRESSLY DISCLAIMS AND TENANT WAIVES ANY EXPRESS OR IMPLIED WARRANTIES WITH RESPECT TO ANY SUCH MATTERS.

**12.23 Waiver and Releases**. TENANT SHALL NOT HAVE THE RIGHT TO WITHHOLD OR TO OFFSET RENT OR TO TERMINATE THIS LEASE EXCEPT AS EXPRESSLY PROVIDED HEREIN. TENANT WAIVES AND RELEASES ANY AND ALL STATUTORY LIENS AND OFFSET RIGHTS.

**[Remainder of Page Intentionally Blank]**

This Lease is executed by Landlord and Tenant on the respective dates set forth below (the date of signature of the last to sign of the parties hereto is the date of execution of this Lease), but for purposes of identification and reference, the date of this Lease shall be deemed to be the date first set forth on page 1 of this Lease.

**LANDLORD:**

FIRST STATES INVESTORS 3300, LLC
A Delaware limited liability company

EXECUTED ON: July 25, 2007

By: /s/ Glenn Blumenthal
Name: Glenn Blumenthal
Title: Vice President

/s/ [not legible]
Witness

/s/ [not legible]
Witness

**TENANT:**

B/E AEROSPACE, INC
a Delaware corporation

EXECUTED ON: July 16, 2007

By: /s/ Michael B. Baughan
Name: Michael B. Baughan
Title: President & Chief Operating Officer
B/E Aerospace, Inc.

/s/ [not legible]
Witness

/s/ [not legible]
Witness

**EXHIBIT "A"**
**Location of Premises**

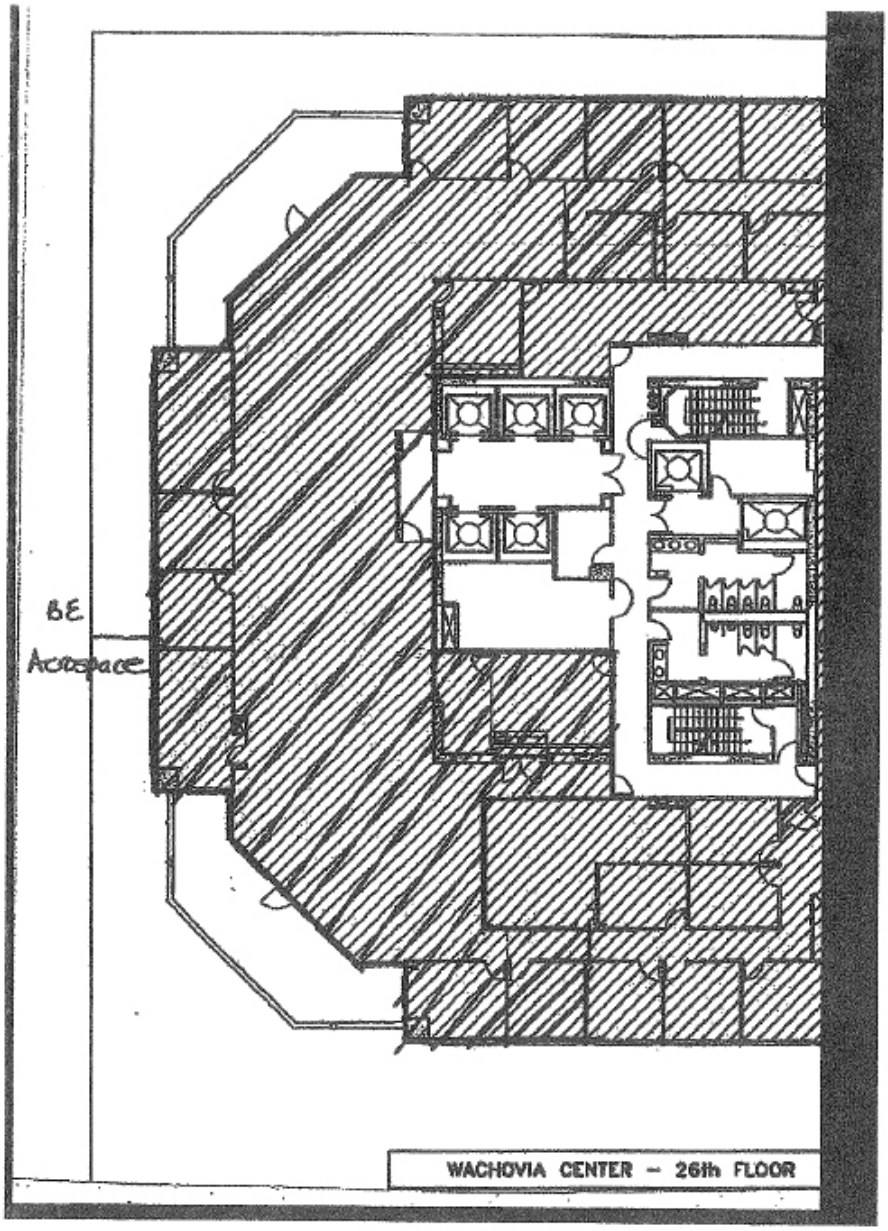


**EXHIBIT "B"**
**Renewal Option Rider**

The following provisions are hereby added to the terms of the Lease. In the event of a conflict between the terms of this Rider and the terms of the Lease, the terms of this Rider shall control. Unless otherwise defined in this Rider, each capitalized term used in this Rider shall have the meaning assigned to it in the Lease. As hereinafter used in this Rider, the term "this Lease" shall mean the Lease, as modified by this Rider.

1. Provided the Lease is still in full force and effect and there is no uncured event of default by Tenant under the Lease beyond any applicable cure period, Tenant shall have the right and option to renew the Lease for one (1) additional two (2) year term (such term being hereinafter called the "Renewal Term"), on the following terms and conditions.

2. The Base Rent (excluding Tenant's share of increases in operating expenses) during each Renewal Term shall be determined as set forth below:

| Beginning | Ending | Base Rent/RSF | Monthly | Annual |
|---|---|---|---|---|
| Month 1 | Month 12 | $ 16.50 | $10,839.13 | $130,069.50 |
| Month 13 | Month 24 | $ 17.00 | $11,167.58 | $134,011.00 |

3. Tenant shall exercise each right and option to renew the term of this Lease by giving Landlord written notice no later than one hundred eighty (180) days prior to the expiration of the primary term or any preceding Renewal Term, as applicable. If Landlord does not receive such notice by such deadline, Tenant shall be deemed to have elected not to exercise such renewal option.

4. The leasing of the Leased Premises by Landlord to Tenant during a Renewal Term shall be upon all terms and conditions set forth in the Lease, except as expressly modified by this Rider, and except that Tenant shall have no further rights to renew the Lease Term. Tenant, if requested by Landlord, agrees to execute a new lease for the Renewal Term(s) on the same terms and conditions set forth in this Lease, except (a) as modified with respect to the Renewal Rate in accordance with the terms of this Rider, (b) that Tenant shall accept the Leased Premises in its then "AS-IS" condition, and (c) that Landlord shall not be required to perform any tenant finish or other work to the Leased Premises, or to provide Tenant any tenant finish allowance or other allowance or inducement with respect to the Leased Premises. At Landlord's request, instead of executing a new lease, as set forth above, the parties shall execute an amendment to the Lease, in form and substance acceptable to Landlord, reflecting the leasing of the Leased Premises for the Renewal Term in accordance with the foregoing.

4. If Tenant fails to properly exercise any renewal option, that renewal option and all subsequent renewal options, if any, shall terminate immediately and Tenant shall have no right to extend the term of this Lease. The renewal option granted herein is personal to the Tenant named in this Lease and may not be transferred or assigned except in connection with an assignment of the Lease approved by Landlord in accordance with the provisions of this Lease.

**EXHIBIT "C"**
**Parking Lot Rider**

The following provisions are hereby added to the terms of the Lease. In the event of a conflict between the terms of this Rider and the terms of the Lease, the terms of this Rider shall control. Unless otherwise defined in this Rider, each capitalized term used in this Rider shall have the meaning assigned to it in the Lease. As hereinafter used in this Rider, the term "this Lease" shall mean the Lease, as modified by this Rider.

1. Landlord hereby grants to Tenant a non-exclusive license to use fourteen (14) available parking spaces (the "Spaces") located in the areas designated from time to time by Landlord for tenant parking. This license is subject to the terms and conditions set forth below. The Spaces are allocated to Tenant in consideration for the lease of the Premises and no fees or charges shall be due and payable by Tenant for these allocated Spaces. Landlord agrees to use reasonable efforts to make additional parking spaces available to Tenant upon Tenant's request on whatever terms and conditions are then applicable for right to use such additional parking spaces.

2. The Spaces shall be used only for the purpose of parking automobiles for a term commencing on the Commencement Date set forth in the Lease and terminating upon the expiration or termination of the Lease for whatever reason.

3. Tenant's rights hereunder do not entitle Tenant to park in any particular Spaces. In addition, Landlord may limit Tenant's use of Spaces if in Landlord's judgment Tenant is overusing or overburdening the parking areas, so that the use of such areas by other tenants or by Landlord's customers or by others using Spaces with Landlord's permission is adversely affected.

4. All automobiles (including all contents thereof) shall be parked in the Spaces at the sole risk of Tenant, its employees, agents, invites and licensees. Landlord has no duty to insure any automobiles (including the contents thereof), and Landlord is not responsible for the protection and security of such automobiles. Landlord shall have no liability whatsoever for any property damage and/or personal injury which might occur as a result of or in connection with the parking of said automobiles in any of the Spaces, and Tenant hereby agrees to indemnify and hold Landlord harmless from and against any and all liabilities, costs, claims, expenses, and/or causes of action which Landlord may incur in connection with or arising out of the use of the Spaces by Tenant or its employees, agents, invitees, or licensees pursuant to this Lease.

5. Landlord will not be liable to Tenant or any of its employees for any unauthorized automobile parking in any Spaces. Landlord reserves the right to charge for use of parking areas (but not as to the spaces allocated to Tenant's use) to establish reserved parking areas and to assign designated parking Spaces therein for exclusive use by specified tenants, to establish any sticker or other identification system, to relocate any parking areas or Spaces from time to time, to alter, reduce or modify any parking areas, to use portions of the parking areas for free, visitor, or other parking needs of Landlord and to take any other actions regarding the parking areas.

6. This Rider shall not create a bailment between the parties hereto. The only relationship created between Landlord and Tenant regarding the Spaces is that of licensor and licensee, respectively.

7. In its use of the Spaces, Tenant shall follow all of the rules and regulations of the Building applicable thereto, as the same may be amended from time to time. Upon the occurrence of any breach of such rules, any failure to pay when due all monthly rental fees due hereunder or any default by Tenant under the Lease, Landlord shall be entitled to terminate the license given hereby, by written notice to Tenant, in which event Tenant's right to utilize the Spaces shall thereupon automatically cease.

8. Tenant shall be responsible for ensuring that its employees and agents do not park their cars in visitor parking spaces or in parking spaces or areas, if any, reserved or designated by Landlord for the use of other

tenants or for other purposes. Tenant agrees to furnish to Landlord the state automobile license numbers of automobiles of Tenant and its employees who will occupy Spaces from time to time within five (5) days from its receipt of written notice from Landlord requesting such information. Landlord shall be entitled to utilize whatever security device Landlord deems necessary (including but not limited to the issuance of parking stickers or access cards), to insure that only those tenants entitled to use Spaces in the designated parking areas are using such Spaces. If Tenant, its agents or employees wrongfully park in any of the parking areas or Spaces designated for the use of others, then Landlord shall be entitled and is hereby authorized to have any such automobile towed away, at Tenant’s sole risk and expense, and Landlord is further authorized to impose upon Tenant an administrative fee of $25 far each such occurrence. Tenant hereby agrees to pay all amounts falling due hereunder upon demand therefor.

**EXHIBIT "D"**
**Right of First Refusal (Lease) Rider**

The following provisions are hereby added to the terms of the Lease. In the event of a conflict between the terms of this Rider and the terms of the Lease, the terms of this Rider shall control. Unless otherwise defined in this Rider, each capitalized term used in this Rider shall have the meaning assigned to it in the Lease. As hereinafter used in this Rider, the term "this Lease" shall mean the Lease, as modified by this Rider.

1. Grant of Right. Provided the Lease is still in full force and effect and there is no uncured event of default by Tenant under the Lease beyond any applicable cure period at the time the offer is to be made and at the time Tenant exercises its rights hereunder, Tenant shall have a right of first refusal ("First Refusal Right"), in accordance with the terms set forth below, to lease space adjacent to the Leased Premises on the twenty-sixth floor of the Building (each such space, the "Additional Premises").

2. Right of First Refusal. Subject to the rights of existing tenants, if during the Term of this Lease, Landlord desires to lease any Additional Premises space to a third party tenant that is not an affiliate of Landlord, Landlord shall so notify Tenant in writing ("Offer Notice"), specifying the intended term, rental rate and other significant terms upon which such rental shall occur. If Tenant desires to lease the Additional Premises on the same terms and conditions in the Offer Notice, Tenant shall so notify Landlord in writing within fifteen (15) business days following Tenant's receipt of the Offer Notice. In such event, Landlord and Tenant shall enter into an amendment to this Lease, incorporating the Additional Space under such terms and conditions (provided, however, that the rent applicable to such Additional Premises shall be the lesser of the prevailing rental rate under this Lease or the rental rate set forth in the Offer Notice and the Additional Space shall be added under this Lease for the remaining portion of the Term of this Lease plus any Renewal Option). If Tenant does not so agree to lease the Additional Premises within said fifteen (15) business day period, at any time thereafter Landlord shall be free to lease the offered Additional Premises free and clear of Tenant's rights under this Rider on terms and conditions substantially the same as those offered to Tenant, provided that if Landlord shall not lease the Additional Premises within one year following the date of the Offer Notice without, in such case, sending a new Notice to Tenant, in which event Tenant shall have a further period of fifteen (15) business days following Tenant's receipt of the new Offer Notice to lease the offered Additional Premises.

3. Limitations. Notwithstanding the foregoing, in no event shall the rights granted herein to Tenant be available if Tenant has less than twelve (12) consecutive months remaining on its then current Term, unless (i) Tenant exercises an available Renewal Option in connection with the taking of the Additional Premises, or (ii) in the event Tenant has no remaining Renewal Options, Landlord and Landlord come to agreement to extend the Team Lease for a mutually agreeable time period.

4. Assignment. The Right of First Refusal granted herein is personal to the Tenant named in this Lease and may not be transferred or assigned except in connection with an assignment of the Lease approved by Landlord in accordance with the provisions of this Lease.

**EXHIBIT "E"**
**Leasehold Improvements Rider**

The following provisions are hereby added to the terms of the Lease. In the event of a conflict between the terms of this Rider and the terms of the Lease, the terms of this Rider shall control. Unless otherwise defined in this Rider, each capitalized term used in this Rider shall have the meaning assigned to it in the Lease. As hereinafter used in this Rider, the term "this Lease" shall mean the Lease, as modified by this Rider.

1. Description of Improvements. Landlord shall at its expense perform certain work (the "Work") to make the Premises ready for Tenant's occupancy. The Work shall consist of the following (check applicable items; items that are not checked are not part of the Work):

1) Construction of such portions of a demising wall in order to separate Tenant's Premises from the surrounding premises.

2. Budget. If applicable, in connection with the Work, Landlord shall prepare and the parties shall initial a final budget for the Work (the "Budget"). After the Budget has been initialed by both parties, the Budget shall be attached to this Rider and form a part hereof. The Budget shall be on a form designated by Landlord and shall list the major cost items involved in such Work and the cost allocated to each such item, with a total cost indicated for all items. However, if the Budget is not so initialed or so attached, that shall not impair or release Tenant from any of Tenant's obligations herein or otherwise adversely affect Landlord's rights herein.

3. Completion of the Work. Landlord shall use commercially reasonable efforts to complete the Work within thirty (30) days after the Commencement Date. However, notwithstanding any other provisions hereof or of the Lease, Landlord shall not be liable for any claims or damages by reason thereof for failing to complete the Work within thirty (30) days after the Commencement Date. Until such demising walls have been completed by Landlord, Landlord agrees to limit access to the floor on which the Premises is located to Tenant, its employees and invitees so that no other tenant or licensee shall occupy or have access to the remaining portion of the floor on which the Premises is located.

4. Changes. Landlord's obligation to prepare the Premises for Tenant's occupancy is limited to the completion of the Work. Landlord shall not be required to furnish, construct or install any items not listed above. If there are any changes to the Work that are specifically agreed to by Landlord in writing ("Changes"), then the Budget shall be revised to take into account any changes in the cost of performing the Work, the revised Budget shall be initialed by the parties and Landlord shall perform such additional Work and Tenant shall pay or reimburse Landlord for the costs of such Changes within fifteen (15) days after billing. However, if the revised Budget is not so initialed or so attached, that shall not impair or release Tenant from any of Tenant's obligations herein or otherwise adversely affect Landlord's rights herein. Any delay caused by Tenant's request for any Changes or from the construction of any changes shall not, in any event, delay the Commencement Date, which shall occur on the date it would have occurred but for such Changes. The Work shall be the property of Landlord and shall remain upon and be surrendered with the Premises upon the expiration of the Term.

5. Consequential Damages. Nothing contained in this Rider shall render Landlord liable to Tenant for consequential damages arising out of any breach or default under this Rider, including, without limitation loss of use or income from the Building or the Premises or any equipment or facilities therein, whether by Tenant or any person claiming through or under Tenant.

6. Letter of Acceptance. After substantial completion of the Work, Tenant shall sign an Acceptance of Premises memorandum in the form to be prepared by Landlord.

7. Landlord's Liability. If Landlord shall be in default under this Rider and, if as a consequence of such default, Tenant shall recover a money judgment against Landlord, such judgment shall be satisfied only out

of the right, title, and interest of Landlord in the Property as the same may then be encumbered and neither Landlord nor any person or entity comprising Landlord shall be liable for any deficiency. In no event shall Tenant have the right to levy execution against any property of Landlord nor any person or entity comprising Landlord other than its interest in the Property as herein expressly provided. In addition, no sum payable to Tenant as the result of any breach or default by Landlord under this Rider shall be deducted from or offset against any rent or other sums payable under the Lease, and no such beach or default by Landlord under this Rider shall be the subject of a defense or counterclaim in any action or proceeding brought by Landlord to enforce its rights under the Lease or excuse Tenant from the performance of any of its obligations under the Lease or relieve Tenant of any of its liabilities thereunder.

**FIRST AMENDMENT TO LEASE**

**THIS FIRST AMENDMENT TO LEASE** (this "Amendment") is made as of the 8th day of Oct., 2010 (the "Effective Date"), by and between **SL WINSTON-SALEM LLC**, a Delaware limited liability company with offices at 601 West 26th Street, Suite 1260, New York, New York 10001 ("Landlord"), and **BE AEROSPACE, INC.**, a Delaware corporation having an office at 100 Main Street, Suite 2600, Winston-Salem, North Carolina 27101 ("Tenant").

**W I T N E S S E T H :**

Landlord and Tenant are, respectively, the current landlord and the current tenant under that certain Office Lease Agreement dated as of July 16, 2007 (the "Original Lease") between First States Investors 3300, LLC (Landlord's predecessor-in-interest), as landlord, and Tenant covering Suite 2600 on the 26th Floor of the building located at 100 Main Street, Winston-Salem, North Carolina (the "Building"), which premises (the "Original Premises") are shown on Exhibit A to the Original Lease and have an agreed-upon area of 7,883 rentable square feet (which agreed-upon area shall not be subject to re-measurement or adjustment).

Landlord and Tenant wish to modify the Lease so as (i) to relocate the Premises to a portion of the Fifteenth (15th) Floor of the Building, having an agreed-upon area of 14,254 rentable square feet (which agreed-upon area shall not be subject to re-measurement or adjustment), and generally depicted on Exhibit A attached hereto and incorporated herein; (ii) to extend the Term of the Lease as to the Premises; (iii) to surrender the Original Premises; and (iv) to make various other modifications thereto, all in accordance with the terms and conditions set forth in this Amendment.

**NOW, THEREFORE**, for and in consideration of the mutual covenants and agreements herein contained, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto hereby agree to the following terms set forth in this Amendment.

1. **New Space**. As of the Effective Date, the Lease shall be amended as follows:

"New Space. (i) Landlord hereby leases to Tenant, and Tenant hereby leases from Landlord, a portion of the 15th Floor of the Building known as Suites 1510, 1525 and 1575, and described on Exhibit A hereto (the "15th Floor Space") on the same terms and conditions (except as otherwise set forth in this Amendment) as are set forth in the Lease applicable to Original Premises; (ii) the term "demised premises" or "Premises" as set forth in the Lease shall be deemed to collectively mean the Original Premises and the 15th Floor Space, until such time as Tenant surrenders to Landlord possession of the Original Premises, as provided for below, after which the term Premises shall mean only the 15th Floor Space; and (iii) Tenant shall not be required to pay Base Rent or Tenant's Proportionate Share of Operating Expenses for the 15th Floor Space until the Rent Commencement Date defined below. Tenant may take possession of the 15th Floor Space as of the Effective Date."

2. **Extension of Term**. Anything contained in the Lease to the contrary notwithstanding, the Term (as to the 15th Floor Space) is hereby extended to December 31, 2015. For the sake of certainty, Landlord and Tenant acknowledge and agree that (i) the Term of the Lease as to the Original Premises is hereby extended until the Rent Commencement Date; and (ii) all references in the Lease to the term "Expiration Date" shall mean December 31, 2015.

3. **Rent Commencement Date**. The Rent Commencement Date shall be January 1, 2011. If the Tenant's Initial Installations (defined below) are completed in accordance with applicable law by December 1, 2010, and all necessary permits have been obtained and all necessary paperwork has been timely submitted to the appropriate governmental agency in connection with such work, and if through no fault or delay by Tenant the City of Winston-Salem fails to issue a certificate of occupancy for the 15th Floor Space, and as a result,

Tenant cannot and does not take occupancy of the 15th Floor Space on or before January 1, 2011, the Rent Commencement Date shall be extended to the earlier of (i) the date the City of Winston-Salem issues a certificate of occupancy for the 15th Floor Space, or (ii) the date Tenant occupies the 15th Floor Space for the operation of its business.

4. **Surrender of the Original Premises**. Landlord and Tenant hereby agree that on or before the Rent Commencement Date, Tenant shall give, grant and surrender unto Landlord and Landlord shall accept such grant and surrender of, all of Tenant's right, title, property, claim, term of years and interest in the Original Premises with the same force and effect as if such date were the date initially set forth in the Lease as the Expiration Date, time being of the essence as to Tenant's obligation so to do. Tenant shall surrender and deliver vacant possession of the Original Premises, in broom clean condition, free and clear of all tenants, subtenants, other occupants, leases, subleases and rights of possession. Upon delivery to Landlord of the Original Premises by the Rent Commencement Date in accordance herewith, Tenant shall be relieved of all liabilities and obligations under the Lease accruing with respect to said space from and after the Rent Commencement Date. Notwithstanding the foregoing to the contrary, during the ten (10) day period commencing on the Rent Commencement Date, Tenant Will be allowed to occupy both the Original Premises and the 15th Floor Space in order to effect a smooth relocation to the 15th Floor Space and to minimize the impact on the Tenant's operation of its business. During this ten (10) day transition period, Tenant will pay rent for the 15th Floor Space only, and no rent will be paid for the Original Space. In connection with the surrender of the Original Premises, Tenant hereby covenants that nothing has been or will be done or suffered whereby the leasehold estate granted in the Original Premises or any part thereof, including the alterations, decorations, installations, additions and improvements have been or will be assigned, encumbered or subleased in any way whatsoever; and that Tenant has and will have good and unencumbered right to surrender the same.

5. **Obligations Applicable to the Original Premises**. Anything contained in the Lease to the contrary notwithstanding, there shall be no further reconciliation between Landlord and Tenant of Tenant's Proportionate Share of Operating Expenses for the Original Premises in respect of any period on or prior to January 1, 2010 and Landlord and Tenant each waive any entitlement to any payment, refund or credit Landlord or Tenant might have been due by reason of such reconciliation.

6. **Base Rent for the Original Premises and the 15th Floor Space from the Effective Date through the Expiration Date**. During the period from the Effective Date through and including the earlier of (i) December 31, 2010, and (ii) the Rent Commencement Date, Tenant shall continue to pay Base Rent and Additional Rent for the Original Premises at the rates set forth in Article I of the Lease, and not at the holdover rate set forth in Section 2.7 of the Lease; Landlord agreeing that in connection with Tenant remaining in the Original Premises beyond August 1, 2010, and in consideration of Tenant signing this Amendment, Landlord shall not collect the holdover rent described in Section 2.7 of the Lease. If Tenant remains in possession of the Original Premises beyond December 31, 2010, the Base Rent for the Original Premises shall be $10,510.67 for the month of January 2011. Commencing on February 1, 2011 and each month thereafter that Tenant fails to surrender to Landlord vacant possession of the Original Premises, free and clear of all occupants and subtenants, the Base Rent for the Original Premises shall be $21,000.00 per month, provided that Landlord agrees to extend the February 1, 2011 date by one day for each one day that the Rent Commencement Date is extended pursuant to paragraph 3 above. During the period from the Rent Commencement Date through and including the Expiration Date, Tenant shall pay Base Rent for the 15th Floor Space in the amounts and at the rates set forth below:

| Time Period | Monthly Fixed Rent | Fixed Rent Rate per Annum |
|---|---|---|
| Rent Commencement Date through December 31, 2013 | $20,014.99 | $240,179.90 |
| January 1, 2014 - December 31, 2014 | $20,515.37 | $246,184.40 |
| January 1, 2015 - December 31, 2015 | $21,028.25 | $252,339.01 |

7. **Operating Expense Escalation**. From and after the Effective Date, through the Rent Commencement Date, Tenant shall continue to pay additional rent for the Original Premises, including Tenant's Proportionate Share of the excess of Operating Expenses pursuant to Article 2 of the Lease. From and after the Rent Commencement Date, Tenant shall be obligated to pay Tenant's Proportionate Share of the excess of Operating Expenses for the 15th Floor Space pursuant to Article 2 of the Lease. For the purpose of calculating Tenant's additional rent obligations under Article 2 of the Lease from and after the Rent Commencement Date for the 15th Floor Space, the following provisions shall apply: (i) "Base Year" shall mean, the calendar year 2010; and (ii) the term "Tenant's Proportionate Share" shall mean, with respect to the 15th Floor Space, 2.61%.

8. **Renewal Option**. (a) Exhibit B "Renewal Option Rider" of the Lease is hereby deleted in its entirety and replaced with the following language:

"**Tenant's Renewal Option**. Tenant shall have the right, at its option (referred to herein as the "**Renewal Option**"), to renew the initial term of this Lease, for the entire Premises as then constituted, for one renewal term of five (5) years (referred to herein as the "**Renewal Term**"), which shall commence on January 1, 2016 (the "**Renewal Term Commencement Date**") and expire on December 31, 2020 (the "**Renewal Term Expiration Date**"). Except for the Renewal Option, Tenant shall have no other right to extend or renew the Term of the Lease. Tenant shall have no right to exercise the Renewal Option unless all of the following conditions have been satisfied on the date of the Renewal Notice (as hereinafter defined) and on the Renewal Term Commencement Date:

(i) No Event of Default shall have occurred and be continuing beyond any applicable cure and grace periods; and

(ii) The named Tenant hereunder (or a permitted assignee, successor or transferee pursuant to Section 9.1 of the Lease, but not any other assignee or successor tenant), and its Affiliates shall occupy 100% of the then-existing Premises."

(b) If Tenant elects to renew this Lease for the Renewal Term, Tenant shall exercise such Renewal Option by sending to Landlord written notice thereof (a "Renewal Notice"), by certified mail, return receipt requested, or by reputable overnight courier, no later than July 31, 2015, and time shall be of the essence with respect to the giving of the Renewal Notice. If Tenant shall send the Renewal Notice within the time and in the manner herein provided, this Lease shall be deemed renewed for the Renewal Term upon the terms, covenants and conditions in this Lease contained, with the exception of (a) the Base Rent and rent credit and (b) the Premises shall be leased for such Renewal Term in "as is, where is" condition, without any obligation on the part of Landlord to perform any work or to make any improvements in or to the Premises or the Building, except as otherwise obligated under the Lease. Tenant acknowledges that the terms and provisions of the Lease during the Renewal Term shall: (i) not include a rent credit or Landlord's work contribution or any other free rent, rent abatement or Landlord's work allowance, contribution or other inducement; (ii) include Base Rent at the rates set forth below; and (iii) be a lease of the entire Premises as then constituted for the Renewal Term in an "as is, where is" condition. The Base Year for Operating Expenses shall not be deemed modified during the Renewal Term from the definitions set forth in this Lease for the purpose of calculating Tenant's Proportionate Share of Operating Expenses.

***Time is of the essence with respect to the terms and provisions of this Article.***

(c) Base Rent for the Renewal Term shall be as follows:

| Time Period | Monthly Fixed Rent | Fixed Rent Rate per Annum |
|---|---|---|
| January 1, 2016 - December 31, 2016 | $21,553.96 | $258,647.48 |
| January 1, 2017 - December 31, 2017 | $22,092.81 | $265,113.67 |
| January 1, 2018 - December 31, 2018 | $22,645.13 | $271,741.51 |
| January 1, 2019 - December 31, 2019 | $23,211.25 | $278,535.05 |
| January 1, 2020 - December 31, 2020 | $23,791.54 | $285,498.43 |

9. **No Rent Abatement**. Tenant shall not be entitled to any, free rent or rent abatement in connection with the extension of the Term, the leasing of the 15th Floor Space and/or this Amendment, except that Tenant shall not be obligated to pay Base Rent for the 15th Floor Space if it completes its work or moves into said 15th Floor Space prior to the Rent Commencement Date.

10. **Brokers**. Landlord and Tenant represent and warrant to the other that it neither consulted nor negotiated with any broker or finder with respect to this Amendment, or Tenant's lease of the 15th Floor Space or the extension of the Term pursuant to the terms hereof other than Triad Commercial Properties ("Broker"), whose commission in connection with this Amendment shall be paid by Landlord pursuant to Landlord's separate agreement(s) with Broker. Landlord and Tenant each agree to indemnify, defend and save the other harmless from and against any and all liability, damages, settlement payments, costs and expenses (including, without limitation, reasonable legal fees and disbursements incurred in defending any claim or action or in enforcing this indemnity), incurred by the other party as a result of or in connection with any claim, demand or action for fees or commissions from anyone other than Broker with which the indemnifying party has dealt or retained in connection with this Amendment or Tenant's lease of the 15th Floor Space or the extension of the Term.

11. **Prior Negotiations**. This Amendment supersedes all prior negotiations, representations, understandings and agreements of, by or between Landlord and Tenant with respect to the subject matter hereof, all of which shall be deemed fully merged herein,

12. **Conflicting Terms**. If the terms of the Lease conflict or are inconsistent with those of this Amendment, then the terms of this Amendment will control.

13. **Submission of Amendment**. Submission of this Amendment by Landlord to Tenant for examination and/or execution shall not in any manner bind Landlord, and no obligation or liability on Landlord shall arise under this Amendment unless and until this Amendment is fully signed and delivered by Landlord and Tenant.

14. **Miscellaneous**.

(a) This Amendment shall be binding upon and inure to the benefit of the parties hereto and their respective legal representatives, successors and permitted assigns.

(b) Landlord and Tenant agree that this Amendment shall not be recorded.

(c) This Amendment, together with the Lease, constitutes the entire agreement of the parties hereto with respect to the matters stated herein, and may not be amended or modified unless such amendment or modification shall be in writing and shall have been signed by the party against whom enforcement is sought.

(d) This Amendment shall be construed and governed by the laws of the State of North Carolina.

(e) No waiver by either party of any failure or refusal by the other party to comply with its obligations hereunder shall be deemed a waiver of any other or subsequent failure or refusal to so comply.

(f) Capitalized terms used but not otherwise defined in this Amendment shall have the meanings ascribed to them in the Lease.

15. **Invalidity**. If any provision of this Amendment shall be invalid or unenforceable, the remainder of this Amendment or the application of such provision other than to the extent that it is invalid or unenforceable shall not be affected, and each provision of this Amendment shall remain in full force and effect notwithstanding the invalidity or unenforceability of such provision, but only to the extent that application and/or enforcement, as the case may be, would be equitable and consistent with the intent of the parties in entering into this Amendment.

16. **Tenant's Representations and Warranties**. Tenant represents and warrants that: (a) the Lease is in full force and effect; (b) the Lease has not been assigned or encumbered by Tenant and the Premises have not been sublet in whole or in part; (c) Tenant has no defense or counterclaim to the enforcement of the Lease, as amended hereby; (d) Landlord is not in default under any of its obligations under the Lease; (e) to Tenant's actual knowledge, Tenant is not in default under any of its obligations under the Lease; and (f) the person executing this Amendment on behalf of Tenant is duly authorized to do so by all necessary action and this Amendment is enforceable against Tenant in accordance with its terms.

17. **Landlord's Representations and Warranties**. Landlord represents and warrants that: (a) the Lease is in full force and effect; (b) Landlord has not served Tenant with a notice alleging defaults of Tenant's Lease obligations which remain uncured, and Landlord is not

aware of any default by Tenant in its obligation to pay Base Rent or Additional Rent; (c) the person executing this Amendment on behalf of Landlord is duly authorized to do so by all necessary action, and this Amendment is enforceable against Landlord in accordance with its terms; (d) the execution of this Amendment by Landlord is conditioned upon obtaining consent of the holder of the mortgage on the Building; (e) there are no pending claims or disputes involving Landlord or the 15th Floor Space which could materially affect the rights and obligations of the parties to the Lease; (f) the Certificate of Occupancy for the Building permits the Premises to be used for the Permitted Uses; and (g) Landlord has received no written notice from any governmental authorities that there are violations against the Building which would prevent Tenant from obtaining its work permits or sign-offs for Tenant's Initial Installations (defined below) to the 15th Floor Space.

18. **HVAC for the Server Room**. Landlord agrees that Tenant may use the heating, ventilation and air conditioning system ("HVAC") serving the computer server room located in the 15th Floor Space. Landlord makes no representation or warranty that the HVAC is in good working order and not subject to any deferred maintenance. Tenant will solely be responsible for the maintenance, repair and replacement of the HVAC. In the event that the HVAC is required to be repaired or replaced, and Tenant elects to so repair or replace the HVAC, Tenant will do so at its sole cost and expenses. Tenant shall have no restoration or repair obligation at the end of the Lease term, with regard to the HVAC serving the computer server room.

19. **Parking Space**. Tenant shall continue to have the right to use the Parking Space described in the Parking Lot Rider. Additionally, Tenant can sublet parking spaces from Wells Fargo on a month-to-month basis at the current monthly rates of $50.00 for an unreserved space, and $75.00 for a reserved space in the remote deck, and $110.00 per space below the Building.

20. **Notices**. In Article I of the Lease, the "Landlord's Notice Address" is deleted in its entirety and replaced instead with the following:

SL WINSTON-SALEM LLC
601 West 26th Street, Suite 1260
New York, New York 10001

with a required copy to:
TRIAD COMMERCIAL PROPERTY MANAGEMENT, AGENT
PO Box 49579
Greensboro, North Carolina 27419

and with a required copy to:
GERSTEIN STRAUSS & RINALDI
57 West 38th Street, 9th Floor
New York, New York 10018
Attn: Victor Gerstein, Esq.

21. **Operating Expenses**. The term "Operating Expense" as used herein specifically excludes the following items, in addition to those items excluded in paragraph 2.4 of the Lease:

(a) expenditures deemed by accepted accounting principles to be of a capital nature (except for capital improvements made which will result in savings of Operating Expenses or are made in order to comply with law not in existence on the Effective Date, or which are included in Operating Expenses pursuant to Paragraph 2.4, the cost of which will be amortized as an Operating Expense on a straight-line basis over the useful life of the improvement, in accordance with generally accepted accounting principles);

(b) non-cash items, such as deductions for depreciation, or obsolescence of the Building and the Building equipment;

(c) the cost of repairs or replacements incurred by reason of fire or casualty, or eminent domain to the extent Landlord is compensated by insurance proceeds or condemnation awards;

(d) items peculiar to one tenant for which Landlord has been reimbursed by that tenant;

(e) executives' salaries above the grade of regional Building manager and regional Building engineer, and their bonuses and other direct compensation and fringe benefits;

(f) Landlord's contribution or any funds or money given to tenants (including Tenant) of the Building on account of work to ready a leased space for occupancy, or work done for other tenants in the Building connection with the leasing of space in the Building;

(g) franchise, gross receipts, unincorporated business, inheritance, foreign ownership or control or income tax imposed upon Landlord;

(h) attorneys' fees, appraisals, accounting fees, and other charges incurred in connection with the sale, financing or refinancing of the Building;

(i) the cost of any work or service provided for another tenant at that tenant's sole cost and expense;

(j) costs reimbursed by landlord's insurance;

(k) costs of employees for time devoted to properties other than the Land and the Building and parking structure;

(l) attorneys' fees and disbursements and other costs in connection with any judgment, settlement or arbitration resulting from a tort liability arising out of the negligence of Landlord and the amount of such settlement or judgment;

(m) costs incurred in connection with the removal, enclosure or encapsulation of any asbestos or other hazardous materials existing in the Building on the Effective date, provided Tenant or its agents did not introduce such asbestos or hazardous materials into the Building, except for costs incurred for monitoring on an on-going basis the presence of asbestos in the Building as part of a customary air monitoring program;

(n) any costs incurred in buying out or relocating existing tenancies;

(o) any costs incurred in respect of or for the benefit of any other property;

(p) fines or penalties payable by Landlord resulting from Landlord negligently failing to comply with laws; and

(q) the cost of electricity furnished to the Premises or any other space in the Building where tenants pay for, or reimburse Landlord for, the cost of electricity used.

22. **Compliance**. Section 3.3 of the Lease is clarified to provide that Tenant is responsible for compliance with all federal, state, county and municipal laws and ordinances and all rules, regulations and orders of any duly constituted authority, present or future, which are directly related to the nature or manner of use and occupancy of the Premises and the carrying on of Tenant's business in the Premises, as distinguished from the mere use and occupancy of the Premises. If compliance with the foregoing covenant requires any changes to the Premises that would be required regardless of the nature or manner of Tenant's use of the

Premises, Landlord shall make such changes at its sole cost and expense, provided however that Landlord shall not be obligated to make any changes to Tenant's Initial Installations or other work performed by Tenant in the Premises, which shall be Tenant's obligation.

23. **Indemnity**. Any and all indemnity provisions in the Lease are deleted in their entirety and replaced instead with the following:

(i) Tenant Indemnification. Tenant agrees to indemnify, defend and save Landlord, its partners, officers, directors, members, employees, agents, lenders, contractors and each of their respective successors and assigns (collectively, including Landlord, the "Landlord Indemnified Parties") harmless from and against any and all actual losses, liabilities, fines, penalties and damages to persons or property (including without limitation, amounts paid in settlement, reasonable cost of investigation, reasonable attorneys' fees and other legal expenses and reasonable fees of other necessary professionals) (collectively "Losses") in any manner directly arising out of or in connection with: (a) Tenant's possession, occupancy and use of the Premises; (b) performance of any labor or services or the furnishing of any materials or other property in respect of space occupied by Tenant in the Building; (c) the breach or default on the part of Tenant in the performance of any covenant or agreement contained in this Lease; and (d) any gross negligence or willful act of Tenant, its employees or agents. Landlord will promptly notify Tenant of any actions, proceedings, claims, or demands for which Landlord requests indemnification from Tenant. Tenant has the right to assume the entire control of the defense thereof, and Landlord will cooperate fully with Tenant in such defense at Tenant's cost. Tenant's obligations pursuant to this subparagraph shall survive the termination or expiration of the Lease. Except as set forth in Landlord's indemnification obligations below, Landlord shall not be liable under any circumstances for any Losses to or interference with any merchandise, equipment, fixtures, furniture, furnishings or other personal property or the business operations of Tenant or anyone in the space occupied by Tenant in the Building occasioned by (1) the act or omission of persons occupying other premises, or (2) force majeure events.

(ii) Landlord Indemnification. Subject to the provisions of Tenant's indemnification obligations above, Landlord agrees to indemnify, defend and save Tenant and each of its partners, directors, officers, members, employees and agents, and their respective personal representatives, heirs, successors and assigns (collectively, including Tenant, the "Tenant Indemnified Parties"), harmless from and against any and all Losses directly arising out of: (a) the breach or default on the part of Landlord in the performance of any covenant or agreement contained in this Lease for

which written notice (if the breach or default relates to a condition within the Premises) has been received by Landlord; and (b) any gross negligence or willful act of Landlord, its agents or employees. Tenant will promptly notify Landlord of any actions, proceedings, claims, or demands for which Tenant requests indemnification from Landlord. Landlord has the right to assume the entire control of the defense thereof, and Tenant will cooperate fully with Landlord in such defense at Landlord's cost. Landlord's obligations pursuant to this subparagraph shall survive the termination or expiration of the Lease. Except as set forth in Tenant's indemnification obligations above, Tenant shall not be liable under any circumstances for any Losses to or interference with any merchandise, equipment, fixtures, furniture, furnishings or other personal property or the business operations of Landlord or anyone in the Building occasioned by (1) the act or omission of persons occupying other premises, or (2) force majeure events.

24. **Tenant's Personal Property**. Landlord shall have no lien or other security interest in any of the Tenant's personal property, moveable furniture, inventory or trade fixtures (including those which are a part of Tenant's Initial Installations) (collectively, the "Personal Property"). Landlord specifically waives its right to a lien on or any interest in any of the Personal Property to which it may otherwise be entitled by law. Tenant shall have the right, without the consent of Landlord to: (i) mortgage, pledge or grant a security interest in the Personal Property, but not on the Lease; and/or (ii) grant a pledge or a collateral assignment in and to stock, partnership and/or membership interest in the Tenant or any shareholder, partner, or member thereof as security in favor of any secured lender, which mortgage(s) and/or pledge(s) shall not be deemed a prohibited transaction pursuant to the Lease. Landlord agrees to execute and deliver to any such secured creditor and/or lessor, a waiver of any lien that Landlord may have upon the Personal Property, in form and substance reasonably acceptable to all such parties. Notwithstanding the foregoing, the Tenant shall have no right to grant to any party, whether a lender or otherwise, a security interest in, or lien upon, this Lease.

25. **Insurance**. In Section 7.3 of the Lease, Landlord shall also be required to maintain: (i) rental abatement insurance against loss of rent in an amount equal to the amount of

rent for a period to be determined by Landlord in it's reasonable discretion; and (ii) commercially reasonable policies of commercial general liability insurance and worker's compensation insurance as determined to be appropriate in Landlord's reasonable business judgment

26. **Section 7.5 Deleted**. Section 7.5 of the Lease is deleted in its entirety.

27. **Assignment**. Section 9.1 of the Lease is amended to provide that Landlord's consent shall not be necessary or required for a transfer or assignment of the Lease, or for a transfer or assignment of Tenant's interest in the Premises, or for a sublease of 100% of the Premises, if the transferee or sublessee is an entity that is the successor to Tenant by way of merger, consolidation, sale of all or substantially all of Tenant's assets, or purchase or sale of a controlling interest in stock, membership or other equity interests of Tenant. In the event of an assignment where the net worth of the successor is equal to or greater than that of Tenant as of the date hereof, and provided Tenant has given Landlord documentation evidencing the net worth, Tenant shall be automatically released from its future obligations under the Lease accruing after the date of the assignment (without any further action on the part of either Landlord or Tenant or any other person or entity being necessary or required to effectuate the release), and provided further that Tenant's successor has assumed all of Tenant's obligations under the Lease. If Tenant is released from its obligations hereunder, any guarantor shall also be automatically released from its obligations hereunder without any further action on the part of such guarantor, Landlord, Tenant, or any other person or entity being necessary or required to effectuate the release.

28. **Attornment**. Section 93 of the Lease is amended to provide that Tenant's attornment is conditioned upon every such mortgage recognizing the validity of the Lease in the event of a foreclosure or other transfer of Landlord's interest as long as Tenant shall not be in default under any of the terms of the Lease.

29. **Section 11.5 Amended**. Section 11.5 of the Lease is amended to: (i) delete all references to ninety (90) days and replace them instead with sixty (60) days; and (ii) provide that if Landlord fails to make an emergency repair, or such other repair that must be made in less than thirty (30) days, Tenant shall not be required to provide Landlord with such thirty (30) day notice before Tenant will be entitled to commence to cure the same as provided for in this paragraph.

30. **Section 12.1 Reciprocal**. Section 12.1 of the Lease shall be reciprocal in nature.

31. **Section 12.16 Deleted**. Section 12.16 of the Lease is deleted in its entirety.

32. **Estoppel Certificates**. Section 9.4 of the Lease is amended to add the following:

"Landlord agrees to provide to Tenant, not more than once in any Lease year, and within ten (10) days after request, a statement as to the last date through which Base Rent or Additional Rent has been paid, whether the Lease is in full force and effect, and whether there are any outstanding notices of default that have not been cured."

33. **Landlord's Work Contribution**. (a) Landlord agrees to reimburse Tenant the maximum sum of $313,810 (the "Work Contribution") to be applied to the costs of Tenant's work to ready the 15th Floor Space for its occupancy, furniture, fixtures and equipment to be used within the 15th Floor Space, the cost of telephone and computer cabling, and the cost of relocating from the Original Premises to the 15th Floor Space ("Tenant's Initial Installations"). Provided Tenant shall not be in default in the observance or performance of any of the material terms, covenants or conditions of this Lease on Tenant's part to be observed or

performed beyond any applicable period of notice and/or grace (including, without limitation, the relevant provisions of Article 3.3 and Article 6 of the Lease applicable to Tenant Improvements), from time to time during the performance of Tenant's Initial Installations, but not more frequently than once in each thirty (30) day period, Tenant may submit to Landlord an application (herein, an "Application") for the payment by Landlord directly to the contractors and vendors providing work or material for Tenant's Initial Installations. Landlord shall withhold ten (10%) percent of the amount sought in each Application as retainage ("Retainage"). As a condition to Landlord's obligation to reimburse the full amount of the Work Contribution, Tenant shall provide evidence reasonably satisfactory to Landlord that the portion of the Work Contribution sought from Landlord is allocable to a completed portion of the costs comprising materials incorporated into Tenant's Initial Installations. It shall be a condition to Landlord's obligation to fund the last requisition of the Work Contribution that Tenant shall have paid the costs of Tenant's Initial Contribution exceeding the Work Contribution and shall have delivered proof of such payments to Landlord. If Tenant fails to requisition the Work Contribution within one year from the Rent Commencement Date, Landlord shall have no further obligation to pay to or reimburse to Tenant the Work Contribution.

(b) Each Application shall contain the following material: (i) together with the first Application, a copy of the agreement (herein, the "Construction Agreement") pursuant to which the general contractor (herein, "Tenant's Contractor") has been engaged to perform Tenant's Initial Installations, and (ii) an original copy of Tenant's Contractor's Application and Request for Payment on the then current AIA form, with continuation sheets attached, signed and notarized by the Tenant's Contractor and the supervising architect, and showing the value of each trade or line item of work, the percentage and dollar amount of completion with respect to

each trade or line item, the retainage applicable to each line item and showing any change orders and the value thereof, together with a description of the change order. In addition, the Tenant's Contractor's Application shall (w) be accompanied by a partial waiver of lien (in the case of progress payments) and a final lien waiver and release (in the case of the final payment), in each case conditioned only on payment, (x) contain a statement that all materials and labor appearing on all prior applications for payment have been paid for in full (less the applicable retainage) from the proceeds of such prior applications and (y) contain a statement that the construction agreement is in full force and effect, unmodified (except as therein stated); and be accompanied by a statement of Tenant's supervising architect that as of the date of the Application, that (1) all work completed to the date of the Application conforms substantially to the plans and specifications approved by Landlord, (2) all work completed to the date of the Application complies with the requirements of all applicable laws, regulations, rules, statutes and ordinances, (3) the work can be completed in accordance with the Plans and the other approved plans and specifications approved by Landlord at a cost not in excess of the amount shown in the Construction Agreement, or showing any change orders or other modifications to the Construction Agreement, or showing any change orders or other modifications to the Construction Agreement which affect the cost of Tenant's Initial Installations, and (4) in the case of the final Application for the Retainage, duplicate originals of all required signoffs, approvals, inspection reports and like matters from all municipal agencies having jurisdiction over the performance of Tenant's Initial Installations. In connection with the Application for final payment, Tenant shall include unconditional lien waivers from all sub-contractors who performed work or materialmen who supplied materials for Tenant's Initial Installations.

(c) Within forty-five (45) days after the receipt of an Application, Landlord shall pay to the contractors/vendors the amount requested by Tenant or notify Tenant of any dispute concerning any items contained in the Application or any deficiency in the Application. Landlord's reimbursement of any portion of the Work Contribution shall operate as a discharge of Landlord's obligation to reimburse such portion of the Work Contribution pursuant to this Article. In the event of any dispute concerning the Application, Landlord may (but shall not be obligated) pay any lesser amount reasonably deemed appropriate by Landlord in respect of such Application.

34. **Right of First Offer**.

(a) Provided that (i) the Lease is in full force and effect, (ii) Tenant is not then in default under the monetary or material non-monetary terms of the Lease, after receipt of notice of default from Landlord and expiration of applicable grace periods (if any); and (iii) Tenant is then in actual physical occupancy of at least one hundred percent (100%) of the Premises, if on or before March 31, 2011, Landlord determines to offer for lease to the public a portion of the twenty fourth (24th) floor of the Building identified on Exhibit B hereto and consisting of 7,375 rentable square feet (the "ROFO Space"), Landlord shall, before entering into a written lease of the ROFO Space with a third patty tenant, first send a notice to Tenant (the "Offer Notice") stating that Landlord intends to offer for lease all or a portion of the ROFO Space. Tenant shall then have the right, exercisable within ten (10) days after Tenant's receipt of the Offer Notice, ***time being of the essence***, to notify Landlord in writing of Tenant's desire to lease the ROFO Space set forth in the Offer Notice on the following terms:

(i) Base Rent $114,312.50 per annum, with annual cumulative increases of 2.5% on January 1st of each year during the term;

(ii) A Work Contribution payable in accordance with paragraph 33 of this Agreement, in the amount of $110,625;

(iii) Additional Rent to be paid in accordance with the Lease, as amended hereby, including but not limited to, Operating Expenses;

(iv) Tenant's Proportionate Share for the ROFO Space shall be 1.35%;

(v) There shall be no free rent or rent abatement;

(vi) The ROFO Space shall not be subject to re-measurement; and

(vii) The ROFO Space shall be delivered in an "as is" condition (collectively, the "Offer Terms").

If Tenant timely exercises such right, on the date upon which Landlord delivers vacant, broom-clean possession of the ROFO Space to Tenant (the "ROFO Space Inclusion Date"), the ROFO Space shall be added to and included within the Premises upon all of the Offer Terms and, to the extent not in conflict with the Offer Terms, on the terms and conditions set forth in the Lease, as amended hereby (it being understood that if and to the extent of any inconsistency between the Offer Terms and the terms set forth in this Lease, the Offer Terms shall prevail as to the lease of the ROFO Space). In the event Tenant fails to exercise its right of first offer within such ten (10) day period, Landlord shall have no further obligation to offer the ROFO Space to Tenant for lease, and shall thereafter be free for the remainder of the Term to lease the ROFO Space to any third party at such rent and upon such conditions as Landlord may determine in its sole and absolute discretion and this Article shall be of no force or effect with respect to the ROFO Space. The provisions of this paragraph 34 shall be of no force and effect from and after April 1 2011, if being agreed that from and after such date, Landlord shall thereafter be free for the remainder of the Term to lease the ROFO Space to any third party at such rent and upon such conditions as Landlord may determine in its sole and absolute discretion, without first offering said Space to Tenant.

(b) Time is of the essence with respect to the terms and provisions of this Article.

(c) With respect to the ROFO Space, Landlord represents and warrants to Tenant that there are no existing options, rights of first offer and/or rights of first refusal and/or expansion rights and other like rights heretofore granted by Landlord to any other parties (including tenants of the Building under leases of space in the Building) in existence on the date hereof.

(d) Promptly after Tenant's timely exercise of the right of first offer set forth herein, Landlord and Tenant shall enter into an amendment to the Lease, as amended hereby, prepared by Landlord confirming the terms upon which Landlord shall lease to Tenant the ROFO Space (which terms shall be on the Offer Terms), but the failure to do so shall not impair, affect or reduce the parties' obligations with respect to the lease of such ROFO Space.

35. **Tenant's Expansion Option**.

(a) Provided that (i) the Lease is in full force and effect, (ii) Tenant is not then in default under the monetary or material non-monetary terms of the Lease, after receipt of notice of default from Landlord and expiration of applicable grace periods (if any); and (iii) Tenant is then in actual physical occupancy of at least one hundred percent (100%) of the Premises, Tenant shall have the option, (the "Expansion Option") exercisable by sending written notice to Landlord (the "Expansion Option Notice") on or before March 31, 2011, *time being of the essence as to the service of the Expansion Option Notice*, to lease the ROFO Space on the Offer Terms set forth in Paragraph 34 above. If Tenant timely exercises the Expansion Option on the

date upon which Landlord delivers vacant, broom-clean possession of the ROFO Space to Tenant, the ROFO Space shall be added to and included within the Premises upon all of the Offer Terms and, to the extent not in conflict with the Offer Terms, on the terms and conditions set forth in the Lease, as amended hereby (it being understood that if and to the extent of any inconsistency between the Offer Terms and the terms set forth in this Lease, the Offer Terms shall prevail as to the lease of the ROFO Space). In the event Tenant fails to deliver the Expansion Option Notice on or before March 31, 2011, the Expansion Option, and the provisions of this paragraph 35 shall be null and void, and of no further force and effect and Landlord shall thereafter be free for the remainder of the Term to lease the ROFO Space to any third party at such rent and upon such conditions as Landlord may determine in its sole and absolute discretion.

(b) Time is of the essence with respect to the terms and provisions of this Article.

(c) Promptly after Tenant's timely exercise of the Expansion Offer, Landlord and Tenant shall enter into an amendment to the Lease, as amended hereby, prepared by Landlord confirming the terms upon which Landlord shall lease to Tenant the ROFO Space (which terms shall be on the Offer Terms), but the failure to do so shall not impair, affect or reduce the parties' obligations with respect to the lease of the ROFO Space.

[*The remainder of this page is intentionally blank. Signatures are on the next page.]*

36. **Counterparts; Facsimile/Electronic Mail**. This Amendment may be signed in several counterparts, each of which shall be deemed an original, and all such counterparts shall constitute one and the same instrument. A facsimile or electronic copy of this Amendment and any signatures thereon will be considered for all purposes as originals.

**IN WITNESS WHEREOF**, this First Amendment to Lease has been executed as of the day and year first above written.

LANDLORD:

SL WINSTON-SALEM LLC
a Delaware limited liability company

By: /s/ [not legible]
Name:
Title:

TENANT:

BE AEROSPACE, INC., a Delaware corporation

By: /s/ [not legible]
Name: not legible
Title: Corporate Vice President, Business Planning

**ACKNOWLEDGEMENT**

State of )
: ss.:
County of )

On the day of in the year 2010 before me, the undersigned, personally appeared , personally known to me or proved to me on the basis of satisfactory evidence to be the individual whose name is subscribed to the within instrument and acknowledged to me that he executed the same in his capacity, and that by his signature on the instrument, the individual, or the person upon behalf of which the individual acted, executed the instrument.

Notary Public

State of )
: ss.:
County of )

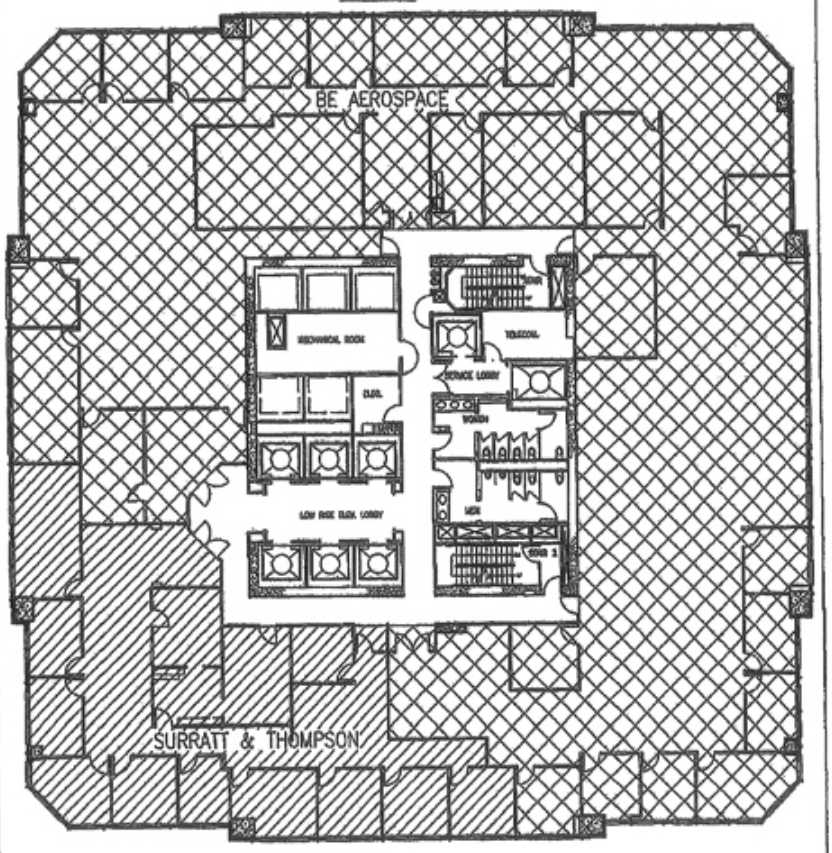
On the day of in the year 2010 before me, the undersigned, personally appeared , personally known to me or proved to me on the basis of satisfactory evidence to be the individual whose name is subscribed to the within instrument and acknowledged to me that he executed the same in his capacity, and that by his signature on the instrument, the individual, or the person upon behalf of which the individual acted, executed the instrument.

Notary Public

**EXHIBIT A**

**15th FLOOR SPACE**

EXHIBIT 'A'



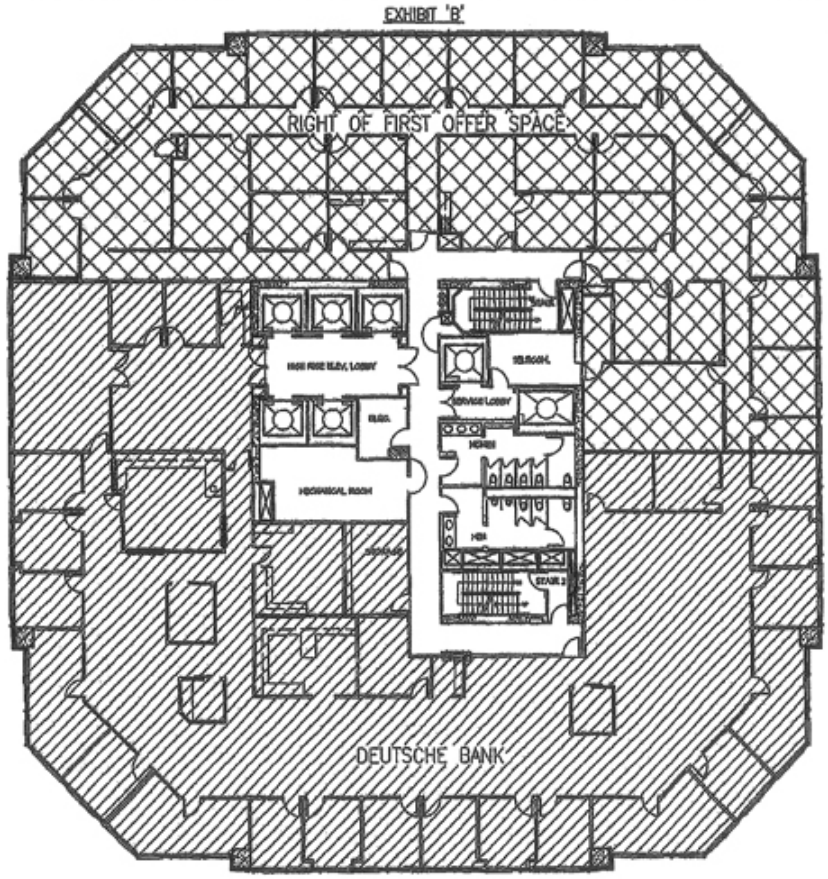

| WACHOVIA CENTER – 15th FLOOR | |
|---|---|
| | |
| BE AEROSPACE<br>SURRATT & THOMPSON | 14,254 RSF |

RELEASED SEPT. 21, 2010

**EXHIBIT B**

**RIGHT OF FIRST OFFER SPACE**

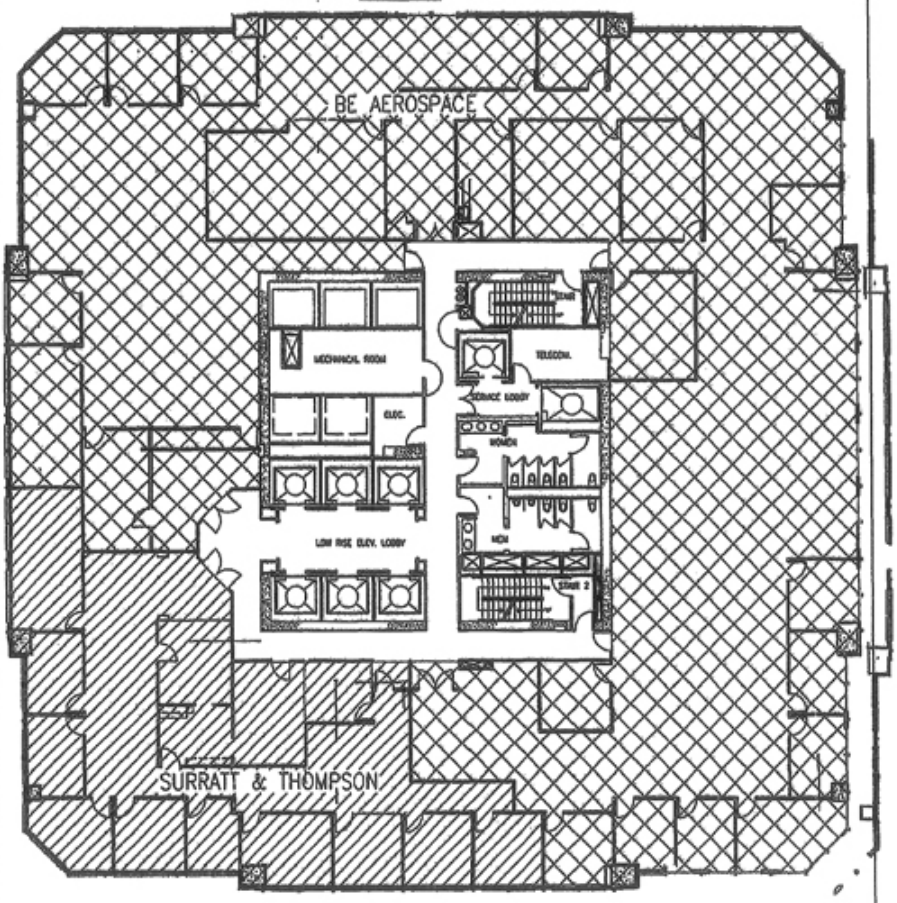
EXHIBIT 'B'




| WACHOVIA CENTER – 24th FLOOR | |
|---|---|
| | |
| RIGHT OF FIRST OFFER<br>DEUTSCHE BANK | 7,375 RSF |

RELEASED: SEPT. 21, 2010

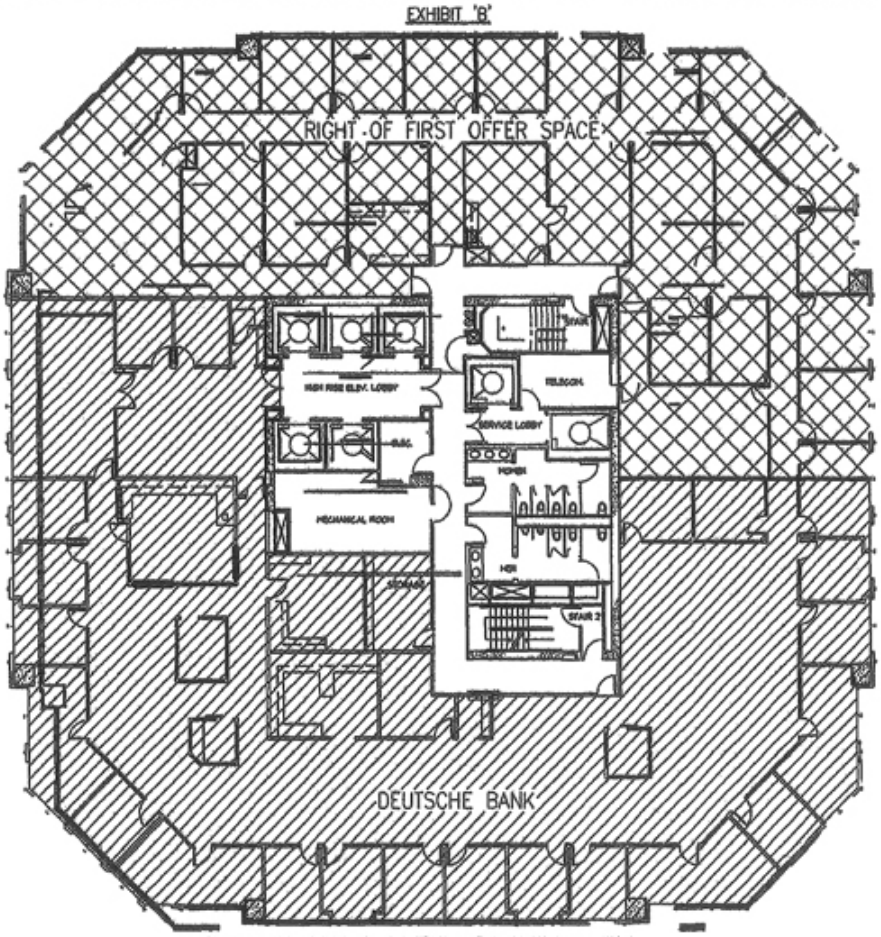
EXHIBIT 'A'




| WACHOVIA CENTER – 15th FLOOR | |
|---|---|
| | |
| BE AEROSPACE<br>SURRATT & THOMPSON | 14,254 RSF |

RELEASED SEPT. 21, 2010

EXHIBIT 'B'




| WACHOVIA CENTER – 24th FLOOR | |
|---|---|
| | |
| RIGHT OF FIRST OFFER<br>DEUTSCHE BANK | 7,375 RSF |

RELEASED: SEPT. 21, 2010

**SECOND AMENDMENT TO LEASE**

**THIS SECOND AMENDMENT TO LEASE** (this "Amendment") is made as of the 7th day of February, 2011 (the "Effective Date"), by and between **SL WINSTON-SALEM LLC**, a Delaware limited liability company with offices at 601 West 26th Street, Suite 1260, New York, New York 10001 ("Landlord"), and **BE AEROSPACE, INC**., a Delaware corporation having an office at 100 Main Street, Suite 1510, Winston-Salem, North Carolina 27101 ("Tenant").

**W I T N E S S E T H:**

Landlord and Tenant are, respectively, the current landlord and the current tenant under that certain Office Lease Agreement dated as of July 16, 2007 (the "Original Lease") between First States Investors 3300, LLC (Landlord's predecessor-in-interest), as landlord, and Tenant, which Original Lease was amended by that certain First Amendment to Lease dated as of October 8, 2010 (the "First Amendment;" the Original Lease and First Amendment, as amended hereby, are sometimes hereinafter collectively referred to as the "Lease") covering a portion of the fifteenth (15th) floor of the building located at 100 Main Street, Winston-Salem, North Carolina (the "Building"), which premises (the "Leased Premises") are shown on Exhibit A to the First Amendment and have an agreed-upon area of 14,254 rentable square feet (which agreed-upon area shall not be subject to re-measurement or adjustment).

Landlord and Tenant wish to modify the Lease so as (i) to add to the Leased Premises the balance of the fifteenth (15th) floor of the Building, having an agreed-upon area of 4,028 rentable square feet (the "Additional Premises") (which agreed-upon area shall not be subject to re-measurement or adjustment), and generally depicted on Exhibit A attached hereto and incorporated herein; and (ii) to make various other modifications thereto, all in accordance with the terms and conditions set forth in this Amendment.

**NOW, THEREFORE**, for and in consideration of the mutual covenants and agreements herein contained, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto hereby agree to the following terms set forth in this Amendment.

1. **Additional Premises**. As of the Effective Date, the Lease shall be amended as follows:

"Additional Premises. (i) Landlord hereby leases to Tenant, and Tenant hereby leases from Landlord, the balance of the fifteenth (15th) floor of the Building, and described on Exhibit A attached hereto and incorporated hereon (the "Additional Premises") on the same terms and conditions (except as otherwise set forth in this Amendment) as are set forth in the Lease applicable to Leased Premises; (ii) the term "demised premises" or "Premises" as set forth in the Lease shall be deemed to collectively mean the Leased Premises and the Additional Premises; and (iii) Tenant shall not be required to pay Base Rent or Tenant's Proportionate Share of Operating Expenses for the Additional Premises until the Additional Premises Rent Commencement Date defined below."

2. **Rent Commencement Date**. The Additional Premises Rent Commencement Date means that date which is ten (10) days after Tenant's Additional Premises Initial Installations (defined below) are completed in accordance with applicable law and the City of Winston-Salem has issued a certificate of occupancy for the Additional Premises. Tenant hereby acknowledges that the Additional Premises is currently occupied by an existing tenant (the "Existing Tenant"). If Landlord is unable to give possession of the Additional Premises to Tenant because of the holding over or retention of possession of the Additional Premises by the Existing Tenant or any undertenants or occupants, Landlord shall not be subject to any liability whatsoever for the failure to deliver or give possession of the Additional Premises to Tenant and the validity of this Amendment shall not be impaired under such circumstances, nor shall the

same be construed in any way to extend the term of the Lease beyond the Expiration Date. Once the Existing Tenant has vacated the Additional Premises, Landlord shall provide written notice to Tenant stating that the Additional Premises is vacant and tender the Additional Premises to Tenant. The tenth (10th) business day following Tenant's receipt of such written notice is referred to as the "Tender Date." Notwithstanding the foregoing, in the event Tenant's Additional Premises Initial Installations shall not have been completed by Tenant within six (6) months after the Tender Date, the Additional Premises Rent Commencement Date shall be deemed to mean that day immediately following the expiration of the aforesaid six (6) month period.

3. **Base Rent for the Additional Premises from the Additional Premises Commencement Date through the Expiration Date**. During the period commencing on the Additional Premises Rent Commencement Date and ending on the Expiration Date, Tenant shall pay Base Rent for the Additional Premises only in the amounts and at the rates set forth below:

| Time Period | Monthly Fixed Rent | Fixed Rent Rate per Annum |
|---|---|---|
| Rent Commencement Date through December 31, 2013 | $5,655.92 | $ 67,871.00 |
| January 1, 2014 - December 31, 2014 | $5,797.31 | $ 69,567.78 |
| January 1, 2015 - December 31, 2015 | $5,942.25 | $ 71,307.00 |

Notwithstanding the foregoing, Tenant shall remain obligated to pay Base Rent and additional rent applicable to the Leased Premises at the time and manner as set forth in the Lease.

4. **Operating Expense Escalation**. From and after the Additional Premises Rent Commencement Date, Tenant shall be obligated to pay Tenant's Proportionate Share of the

excess of Operating Expenses for the Additional Premises pursuant to Article 2 of the Lease. For the purpose of calculating Tenant's additional rent obligations under Article 2 of the Lease from and after the Additional Premises Rent Commencement Date for the Additional Premises, the following provisions shall apply: (i) "Base Year" shall mean, the calendar year 2010; and (ii) the term "Tenant's Proportionate Share" shall mean, with respect to the Additional Premises only, 0.74%.

Notwithstanding the foregoing, Tenant shall remain obligated to pay Tenant's Proportionate Share of the excess of Operating Expenses for the Leased Premises at the time and manner as set forth in the Lease.

5. **Renewal Option**. The terms and conditions of the Renewal Option shall be fully applicable to the Additional Premises as if set forth in this Amendment in their entirety, except that the following provisions shall be applicable to the Additional Premises only.

Base Rent for the Additional Premises only during the Renewal Term shall be as follows:

| Time Period | Monthly Fixed Rent | Fixed Rent Rate per Annum |
|---|---|---|
| January 1, 2016 - December 31, 2016 | $6,090.80 | $73,089.64 |
| January 1, 2017 - December 31, 2017 | $6,243.07 | $74,916.88 |
| January 1, 2018 - December 31, 2018 | $6,399.15 | $76,789.81 |
| January 1, 2019 - December 31, 2019 | $6,559.13 | $78,709.55 |
| January 1, 2020 - December 31, 2020 | $6,723.11 | $80,677.29 |

6. **No Rent Abatement**. Tenant shall not be entitled to any free rent or rent abatement in connection with the leasing of the Additional Premises and/or this Amendment,

except that Tenant shall not be obligated to pay Base Rent for the Additional Premises if it completes its work or moves into the Additional Premises prior to the Additional Premises Rent Commencement Date.

7. **Landlord's Additional Premises Work Contribution**. (a) Landlord agrees to reimburse Tenant the maximum sum of the product of (i) $88,696.56 (*i.e.*, $22.02/r.s.f. x 4,028 r.s.f.) multiplied by (ii) a fraction, the numerator of which shall be the number of months occurring during the period commencing on the Additional Premises Rent Commencement Date and ending on the Expiration Date (*i.e.*, December 31, 2015) and the denominator of which shall be 60 (the "Additional Premises Work Contribution") to be applied to the costs of Tenant's work to ready the Additional Premises for its occupancy, furniture, fixtures and equipment to be used within the Additional Premises, and the cost of telephone and computer cabling ("Tenant's Additional Premises Initial Installations"). Provided Tenant shall not be in default in the observance or performance of any of the material terms, covenants or conditions of the Lease on Tenant's part to be observed or performed beyond any applicable period of notice and/or grace (including, without limitation, the relevant provisions of Article 3.3 and Article 6 of the Lease applicable to Tenant Improvements), the Additional Premises Work Contribution shall be disbursed in the manner set forth in Paragraph 33 of the First Amendment.

8. **Deletions to Lease**. Effective as of the Effective Date of this Amendment, Paragraphs 34 and 35 of, and Exhibit B to, the First Amendment shall be deemed deleted therefrom in their entirety.

9. **Brokers**. Landlord and Tenant represent and warrant to the other that it neither consulted nor negotiated with any broker or finder with respect to this Amendment, or Tenant's lease of the Additional Premises pursuant to the terms hereof other than Triad

Commercial Properties ("Broker"), whose commission in connection with this Amendment shall be paid by Landlord pursuant to Landlord's separate agreement(s) with Broker. Landlord and Tenant each agree to indemnify, defend and save the other harmless from and against any and all liability, damages, settlement payments, costs and expenses (including, without limitation, reasonable legal fees and disbursements incurred in defending any claim or action or in enforcing this indemnity), incurred by the other party as a result of or in connection with any claim, demand or action for fees or commissions from anyone other than Broker with which the indemnifying party has dealt or retained in connection with this Amendment or Tenant's lease of the Additional Premises.

10. **Prior Negotiations**. This Amendment supersedes all prior negotiations, representations, understandings and agreements of, by or between Landlord and Tenant with respect to the subject matter hereof, all of which shall be deemed fully merged herein.

11. **Conflicting Terms**. If the terms of the Lease conflict or are inconsistent with those of this Amendment, then the terms of this Amendment will control.

12. **Submission of Amendment**. Submission of this Amendment by Landlord to Tenant for examination and/or execution shall not in any manner bind Landlord, and no obligation or liability on Landlord shall arise under this Amendment unless and until this Amendment is fully signed and delivered by Landlord and Tenant.

13. **Miscellaneous**.

(a) This Amendment shall be binding upon and inure to the benefit of the parties hereto and their respective legal representatives, successors and permitted assigns.

(b) Landlord and Tenant agree that this Amendment shall not be recorded.

(c) This Amendment, together with the Lease, constitutes the entire agreement of the parties hereto with respect to the matters stated herein, and may not be amended or modified unless such amendment or modification shall be in writing and shall have been signed by the party against whom enforcement is sought.

(d) This Amendment shall be construed and governed by the laws of the State of North Carolina.

(e) No waiver by either party of any failure or refusal by the other party to comply with its obligations hereunder shall be deemed a waiver of any other or subsequent failure or refusal to so comply.

(f) Capitalized terms used but not otherwise defined in this Amendment shall have the meanings ascribed to them in the Lease.

14. **Invalidity**. If any provision of this Amendment shall be invalid or unenforceable, the remainder of this Amendment or the application of such provision other than to the extent that it is invalid or unenforceable shall not be affected, and each provision of this Amendment shall remain in full force and effect notwithstanding the invalidity or unenforceability of such provision, but only to the extent that application and/or enforcement, as the case may be, would be equitable and consistent with the intent of the parties in entering into this Amendment.

15. **Tenant's Representations and Warranties**. Tenant represents and warrants that: (a) the Lease is in full force and effect; (b) the Lease has not been assigned or encumbered by Tenant and the Premises have not been sublet in whole or in part; (c) Tenant has no defense or counterclaim to the enforcement of the Lease; (d) Landlord is not in default under any of its obligations under the Lease; (e) to Tenant's actual knowledge, Tenant is not in default

under any of its obligations under the Lease; and (f) the person executing this Amendment on behalf of Tenant is duly authorized to do so by all necessary action and this Amendment is enforceable against Tenant in accordance with its terms.

16. **Landlord's Representations and Warranties**. Landlord represents and warrants that: (a) the Lease is in full force and effect; (b) Landlord has not served Tenant with a notice alleging defaults of Tenant's Lease obligations which remain uncured, and Landlord is not aware of any default by Tenant in its obligation to pay Base Rent or Additional Rent; (c) the person executing this Amendment on behalf of Landlord is duly authorized to do so by all necessary action, and this Amendment is enforceable against Landlord in accordance with its terms; (d) the execution of this Amendment by Landlord is conditioned upon obtaining consent of the holder of the mortgage on the Building; (e) there are no pending claims or disputes involving Landlord or the Additional Premises which could materially affect the rights and obligations of the parties to the Lease; (f) the Certificate of Occupancy for the Building permits the Additional Premises to be used for the Permitted Uses; and (g) Landlord has received no written notice from any governmental authorities that there are violations against the Building which would prevent Tenant from obtaining its work permits or sign-offs for Tenant's Additional Premises Initial Installations (defined below) to the Additional Premises.

17. **Counterparts; Facsimile/Electronic Mail**. This Amendment may be signed in several counterparts, each of which shall be deemed an original, and all such counterparts shall constitute one and the same instrument. A facsimile or electronic copy of this Amendment and any signatures thereon will be considered for all purposes as originals.

**IN WITNESS WHEREOF**, this First Amendment to Lease has been executed as of the day and year first above written

LANDLORD:

SL WINSTON-SALEM LLC
a Delaware limited liability company

By: /s/ [not legible]
Name:
Title:

TENANT:

BE AEROSPACE, INC., a Delaware corporation

By: /s/ Eric J. Wesch
Name: Eric J. Wesch
Title: Corporate Treasurer

**ACKNOWLEDGEMENT**

State of FLORIDA )
: ss.:
County of PALM BEACH )

On the 7th day of February in the year 2011 before me, the undersigned, personally appeared Eric J. Wesch, personally known to me or proved to me on the basis of satisfactory evidence to be the individual whose name is subscribed to the within instrument and acknowledged to me that he executed the same in his capacity, and that by his signature on the instrument, the individual, or the person upon behalf of which the individual acted, executed the instrument.


/s/ Kim Faller
Notary Public

State of )
: ss.:
County of )

On the day of in the year 2011 before me, the undersigned, personally appeared , personally known to me or proved to me on the basis of satisfactory evidence to be the individual whose name is subscribed to the within instrument and acknowledged to me that he executed the same in his capacity, and that by his signature on the instrument, the individual, or the person upon behalf of which the individual acted, executed the instrument.

Notary Public

**EXHIBIT A**

**ADDITIONAL PREMISES**

# TARGACEPT, INC.

# 2006 STOCK INCENTIVE PLAN

**(As Amended and Restated Through March 9, 2011)**

**TARGACEPT, INC.**
**2006 STOCK INCENTIVE PLAN**
**(As Amended and Restated Through March 9, 2011)**

***1. Definitions***

In addition to other terms defined herein, the following terms shall have the meanings given below:

(a) Administrator means the Board, and, upon its delegation of all or part of its authority to administer the Plan to the Committee, the Committee.

(b) Affiliate means any Parent or Subsidiary of the Corporation, and also includes any other business entity which is controlled by, under common control with or controls the Corporation; provided, however, that the term "Affiliate" shall be construed in a manner in accordance with the registration provisions of applicable federal securities laws.

(c) Annual Option means an Option granted on an annual basis to a Nonemployee Director of the Corporation as provided in Section 8.

(d) Award means, individually or collectively, a grant under the Plan of an Option (including an Incentive Option, Nonqualified Option or a Director Option); a Stock Appreciation Right (including a Related SAR or a Freestanding SAR); a Restricted Award (including a Restricted Stock Award or a Restricted Unit Award); a Performance Award (including a Performance Share Award or a Performance Unit Award); a Phantom Stock Award; a Dividend Equivalent Award; or any other award granted under the Plan.

(e) Award Agreement means an agreement (which may be in written or electronic form, in the Administrator's discretion, and which includes any amendment or supplement thereto) between the Corporation and a Participant specifying the terms, conditions and restrictions of an Award granted to the Participant. An Agreement may also state such other terms, conditions and restrictions, including but not limited to terms, conditions and restrictions applicable to shares or any other benefit underlying an Award, as may be established by the Administrator.

(f) Board or Board of Directors means the Board of Directors of the Corporation.

(g) Cause shall mean, unless the Administrator determines otherwise, a Participant's termination of employment or service resulting from the Participant's (i) termination for "cause" as defined under the Participant's employment, consulting or other agreement with the Corporation or an Affiliate, if any, or (ii) if the Participant has not entered into any such employment, consulting or other agreement (or if any such agreement does not address the effect of a "cause" termination), then the Participant's termination shall be for "Cause" if termination results due to the Participant's (A) dishonesty; (B) refusal to perform his duties for the Corporation; (C) engaging in fraudulent conduct; or (D) engaging in any conduct that could be materially damaging to the Corporation without a reasonable good faith belief that such conduct was in the best interest of the Corporation. The determination of "Cause" shall be made by the Administrator and its determination shall be final and conclusive.

(h) Change in Control:

(i) *General*: Except as may be otherwise provided in an individual Award Agreement or as may be otherwise required in order to comply with Code Section 409A, a Change in Control shall be deemed to have occurred on the earliest of the following dates:

(A) The date any entity or person shall have become the beneficial owner of, or shall have obtained voting control over, thirty percent (30%) or more of the outstanding Common Stock of the Corporation;

(B) With respect to Awards granted before March 9, 2011, the date of stockholder approval of, and, with respect to Awards granted on or after March 9, 2011, the date of the consummation of: (A) a merger, consolidation, reorganization or similar business transaction of the Corporation with or into another corporation or other business entity (each, a "corporation"), in which the Corporation is not the continuing or surviving entity or pursuant to which any shares of Common Stock of the Corporation would be converted into cash, securities or other property of another entity, other than a transaction of the Corporation in which holders of Common Stock immediately prior to the transaction continue to own at least 50% of the outstanding Common Stock, or if the Corporation is not the surviving entity, the common stock (or other voting securities) of the surviving entity immediately after the transaction as immediately before (provided, however, that, solely with respect to Awards granted prior to March 9, 2011, if consummation of such transaction is subject to the approval of federal, state or other regulatory authorities, then, unless the Administrator determines otherwise, a "Change in Control" shall not be deemed to occur until the later of the date of stockholder approval of such transaction or the date of final regulatory clearance or approval of such transaction); or (B) the sale or other disposition of all or substantially all of the assets of the Corporation; or

(C) The date there shall have been a change in a majority of the Board of Directors of the Corporation within a 12-month period unless the nomination for election by the Corporation's stockholders of each new Director was approved by the vote of two-thirds of the members of the Board (or a committee of the Board, if nominations are approved by a Board committee rather than the Board) then still in office who were in office at the beginning of the 12-month period.

(For the purposes herein, the term "person" shall mean any individual, corporation, partnership, group, association or other person, as such term is defined in Section 13(d)(3) or Section 14(d)(2) of the Exchange Act, other than the Corporation, a subsidiary of the Corporation or any employee benefit plan(s) sponsored or maintained by the Corporation or any subsidiary thereof, and the term "beneficial owner" shall have the meaning given the term in Rule 13d-3 under the Exchange Act.)

(D) The Administrator shall have full and final authority, in its discretion, to determine whether a Change in Control of the Corporation has occurred pursuant to the above definition, the date of the occurrence of such Change in Control and any incidental matters relating thereto.

(ii) *Definition Applicable to Awards subject to Code Section 409A*: Notwithstanding the preceding provisions of Section 1(h)(i), in the event that any Awards granted under the Plan

are deemed to be deferred compensation subject to the provisions of Code Section 409A, then distributions related to such Awards may be permitted, in the Administrator's discretion, upon the occurrence of one or more of the following events (as they are defined and interpreted under Code Section 409A): (A) a change in the ownership of the Corporation, (B) a change in effective control of the Corporation, or (C) a change in the ownership of a substantial portion of the assets of the Corporation.

(i) Code means the Internal Revenue Code of 1986, as amended. Any reference herein to a specific Code section shall be deemed to include all related regulations or other guidance with respect to such Code section.

(j) Committee means the Compensation Committee of the Board appointed to administer the Plan.

(k) Common Stock means the common stock of Targacept, Inc., $0.001 par value.

(l) Corporation means Targacept, Inc., a Delaware corporation, together with any successor thereto.

(m) Covered Employee shall have the meaning given the term in Section 162(m) of the Code.

(n) Director means a member of the Board or of the board of directors of an Affiliate.

(o) Director Option means an Option granted to a Nonemployee Director of the Corporation as provided in Section 8. Director Options may be Initial Options or Annual Options as provided in Section 8.

(p) Disability shall, except as may be otherwise determined by the Administrator (taking into account any Code Section 409A considerations), have the meaning given in any employment agreement, consulting agreement or other similar agreement, if any, to which a Participant is a party, or, if there is no such agreement (or if any such agreement does not address the effect of termination due to disability), "Disability" shall mean the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death, or which has lasted or can be expected to last for a continuous period of not less than 12 months. The Administrator shall have discretion to determine if a termination due to Disability has occurred.

(q) Displacement shall, as applied to any Participant, be as defined in any employment agreement, consulting agreement or other similar agreement, if any, to which the Participant is a party, or, if there is no such agreement (or if any such agreement does not address the effect of a termination due to displacement), "Displacement" shall mean the termination of the Participant's employment or service due to the elimination of the Participant's job or position without fault on the part of the Participant (as determined by the Administrator).

(r) Dividend Equivalent Award means a right granted to a Participant pursuant to Section 13 to receive the equivalent value (in cash or shares of Common Stock) of dividends paid on Common Stock.

(s) Effective Date means the effective date of the Plan, as provided in Section 4.

(t) Employee means any person who is an employee of the Corporation or any Affiliate (including entities which become Affiliates after the Effective Date of the Plan). For this purpose, an individual shall be considered to be an Employee only if there exists between the individual and the Corporation or an Affiliate the legal and bona fide relationship of employer and employee (taking into account any Code Section 409A considerations); provided, however, that, with respect to Incentive Options, "Employee" means any person who is considered an employee of the Corporation or any Parent or Subsidiary for purposes of Treas. Reg. Section 1.421-1(h) (or any successor provision related thereto).

(u) Exchange Act means the Securities Exchange Act of 1934, as amended.

(v) Fair Market Value per share of the Common Stock shall be established in good faith by the Administrator and, unless otherwise determined by the Administrator, the Fair Market Value shall be determined in accordance with the following provisions: (A) if the shares of Common Stock are listed for trading on the New York Stock Exchange, the American Stock Exchange or the Nasdaq Stock Market, the Fair Market Value shall be the closing sales price per share of the shares on the New York Stock Exchange, the American Stock Exchange or the Nasdaq Stock Market (as applicable) on the date an Option is granted or other determination is made (such date of determination being referred to herein as a "valuation date"), or, if there is no transaction on such date, then on the trading date nearest preceding the valuation date for which closing price information is available, and, provided further, if the shares are not listed for trading on the New York Stock Exchange, the American Stock Exchange or the Nasdaq Stock Market, the Fair Market Value shall be the average between the highest bid and lowest asked prices for such stock on the date of grant or other valuation date as reported on the Nasdaq OTC Bulletin Board Service or by the National Quotation Bureau, Incorporated or a comparable service; or (B) if the shares of Common Stock are not listed or reported in any of the foregoing, then the Fair Market Value shall be determined by the Administrator based on such valuation measures or other factors as it deems appropriate. Notwithstanding the foregoing, (i) with respect to the grant of Incentive Options, the Fair Market Value shall be determined by the Administrator in accordance with the applicable provisions of Section 20.2031-2 of the Federal Estate Tax Regulations, or in any other manner consistent with the Code Section 422; and (ii) Fair Market Value shall be determined in accordance with Code Section 409A to the extent required.

(w) Freestanding SAR means an SAR that is granted without relation to an Option, as provided in Section 9.

(x) Incentive Option means an Option that is designated by the Administrator as an Incentive Option pursuant to Section 7 and intended to meet the requirements of incentive stock options under Code Section 422.

(y) Independent Contractor means an independent contractor, consultant or advisor providing services to the Corporation or an Affiliate.

(z) Initial Option means an Option granted to a Nonemployee Director of the Corporation upon initial election or appointment to the Board, as provided in Section 8.

(aa) Nonemployee Director means a Director of the Board who is not an Employee of the Corporation or an Affiliate and who is eligible to receive a Director Option pursuant to Section 8.

(bb) Nonqualified Option means an Option granted under Section 7 or Section 8 that is not intended to qualify as an incentive stock option under Code Section 422.

(cc) Option means a stock option granted under Section 7 or Section 8 that entitles the holder to purchase from the Corporation a stated number of shares of Common Stock at the price set forth in an Award Agreement.

(dd) Option Period means the term of an Option, as provided in Section 7(d) and Section 8(f).

(ee) Option Price means the price at which an Option may be exercised, as provided in Section 7(b) and Section 8(e).

(ff) Parent means a "parent corporation," whether now or hereafter existing, as defined in Section 424(e) of the Code.

(gg) Participant means an individual employed by, or providing services to, the Corporation or an Affiliate who satisfies the requirements of Section 6 and is selected by the Administrator to receive an Award under the Plan.

(hh) Performance Award means a Performance Share Award and/or a Performance Unit Award, as provided in Section 11.

(ii) Performance Measures mean one or more performance factors which may be established by the Administrator with respect to an Award. Performance factors may be based on such corporate, business unit or division and/or individual performance factors and criteria as the Administrator in its discretion may deem appropriate; provided, however, that, such performance factors shall be limited to one or more of the following (as determined by the Administrator in its discretion): (i) cash flow; (ii) return on equity; (iii) return on assets; (iv) earnings per share; (v) achievement of clinical development or regulatory milestones; (vi) operations expense efficiency milestones; (vii) consolidated earnings before or after taxes (including earnings before interest, taxes, depreciation and amortization); (viii) net income; (ix) operating income; (x) book value per share; (xi) return on investment; (xii) return on capital; (xiii) improvements in capital structure; (xiv) expense management; (xv) profitability of an identifiable business unit or product; (xvi) maintenance or improvement of profit margins; (xvii) stock price or total stockholder return; (xviii) market share; (xix) revenues or sales; (xx) costs; (xxi) working capital; (xxii) economic wealth created; (xxiii) strategic business criteria; (xxiv) efficiency ratio(s); (xxv) achievement of division, group, function or corporate financial, strategic or operational goals; and (xxvi) comparisons with stock market indices or performances of metrics of peer companies. To the extent that Section 162(m) of the Code is applicable, the Administrator shall, within the time and in the manner prescribed by Section 162(m) of the Code, define in an objective fashion the manner of calculating the Performance Measures it selects to use for Participants during any specific performance period. Such performance factors may be adjusted or modified due to extraordinary items, transactions, events or developments, or in recognition of, or in anticipation of, any other unusual or nonrecurring events affecting the Corporation or the financial statements of the Corporation, or in response to, or in anticipation of, changes in applicable laws, regulations, accounting principles or business conditions, in each case as determined by the Administrator.

(jj) Performance Share means an Award granted under Section 11, in an amount determined by the Administrator and specified in an Award Agreement, stated with reference to a specified number of shares of Common Stock, that entitles the holder to receive shares of Common Stock, a cash payment or a combination of Common Stock and cash (as determined by the Administrator), subject to the terms of the Plan and the terms and conditions established by the Administrator.

(kk) Performance Unit means an Award granted under Section 11, in an amount determined by the Administrator and specified in an Award Agreement, that entitles the holder to receive Shares of Common Stock, a cash payment or a combination of Common Stock and cash (as determined by the Administrator), subject to the terms of the Plan and the terms and conditions established by the Administrator.

(ll) Phantom Stock Award means an Award granted under Section 12, entitling a Participant to a payment in cash, shares of Common Stock or a combination of cash and Common Stock (as determined by the Administrator), following the completion of the applicable vesting period and compliance with the terms of the Plan and other terms and conditions established by the Administrator. The unit value of a Phantom Stock Award shall be based on the Fair Market Value of a share of Common Stock.

(mm) Plan means the Targacept, Inc. 2006 Stock Incentive Plan, as amended and restated through March 9, 2011, and as it may be hereafter amended and/or restated.

(nn) Prior Plan or Prior Plans means the 2000 Equity Incentive Plan of Targacept, Inc., as amended, and any other employee stock incentive plan maintained by the Corporation prior to the Effective Date of the Plan.

(oo) Public Offering Date means the date on which the Underwriting Agreement between the Corporation and the managing underwriters of the Corporation's initial public offering of its Common Stock was executed and delivered.

(pp) Related SAR means an SAR granted under Section 9 that is granted in relation to a particular Option and that can be exercised only upon the surrender to the Corporation, unexercised, of that portion of the Option to which the SAR relates.

(qq) Restricted Award means a Restricted Stock Award and/or a Restricted Stock Unit Award, as provided in Section 10.

(rr) Restricted Stock Award means shares of Common Stock awarded to a Participant under Section 10. Shares of Common Stock subject to a Restricted Stock Award shall cease to be restricted when, in accordance with the terms of the Plan and the terms and conditions established by the Administrator, the shares vest and become transferable and free of substantial risks of forfeiture.

(ss) Restricted Stock Unit means a Restricted Award granted to a Participant pursuant to Section 10 which is settled (i) by the delivery of one share of Common Stock for each Restricted Stock Unit, (ii) in cash in an amount equal to the Fair Market Value of one share of Common Stock for each Restricted Stock Unit, or (iii) in a combination of cash and Shares equal to the Fair Market Value of one share of Common Stock for each Restricted Stock Unit, as determined by the Administrator. A Restricted Stock Unit Award represents the promise of the Corporation to deliver shares, cash or a combination thereof, as applicable, at the end of the Restriction Period, subject to compliance with the terms of the Plan and the terms and conditions established by the Administrator.

(tt) Retirement shall, as applied to any Participant, be as defined in any employment agreement, consulting agreement or other similar agreement, if any, to which the Participant is a party, or, if there is no such agreement (or if any such agreement does address the effect of termination due to retirement), "Retirement" shall mean retirement in accordance with the retirement policies and

procedures established by the Corporation, as determined by the Administrator (taking into account any Code Section 409A considerations).

(uu) SAR means a stock appreciation right granted under Section 9 entitling the Participant to receive, with respect to each share of Common Stock encompassed by the exercise of such SAR, the excess of the Fair Market Value on the date of exercise over the SAR base price, subject to the terms of the Plan and any other terms and conditions established by the Administrator. References to "SARs" include both Related SARs and Freestanding SARs, unless the context requires otherwise.

(vv) Securities Act means the Securities Act of 1933, as amended.

(ww) Subsidiary means a "subsidiary corporation," whether now or hereafter existing, as defined in Section 424(f) of the Code.

(xx) Termination Date means the date of termination of a Participant's employment or service for any reason, as determined by the Administrator in its discretion.

***2. Purpose***

The purpose of the Plan is to encourage and enable selected Employees, Directors and Independent Contractors of the Corporation and its Affiliates to acquire or to increase their holdings of Common Stock of the Corporation and other proprietary interests in the Corporation in order to promote a closer identification of their interests with those of the Corporation and its stockholders, thereby further stimulating their efforts to enhance the efficiency, soundness, growth and stockholder value of the Corporation. This purpose will be carried out through the granting of Awards to selected Employees, Independent Contractors and Directors, including the granting to selected Participants of Options in the form of Incentive Stock Options and Nonqualified Options; SARs in the form of Related SARs and Freestanding SARs; Restricted Awards in the form of Restricted Stock Awards and Restricted Stock Units; Performance Awards in the form of Performance Shares and Performance Units; Phantom Stock Awards; Director Options in the form of Initial Options and Annual Options; and/or Dividend Equivalent Awards.

***3. Administration of the Plan***

(a) The Plan shall be administered by the Board of Directors of the Corporation or, upon its delegation, by the Committee. Unless the Board determines otherwise, the Committee shall be comprised solely of two or more "non-employee directors," as such term is defined in Rule 16b-3 under the Exchange Act, or as may otherwise be permitted under Rule 16b-3. Further, to the extent required by Section 162(m) of the Code, the Plan shall be administered by a committee comprised of two or more "outside directors" (as such term is defined in Section 162(m)) or as may otherwise be permitted under Section 162(m). For the purposes of the Plan, the term "Administrator" shall refer to the Board and, upon its delegation to the Committee of all or part of its authority to administer the Plan, to the Committee. Notwithstanding the foregoing, the Board shall have sole authority to grant discretionary Awards (that is, Awards other than Director Options) to Directors who are not employees of the Corporation or its Affiliates.

(b) Subject to the provisions of the Plan, the Administrator shall have full and final authority in its discretion to take any action with respect to the Plan including, without limitation, the authority (i) to determine all matters relating to Awards, including selection of individuals to be granted Awards, the types of Awards, the number of shares of the Common Stock, if any, subject to an Award, and all terms,

conditions, restrictions and limitations of an Award; (ii) to prescribe the form or forms of Award Agreements evidencing any Awards granted under the Plan; (iii) to establish, amend and rescind rules and regulations for the administration of the Plan; and (iv) to construe and interpret the Plan, Awards and Award Agreements made under the Plan, to interpret rules and regulations for administering the Plan and to make all other determinations deemed necessary or advisable for administering the Plan. In addition, (i) the Administrator shall have the authority, in its sole discretion, to accelerate the date that any Award which was not otherwise exercisable, vested or earned shall become exercisable, vested or earned in whole or in part without any obligation to accelerate such date with respect to any other Award granted to any recipient; and (ii) the Administrator also may in its sole discretion modify or extend the terms and conditions for exercise, vesting or earning of an Award (in each case, taking into account any Code Section 409A considerations). The Administrator may determine that a Participant's rights, payments and/or benefits with respect to an Award (including but not limited to any shares issued or issuable and/or cash paid or payable with respect to an Award) shall be subject to reduction, cancellation, forfeiture or recoupment upon the occurrence of certain specified events, in addition to any otherwise applicable vesting or performance conditions of an Award. Such events may include, but shall not be limited to, termination of employment or service for cause, violation of policies of the Corporation or an Affiliate, breach of non-solicitation, noncompetition, confidentiality or other restrictive covenants that may apply to the Participant, or other conduct by the Participant that is determined by the Administrator to be detrimental to the business or reputation of the Corporation or any Affiliate. In addition, the Administrator shall have the authority and discretion to establish terms and conditions of Awards (including but not limited to the establishment of subplans) as the Administrator determines to be necessary or appropriate to conform to the applicable requirements or practices of jurisdictions outside of the United States. In addition to action by meeting in accordance with applicable laws, any action of the Administrator with respect to the Plan may be taken by a written instrument signed by all of the members of the Board or Committee, as appropriate, and any such action so taken by written consent shall be as fully effective as if it had been taken by a majority of the members at a meeting duly held and called. No member of the Board or Committee, as applicable, shall be liable while acting as Administrator for any action or determination made in good faith with respect to the Plan, an Award or an Award Agreement. The members of the Board or Committee, as applicable, shall be entitled to indemnification and reimbursement in the manner provided in the Corporation's certificate of incorporation and bylaws and/or under applicable law.

(c) Notwithstanding the other provisions of Section 3, the Administrator may delegate to one or more officers of the Corporation the authority to grant Awards, and to make any or all of the determinations reserved for the Administrator in the Plan and summarized in Section 3(b) with respect to such Awards (subject to any restrictions imposed by applicable laws, rules and regulations and such terms and conditions as may be established by the Administrator); provided, however, that, to the extent required by Section 16 of the Exchange Act or Section 162(m) of the Code, the Participant, at the time of said grant or other determination, (i) is not deemed to be an officer or director of the Corporation within the meaning of Section 16 of the Exchange Act; and (ii) is not deemed to be a Covered Employee as defined under Section 162(m) of the Code. To the extent that the Administrator has delegated authority to grant Awards pursuant to this Section 3(c) to one or more officers of the Corporation, references to the Administrator shall include references to such officer or officers, subject, however, to the requirements of the Plan, Rule 16b-3, Section 162(m) of the Code and other applicable laws, rules and regulations.

***4. Effective Date***

The Effective Date of the Plan shall be the day prior to the Public Offering Date. The Plan was amended effective June 14, 2007, amended and restated effective November 28, 2007, amended effective June 10, 2009, and amended and restated effective March 9, 2011. Awards may be granted under the

Plan on and after the Effective Date, but not after the date that is the tenth anniversary less one day after the Effective Date. Awards that are outstanding at the end of the Plan term (or such earlier termination date as may be established by the Board pursuant to Section 15(a)) shall continue in accordance with their terms, unless otherwise provided in the Plan or an Award Agreement.

***5. Shares of Stock Subject to the Plan; Award Limitations***

(a) *Shares of Stock Subject to the Plan*: Subject to adjustments as provided in Section 5(d), the aggregate number of shares of Common Stock that may be issued pursuant to Awards granted under the Plan shall not exceed the sum of (i) 5,620,000 shares, plus (ii) no more than 30,968 shares of Common Stock remaining available for issuance as of the Effective Date of the Plan under any Prior Plan, plus (iii) no more than 1,631,110 shares of Common Stock if and to the extent that any of such shares are subject to an award granted under a Prior Plan, which award was or is forfeited, cancelled, terminated, expires or lapses for any reason without the issuance of shares pursuant to the award. Shares delivered under the Plan shall be authorized but unissued shares, treasury shares or shares purchased on the open market or by private purchase. The Corporation hereby reserves sufficient authorized shares of Common Stock to meet the grant of Awards hereunder.

(b) *Award Limitation*s: Notwithstanding any provision in the Plan to the contrary, the following limitations shall apply to Awards granted under the Plan, in each case subject to adjustments pursuant to Section 5(d):

(i) The maximum number of shares of Common Stock that may be issued under the Plan pursuant to the grant of Incentive Options shall not exceed 7,282,078 shares, or such lesser number of shares as may be available under the Plan pursuant to Section 5(a) herein;

(ii) In any calendar year, no Participant may be granted Options and SARs that are not related to an Option for more than 500,000 shares of Common Stock;

(iii) No Participant may be granted Awards in any calendar year for more than 500,000 shares of Common Stock; and

(iv) No Participant may be paid more than $1,000,000 with respect to any cash-settled award or awards which were granted during any single calendar year.

(For purposes of Section 5(b)(ii) and (iii), an Option and Related SAR shall be treated as a single Award.)

(c) *Shares Not Subject to Limitations*: The following will not be applied to the share limitations of Section 5(a) above: (i) dividends, including dividends paid in shares, or dividend equivalents paid in cash in connection with outstanding Awards; (ii) Awards which by their terms are settled in cash rather than the issuance of shares; and (iii) any shares subject to an Award under the Plan which Award is forfeited, cancelled, terminated, expires or lapses for any reason or any shares subject to an Award which shares are repurchased or reacquired by the Corporation.

(d) *Adjustments*: If there is any change in the outstanding shares of Common Stock because of a merger, consolidation or reorganization involving the Corporation or an Affiliate, or if the Board of Directors of the Corporation declares a stock dividend, stock split distributable in shares of Common Stock, reverse stock split, combination or reclassification of the Common Stock, or if there is a similar change in the capital stock structure of the Corporation or an Affiliate affecting the Common Stock, the

number of shares of Common Stock reserved for issuance under the Plan shall be correspondingly adjusted, and the Administrator shall make such adjustments to Awards and to any provisions of this Plan as the Administrator deems equitable to prevent dilution or enlargement of Awards or as may be otherwise advisable.

***6. Eligibility***

An Award may be granted only to an individual who satisfies all of the following eligibility requirements on the date the Award is granted:

(a) The individual is either (i) an Employee, (ii) a Director, or (iii) an Independent Contractor.

(b) With respect to the grant of Incentive Options, the individual is otherwise eligible to participate under Section 6, is an Employee of the Corporation or a Parent or Subsidiary and does not own, immediately before the time that the Incentive Option is granted, stock possessing more than 10% of the total combined voting power of all classes of stock of the Corporation or a Parent or Subsidiary. Notwithstanding the foregoing, an Employee who owns more than 10% of the total combined voting power of the Corporation or a Parent or Subsidiary may be granted an Incentive Option if the Option Price is at least 110% of the Fair Market Value of the Common Stock, and the Option Period does not exceed five years. For this purpose, an individual will be deemed to own stock which is attributable to him under Section 424(d) of the Code.

(c) With respect to the grant of substitute awards or assumption of awards in connection with a merger, consolidation, acquisition, reorganization or similar business combination involving the Corporation or an Affiliate, the recipient is otherwise eligible to receive the Award and the terms of the award are consistent with the Plan and applicable laws, rules and regulations (including, to the extent deemed applicable, the federal securities laws registration provisions, Code Section 409A and Code Section 424(a)).

(d) The individual, being otherwise eligible under this Section 6, is selected by the Administrator as an individual to whom an Award shall be granted (as defined above, a “Participant”).

***7. Options***

(a) *Grant of Options*: Subject to the limitations of the Plan, the Administrator may in its sole and absolute discretion grant Options to such eligible individuals in such numbers, subject to such terms and conditions, and at such times as the Administrator shall determine. Both Incentive Options and Nonqualified Options may be granted under the Plan, as determined by the Administrator; provided, however, that Incentive Options may only be granted to Employees of the Corporation or a Parent or Subsidiary. To the extent that an Option is designated as an Incentive Option but does not qualify as such under Section 422 of the Code, the Option (or portion thereof) shall be treated as a Nonqualified Option. An Option may be granted with or without a Related SAR.

(b) *Option Price*: The Option Price shall be established by the Administrator and stated in the Award Agreement evidencing the grant of the Option; provided, that (i) the Option Price of an Incentive Option shall be no less than 100% of the Fair Market Value per share of the Common Stock as determined on the date the Option is granted (or 110% of the Fair Market Value with respect to Incentive Options granted to an Employee who owns stock possessing more than 10% of the total voting power of all classes of stock of the Corporation or a Parent or Subsidiary, as provided in Section 6(b)); (ii) the

Option Price of a Nonqualified Option shall be no less than 85% of the Fair Market Value per share of the Common Stock on the date the Option is granted; and (iii) in no event shall the Option Price per share of any Option be less than the par value per share of the Common Stock. Notwithstanding the foregoing, the Administrator may in its discretion authorize the grant of substitute or assumed options of an acquired entity with an Option Price not equal to at least 100% of the Fair Market Value of the stock on the date of grant if the terms of such substitution or assumption otherwise comply, to the extent deemed applicable, with Code Section 409A and Code Section 424(a).

(c) *Date of Grant*: An Option shall be considered to be granted on the date that the Administrator acts to grant the Option or on such other date as may be established by the Administrator in accordance with applicable laws.

(d) *Option Period and Limitations on the Right to Exercise Options*:

(i) The Option Period shall be determined by the Administrator at the time the Option is granted and shall be stated in the Award Agreement. With respect to Incentive Options, the Option Period shall not extend more than 10 years from the date on which the Option is granted (or five years with respect to Incentive Options granted to an Employee who owns stock possessing more than 10% of the total combined voting power of all classes of stock of the Corporation or a Parent or Subsidiary, as provided in Section 6(b)). Any Option or portion thereof not exercised before expiration of the Option Period shall terminate. The period or periods during which, and conditions pursuant to which, an Option may vest and become exercisable shall be determined by the Administrator in its discretion, subject to the terms of the Plan.

(ii) An Option may be exercised by giving written notice to the Corporation in form acceptable to the Administrator at such place and subject to such conditions as may be established by the Administrator or its designee. Such notice shall specify the number of shares to be purchased pursuant to an Option and the aggregate purchase price to be paid therefor and shall be accompanied by payment of such purchase price. The total number of shares that may be acquired upon exercise of an Option shall be rounded down to the nearest whole share. Unless an Award Agreement provides otherwise, such payment shall be in the form of cash or cash equivalent; provided that, where permitted by the Administrator and applicable laws, rules and regulations (and subject to such terms and conditions as may be established by the Administrator), payment may also be made:

(A) By delivery (by either actual delivery or attestation) of shares of Common Stock owned by the Participant for such time period, if any, as may be determined by the Administrator and otherwise acceptable to the Administrator;

(B) By shares of Common Stock withheld upon exercise;

(C) With respect only to purchases upon exercise of an Option after a public market for the Common Stock exists, by delivery of written notice of exercise to the Corporation and delivery to a broker of written notice of exercise and irrevocable instructions to promptly deliver to the Corporation the amount of sale or loan proceeds to pay the Option Price;

(D) By such other payment methods as may be approved by the Administrator and which are acceptable under applicable law; or

(E) By any combination of the foregoing methods.

Shares tendered or withheld in payment on the exercise of an Option shall be valued at their Fair Market Value on the date of exercise. For the purposes of the Plan, a "public market" for the Common Stock shall be deemed to exist (i) upon consummation of a firm commitment underwritten public offering of the Common Stock pursuant to an effective registration statement under the Securities Act, or (ii) if the Administrator otherwise determines that there is an established public market for the Common Stock.

(iii) Unless the Administrator determines otherwise, no Option granted to a Participant who was an Employee at the time of grant shall be exercised unless the Participant is, at the time of exercise, an Employee as described in Section 6(a), and has been an Employee continuously since the date the Option was granted, subject to the following:

(A) The employment relationship of a Participant shall be treated as continuing intact for any period that the Participant is on military or sick leave or other bona fide leave of absence, provided that the period of such leave does not exceed 90 days, or, if longer, as long as the Participant's right to reemployment is guaranteed either by statute or by contract. The employment relationship of a Participant shall also be treated as continuing intact while the Participant is not in active service because of Disability. The Administrator shall have sole authority to determine whether a Participant is disabled under the Plan and, if applicable, the Participant's Termination Date.

(B) Unless the Administrator determines otherwise (taking into account any Code Section 409A considerations), if the employment of a Participant is terminated because of Disability or death, the Option may be exercised only to the extent vested and exercisable on the Participant's Termination Date, except that the Administrator may in its sole discretion (taking into account any Code Section 409A considerations) accelerate the date for exercising all or any part of the Option which was not otherwise vested and exercisable on the Termination Date. The Option must be exercised, if at all, prior to the first to occur of the following, whichever shall be applicable: (X) the close of the one-year period following the Termination Date (or such other period stated in the Award Agreement); or (Y) the close of the Option Period. In the event of the Participant's death, such Option shall be exercisable by such person or persons as shall have acquired the right to exercise the Option by will or by the laws of intestate succession.

(C) Unless the Administrator determines otherwise (taking into account any Code Section 409A considerations), if the employment of the Participant is terminated for any reason other than Disability, death or for "Cause," his Option may be exercised to the extent vested and exercisable on his Termination Date, except that the Administrator may in its sole discretion (taking into account any Code Section 409A considerations) accelerate the date for exercising all or any part of the Option which was not otherwise vested and exercisable on the Termination Date. The Option must be exercised, if at all, prior to the first to occur of the following, whichever shall be applicable: (X) the close of the period of three months next succeeding the Termination Date (or such other period stated in the Award Agreement); or (Y) the close of the Option Period. If the Participant dies following such termination of employment and prior to the earlier of the dates specified in (X) or (Y) of this subparagraph (C), the Participant shall be treated as having died while employed under subparagraph (B) (treating for this purpose the Participant's

date of termination of employment as the Termination Date). In the event of the Participant's death, such Option shall be exercisable by such person or persons as shall have acquired the right to exercise the Option by will or by the laws of intestate succession.

(D) Unless the Administrator determines otherwise (taking into account any Code Section 409A considerations), if the employment of the Participant is terminated for "Cause," his Option shall lapse and no longer be exercisable as of his Termination Date, as determined by the Administrator.

(E) Notwithstanding the foregoing, the Administrator may, in its sole discretion (taking into account any Code Section 409A considerations), accelerate the date for exercising all or any part of an Option which was not otherwise vested and exercisable on the Termination Date, extend the period during which an Option may be exercised, modify the terms and conditions to exercise, or any combination of the foregoing.

(iv) Unless the Administrator determines otherwise (taking into account any Code Section 409A considerations), an Option granted to a Participant who was a Director but who was not an Employee at the time of grant may be exercised only to the extent vested and exercisable on the Participant's Termination Date (unless the termination was for Cause), and must be exercised, if at all, prior to the first to occur of the following, as applicable: (X) the close of the period of six months next succeeding the Termination Date (or such other period stated in the Award Agreement); or (Y) the close of the Option Period. If the services of a Participant are terminated for Cause, his Option shall lapse and no longer be exercisable as of his Termination Date, as determined by the Administrator. Notwithstanding the foregoing, the Administrator may in its sole discretion (taking into account any Code Section 409A considerations), accelerate the date for exercising all or any part of an Option which was not otherwise exercisable on the Termination Date, extend the period during which an Option may be exercised, modify the other terms and conditions to exercise, or any combination of the foregoing.

(v) Unless the Administrator determines otherwise (taking into account any Code Section 409A considerations), an Option granted to a Participant who was an Independent Contractor at the time of grant (and who does not thereafter become an Employee, in which case he shall be subject to the provisions of Section 7(d)(iii)) may be exercised only to the extent vested and exercisable on the Participant's Termination Date (unless the termination was for Cause), and must be exercised, if at all, prior to the first to occur of the following, as applicable: (X) the close of the period of three months next succeeding the Termination Date (or such other period stated in the Award Agreement); or (Y) the close of the Option Period. If the services of a Participant are terminated for Cause, his Option shall lapse and no longer be exercisable as of his Termination Date, as determined by the Administrator. Notwithstanding the foregoing, the Administrator may in its sole discretion (taking into account any Code Section 409A considerations), accelerate the date for exercising all or any part of an Option which was not otherwise exercisable on the Termination Date, extend the period during which an Option may be exercised, modify the other terms and conditions to exercise, or any combination of the foregoing.

(e) *Notice of Disposition*: If shares of Common Stock acquired upon exercise of an Incentive Option are disposed of within two years following the date of grant or one year following the transfer of such shares to a Participant upon exercise, the Participant shall, promptly following such disposition,

notify the Corporation in writing of the date and terms of such disposition and provide such other information regarding the disposition as the Administrator may reasonably require.

(f) *Limitation on Incentive Options*: In no event shall there first become exercisable by an Employee in any one calendar year Incentive Options granted by the Corporation or any Parent or Subsidiary with respect to shares having an aggregate Fair Market Value (determined at the time an Incentive Option is granted) greater than $100,000. To the extent that any Incentive Options are first exercisable by a Participant in excess of such limitation, the excess shall be considered a Nonqualified Option.

(g) *Nontransferability*: Incentive Options shall not be transferable (including by sale, assignment, pledge or hypothecation) other than by will or the laws of intestate succession or, in the Administrator's discretion, as may otherwise be permitted in accordance with Treas. Reg. Section 1.421-1(b)(2) or any successor provision thereto. Nonqualified Options shall not be transferable (including by sale, assignment, pledge or hypothecation) other than by will or the laws of intestate succession, except as may be permitted by the Administrator in a manner consistent with the registration provisions of the Securities Act. An Option shall be exercisable during the Participant's lifetime only by him, by his guardian or legal representative or by a transferee in a transfer permitted by this Section 7(g). The designation of a beneficiary in accordance with Section 19(g) does not constitute a transfer.

***8. Director Options***

(a) *General*: Each Nonemployee Director who is otherwise eligible under this Section 8 shall be granted a Director Option or Director Options as provided in Section 8. Director Options shall be designated as Nonqualified Options. Director Options shall be subject to the other terms and conditions of the Plan except as otherwise provided in Section 8.

(b) *Eligibility*: A Director Option may be granted only to an individual who is a Nonemployee Director of the Corporation on the date the Director Option is granted. A Nonemployee Director may also be eligible for other Awards (including but not limited to Options granted pursuant to Section 7), subject to the terms of the Plan and the Administrator's discretion.

(c) *Grant of Initial Options Upon Initial Election or Appointment to the Board*: Each Nonemployee Director who is first elected or appointed to the Board after the Public Offering Date shall receive an Initial Option to purchase 25,000 shares of Common Stock. The date of grant of such an Initial Option shall be the fifth business day after the date of the annual meeting of stockholders as to those Nonemployee Directors who are first elected at an annual meeting of stockholders and the fifth business day after the date of election or appointment to the Board as to those Nonemployee Directors who are first elected or appointed to the Board other than at an annual meeting of stockholders. In addition, a Nonemployee Director who serves as chairman of the Board shall also receive an Initial Option for 10,000 shares when first elected or appointed as chairman. The date of grant of such Initial Option shall be the fifth business day after the date on which the Director is first elected or appointed as chairman of the Board.

(d) *Grant of Annual Options*: Each Nonemployee Director also shall be granted, on an annual basis commencing with the 2007 annual meeting of stockholders, a Director Option to purchase 7,500 shares of Common Stock (or, a Director Option for 12,500 shares, in the case of the chairman of the Board), provided that the Nonemployee Director continues to serve as a member of the Board as of the date of grant. The date of grant of such an Annual Option shall be the fifth business day after the date of the annual or other stockholders meeting at which directors are elected. For the avoidance of

doubt, a Nonemployee Director elected for the first time to the Board at an annual meeting of stockholders shall only receive an Initial Option in connection with such election, and shall not receive an Annual Option on the fifth business day following such meeting as well.

(e) *Option Price*: The price per share of Common Stock at which a Director Option may be exercised shall be 100% of the Fair Market Value per share of the Common Stock on the date the Option is granted.

(f) *Option Period and Limitations on the Right to Exercise Options*:

(i) The Option Period of a Director Option shall be 10 years from the date of grant. Initial Options shall become exercisable as provided in Section 8(f)(i)(A), and Annual Options shall become exercisable as provided in Section 8(f)(i)(B). To the extent that all or part of an Option becomes exercisable but is not exercised, such Option shall accumulate and be exercisable by the Director in whole or in part at any time before the expiration of the Option Period. The total number of shares that may be acquired upon the exercise of an Initial Option or Annual Option shall be rounded down to the nearest whole share. Any Director Option or portion thereof not exercised before expiration of the Option Period shall terminate.

(A) Initial Options. An Initial Option shall vest and become exercisable with respect to one-third of the shares subject to the Option on the earlier of (w) the first anniversary of the date of grant or (x) the business day immediately preceding the date of the Corporation's annual meeting of stockholders that occurs in the calendar year immediately following the calendar year in which the date of grant occurs, provided that the Nonemployee Director remains in service on such earlier date. An Initial Option shall vest and become exercisable with respect to the remaining two-thirds of the shares subject to the Option in pro rata quarterly installments over the second and third years following the date of grant so that an Initial Option will be vested and exercisable in full on the earlier of (y) the third anniversary of the date of grant or (z) the business day immediately preceding the date of the Corporation's annual meeting of stockholders that occurs in the third calendar year following the calendar year in which the date of grant occurs, provided that the Nonemployee Director remains in service as a Director during such periods.

(B) Annual Options. An Annual Option granted shall vest and become exercisable on the earlier of (i) the first anniversary of the date of grant or (ii) the business day immediately preceding the date of the Corporation's annual meeting of stockholders that occurs in the calendar year immediately following the calendar year in which the date of grant occurs, provided that the Nonemployee Director remains in service as a Director on such earlier date.

(ii) Unless the Administrator determines otherwise (taking into account any Code Section 409A considerations), a Director Option granted to a Nonemployee Director at the time of grant may be exercised only to the extent vested and exercisable on the Nonemployee Director's Termination Date (unless the termination was for Cause), and must be exercised, if at all, prior to the first to occur of the following, as applicable: (X) the close of the period of six months next succeeding the Termination Date (or such other period stated in the Award Agreement); or (Y) the close of the Option Period. If the services of a Nonemployee Director are terminated for Cause, his Director Option shall lapse and no longer be exercisable as of his Termination Date, as determined by the Administrator.

(iii) A Director Option shall be exercised by giving written notice to the Administrator or its designee at such time and place as the Administrator shall direct. Such notice shall specify the number of shares to be purchased pursuant to the Director Option and the aggregate purchase price to be paid therefor, and shall be accompanied by the payment of such purchase price. Payment shall be made in accordance with Section 7(d)(ii).

(g) *Nontransferability*: A Director Option shall not be transferable (including by sale, assignment, pledge or hypothecation) other than by will or the laws of intestate succession, except as may be permitted by the Administrator in a manner consistent with the registration provisions of the Securities Act. Except as may be permitted by the preceding sentence, a Director Option shall be exercisable during the Nonemployee Director's lifetime only by him or by his guardian or legal representative. The designation of a beneficiary in accordance with Section 19(g) does not constitute a transfer.

***9. Stock Appreciation Rights***

(a) *Grant of SARs*: Subject to the limitations of the Plan, the Administrator may in its sole and absolute discretion grant SARs to such eligible individuals, in such numbers, upon such terms and at such times as the Administrator shall determine. SARs may be granted to the holder of an Option (a "Related Option") with respect to all or a portion of the shares of Common Stock subject to the Related Option (a "Related SAR") or may be granted separately to an eligible individual (a "Freestanding SAR"). The base price per share of an SAR shall be no less than 100% of the Fair Market Value per share of the Common Stock on the date the SAR is granted. Notwithstanding the foregoing, the Administrator may in its discretion authorize the grant of substitute or assumed SARs of an acquired entity with a base price per share not equal to at least 100% of the Fair Market Value of the stock on the date of grant, if the terms of such substitution or assumption otherwise comply, to the extent deemed applicable, with Code Section 409A and Code Section 424(a).

(b) *Related SARs*: A Related SAR may be granted either concurrently with the grant of the Related Option or (if the Related Option is a Nonqualified Option) at any time thereafter prior to the complete exercise, termination, expiration or cancellation of such Related Option; provided, however, that Related SARs must be granted in accordance with Code Section 409A. The base price of a Related SAR shall be equal to the Option Price of the Related Option. Related SARs shall be exercisable only at the time and to the extent that the Related Option is exercisable (and may be subject to such additional limitations on exercisability as the Administrator may provide in the agreement), and in no event after the complete termination or full exercise of the Related Option. Notwithstanding the foregoing, a Related SAR that is related to an Incentive Option may be exercised only to the extent that the Related Option is exercisable and only when the Fair Market Value exceeds the Option Price of the Related Option. Upon the exercise of a Related SAR granted in connection with a Related Option, the Option shall be canceled to the extent of the number of shares as to which the SAR is exercised, and upon the exercise of a Related Option, the Related SAR shall be canceled to the extent of the number of shares as to which the Related Option is exercised or surrendered.

(c) *Freestanding SARs*: An SAR may be granted without relationship to an Option (as defined above, a "Freestanding SAR") and, in such case, will be exercisable upon such terms and subject to such conditions as may be determined by the Administrator, subject to the terms of the Plan.

(d) *Exercise of SARs*:

(i) Subject to the terms of the Plan, SARs shall be vested and exercisable in whole or in part upon such terms and conditions as may be established by the Administrator and stated in the applicable Award Agreement. The period during which an SAR may be exercisable shall not exceed 10 years from the date of grant or, in the case of Related SARs, such shorter Option Period as may apply to the Related Option. Any SAR or portion thereof not exercised before expiration of the period established by the Administrator shall terminate.

(ii) SARs may be exercised by giving written notice to the Corporation in form acceptable to the Administrator at such place and subject to such terms and conditions as may be established by the Administrator or its designee. Unless the Administrator determines otherwise, the date of exercise of an SAR shall mean the date on which the Corporation shall have received proper notice from the Participant of the exercise of such SAR.

(iii) Each Participant's Award Agreement shall set forth the extent to which the Participant shall have the right to exercise an SAR following termination of the Participant's employment or service with the Corporation. Such provisions shall be determined in the sole discretion of the Administrator, need not be uniform among all SARs issued pursuant to this Section 9, and may reflect distinctions based on the reasons for termination of employment. Notwithstanding the foregoing, unless the Administrator determines otherwise, no SAR may be exercised unless the Participant is, at the time of exercise, an eligible Participant, as described in Section 6, and has been a Participant continuously since the date the SAR was granted, subject to the provisions of Sections 7(d)(iii), (iv) and (v).

(e) *Payment Upon Exercise*: Subject to the limitations of the Plan, upon the exercise of an SAR, a Participant shall be entitled to receive payment from the Corporation in an amount determined by multiplying (i) the difference between the Fair Market Value of a share of Common Stock on the date of exercise of the SAR over the base price of the SAR by (ii) the number of shares of Common Stock with respect to which the SAR is being exercised. Notwithstanding the foregoing, the Administrator in its discretion may limit in any manner the amount payable with respect to an SAR. The consideration payable upon exercise of an SAR shall be paid in cash, shares of Common Stock (valued at Fair Market Value on the date of exercise of the SAR) or a combination of cash and shares of Common Stock, as determined by the Administrator.

(f) *Nontransferability*: Unless the Administrator determines otherwise, (i) SARs shall not be transferable (including by sale, assignment, pledge or hypothecation) other than by will or the laws of intestate succession, and (ii) SARs may be exercised during the Participant's lifetime only by him or by his guardian or legal representative. The designation of a beneficiary in accordance with Section 19(g) does not constitute a transfer.

***10. Restricted Awards***

(a) *Grant of Restricted Awards*: Subject to the limitations of the Plan, the Administrator may in its sole and absolute discretion grant Restricted Awards to such individuals for such numbers of shares of Common Stock, upon such terms and at such times as the Administrator shall determine. Such Restricted Awards may be in the form of Restricted Stock Awards and/or Restricted Stock Units that are subject to certain conditions, which conditions must be met in order for the Restricted Award to vest and be earned (in whole or in part) and no longer subject to forfeiture. Restricted Stock Awards shall be payable in shares of Common Stock. Restricted Stock Units shall be payable in cash or shares of

Common Stock, or partly in cash and partly in shares of Common Stock, in accordance with the terms of the Plan and the discretion of the Administrator. The Administrator shall determine the nature, length and starting date of the period, if any, during which a Restricted Award may be earned (the "Restriction Period"), and shall determine the conditions which must be met in order for a Restricted Award to be granted or to vest or be earned (in whole or in part), which conditions may include, but are not limited to, payment of a stipulated purchase price, attainment of performance objectives, continued service or employment for a certain period of time (or a combination of attainment of performance objectives and continued service), Retirement, Displacement, Disability, death, or any combination of such conditions. Notwithstanding the foregoing, Restricted Awards that vest based solely on continued service or the passage of time shall be subject to a minimum Restriction Period of one year (except in the case of (i) Restricted Awards assumed or substituted in connection with mergers, acquisitions or other business transactions, (ii) Restricted Awards granted in connection with the recruitment or hiring of a Participant, and/or (iii) Restricted Awards granted pursuant to any incentive compensation or bonus program established by the Corporation). In the case of Restricted Awards based upon performance criteria, or a combination of performance criteria and continued service, the Administrator shall determine the Performance Measures applicable to such Restricted Awards (subject to Section 1(ii)).

(b) *Vesting of Restricted Awards*: Subject to the terms of the Plan (and taking into account any Code Section 409A considerations), the Administrator shall have sole authority to determine whether and to what degree Restricted Awards have vested and been earned and are payable and to establish and interpret the terms and conditions of Restricted Awards. The Administrator may (taking into account any Code Section 409A considerations) accelerate the date that any Restricted Award granted to a Participant shall be deemed to be vested or earned in whole or in part, without any obligation to accelerate such date with respect to other Restricted Awards granted to any Participant.

(c) *Forfeiture of Restricted Awards*: Unless the Administrator determines otherwise (taking into account any Code Section 409A considerations), if the employment or service of a Participant shall be terminated for any reason and all or any part of a Restricted Award has not vested or been earned pursuant to the terms of the Plan and the individual Award, such Award, to the extent not then vested or earned, shall be forfeited immediately upon such termination and the Participant shall have no further rights with respect thereto.

(d) *Dividend and Voting Rights; Share Certificates*: The Administrator shall have sole discretion to determine whether a Participant shall have dividend rights, voting rights or other rights as a stockholder with respect to shares subject to a Restricted Award which has not yet vested or been earned. If the Administrator so determines, a certificate or certificates for shares of Common Stock subject to a Restricted Award may be issued in the name of the Participant as soon as practicable after the Award has been granted; provided, however, that, notwithstanding the foregoing, the Administrator shall have the right to retain custody of certificates evidencing the shares subject to a Restricted Award and to require the Participant to deliver to the Corporation a stock power, endorsed in blank, with respect to such Award, until such time as the Restricted Award vests (or is forfeited) and is no longer subject to a substantial risk of forfeiture.

(e) *Nontransferability*: Unless the Administrator determines otherwise, Restricted Awards that have not vested shall not be transferable (including by sale, assignment, pledge or hypothecation) other than by will or the laws of intestate succession, and the recipient of a Restricted Award shall not sell, transfer, assign, pledge or otherwise encumber shares subject to the Award until the Restriction Period has expired and until all conditions to vesting have been met. The designation of a beneficiary in accordance with Section 19(g) does not constitute a transfer.

***11. Performance Awards***

(a) *Grant of Performance Awards*: Subject to the terms of the Plan, the Administrator may in its discretion grant Performance Awards to such eligible individuals upon such terms and conditions and at such times as the Administrator shall determine. Performance Awards may be in the form of Performance Shares and/or Performance Units. An Award of a Performance Share is a grant of a right to receive shares of Common Stock, the cash value thereof, or a combination thereof (as determined in the Administrator's discretion), which is contingent upon the achievement of performance or other objectives during a specified period and which has a value on the date of grant equal to the Fair Market Value of a share of Common Stock. An Award of a Performance Unit is a grant of a right to receive shares of Common Stock, a designated dollar value amount of Common Stock or a combination thereof (as determined in the Administrator's discretion) which is contingent upon the achievement of performance or other objectives during a specified period, and which has an initial value determined in a dollar amount established by the Administrator at the time of grant. Subject to Section 5(b), the Administrator shall have complete discretion in determining the number of Performance Units and/or Performance Shares granted to any Participant. The Administrator shall determine the nature, length and starting date of the period during which a Performance Award may be earned (the "Performance Period"), and shall determine the conditions which must be met in order for a Performance Award to be granted or to vest or be earned (in whole or in part), which conditions may include but are not limited to specified performance objectives, continued service or employment for a certain period of time, or a combination of such conditions. Subject to Section 1(ii), the Administrator shall determine the Performance Measures to be used in valuing Performance Awards.

(b) *Earning of Performance Awards*: Subject to the terms of the Plan (and taking into account any Code Section 409A considerations), the Administrator shall have sole authority to determine whether and to what degree Performance Awards have been earned and are payable and to interpret the terms and conditions of Performance Awards and the provisions of Section 11. The Administrator, in its sole and absolute discretion, may (taking into account any Code Section 409A considerations) accelerate the date that any Performance Award granted to a Participant shall be deemed to be earned in whole or in part, without any obligation to accelerate such date with respect to other Awards granted to any Participant.

(c) *Form of Payment*: Payment of the amount to which a Participant shall be entitled upon earning a Performance Award shall be made in cash, shares of Common Stock, or a combination of cash and shares of Common Stock, as determined by the Administrator in its sole discretion. Payment may be made in a lump sum or in installments upon such terms as may be established by the Administrator.

(d) *Forfeiture of Performance Awards*: Unless the Administrator determines otherwise (taking into account any Code Section 409A considerations), if the employment or service of a Participant shall terminate for any reason and the Participant has not earned all or part of a Performance Award pursuant to the terms of the Plan and individual Award, such Award, to the extent not then earned, shall be forfeited immediately upon such termination and the Participant shall have no further rights with respect thereto.

(e) *Nontransferability:* Unless the Administrator determines otherwise, Performance Awards that have not been earned shall not be transferable (including by sale, assignment, pledge or hypothecation) other than by will or the laws of intestate succession, and the recipient of a Performance Award shall not sell, transfer, assign, pledge or otherwise encumber any shares subject to the Award until the Performance Period has expired and until the conditions to earning the Award have been met. The designation of a beneficiary in accordance with Section 19(g) does not constitute a transfer.

***12. Phantom Stock Awards***

(a) *Grant of Phantom Stock Awards*: Subject to the terms of the Plan, the Administrator may in its discretion grant Phantom Stock Awards to such eligible individuals, in such numbers, upon such terms and at such times as the Administrator shall determine. A Phantom Stock Award is an Award to a Participant of a number of hypothetical share units with respect to shares of Common Stock, with a value per unit based on the Fair Market Value of a share of Common Stock.

(b) *Vesting of Phantom Stock Awards*: Subject to the terms of the Plan (and taking into account any Code Section 409A considerations), the Administrator shall have sole authority to determine whether and to what degree Phantom Stock Awards have vested and are payable and to interpret the terms and conditions of Phantom Stock Awards.

(c) *Forfeiture of Phantom Stock Awards*: Unless the Administrator determines otherwise (taking into account any under Code Section 409A considerations), if the employment or service of a Participant shall be terminated for any reason and all or any part of a Phantom Stock Award has not vested and become payable pursuant to the terms of the Plan and the individual Award, such Award, to the extent not then vested or earned, shall be forfeited immediately upon such termination and the Participant shall have no further rights with respect thereto.

(d) *Payment of Phantom Stock Awards*: Upon vesting of all or a part of a Phantom Stock Award and satisfaction of such other terms and conditions as may be established by the Administrator, the Participant shall be entitled to a payment of an amount equal to the Fair Market Value of one share of Common Stock with respect to each such Phantom Stock unit which has vested and is payable. Payment may be made, in the discretion of the Administrator, in cash or in shares of Common Stock valued at their Fair Market Value on the applicable vesting date or dates (or other date or dates determined by the Administrator), or in a combination thereof. The Administrator may, however, establish a limitation on the amount payable in respect of each share of Phantom Stock. Payment may be made in a lump sum or upon such terms as may be established by the Administrator.

(e) *Nontransferability*: Unless the Administrator determines otherwise, (i) Phantom Stock Awards that have not vested shall not be transferable (including by sale, assignment, pledge or hypothecation) other than by will or the laws of intestate succession, (ii) Phantom Stock Awards may be exercised during the Participant's lifetime only by him or by his guardian or legal representative, and (iii) shares of Common Stock (if any) subject to a Phantom Stock Award may not be sold, transferred, assigned, pledged or otherwise encumbered until the Phantom Stock Award has vested and all other conditions established by the Administrator have been met. The designation of a beneficiary in accordance with Section 19(g) does not constitute a transfer.

***13. Dividends and Dividend Equivalents***

The Administrator may, in its sole discretion, provide that the Awards granted under the Plan earn dividends or dividend equivalents; provided, however, that dividends and dividend equivalents, if any, on unearned or unvested awards shall not be paid (even if accrued) unless and until the underlying Award (or portion thereof) has vested and/or been earned. Any crediting of dividends or dividend equivalents may be subject to such additional restrictions and conditions as the Administrator may establish, including reinvestment in additional shares of Common Stock or share equivalents. Notwithstanding the other provisions herein, any dividends or dividend equivalent rights related to an Award shall be structured in a manner so as to avoid causing the Award and related dividends or

dividend equivalent rights to be subject to Code Section 409A or shall otherwise be structured so that the Award and the dividends or dividend equivalents are in compliance with Code Section 409A.

***14. No Right or Obligation of Continued Employment or Service***

Neither the Plan, the grant of an Award nor any other action related to the Plan shall confer upon the Participant any right to continue in the employment or service of the Corporation or an Affiliate as an Employee, Director or Independent Contractor or to interfere in any way with the right of the Corporation or an Affiliate to terminate the Participant's employment or service at any time.

***15. Amendment and Termination of the Plan***

(a) *Amendment and Termination of Plan*: The Plan may be amended, altered and/or terminated at any time by the Board; provided, that (i) approval of an amendment to the Plan by the stockholders of the Corporation shall be required to the extent, if any, that stockholder approval of such amendment is required by applicable law, rule or regulation; and (ii) except for adjustments made pursuant to Section 5(d), (A) the Option Price for any outstanding Option or base price of any outstanding SAR may not be decreased after the date of grant and (B) as of any particular date, no outstanding Option or SAR that has an Option Price or base price above Fair Market Value on such date may be surrendered to the Corporation as consideration for the grant of a new Option or SAR with a lower Option Price or base price than the original Option or SAR, as the case may be, or for another equity award, in each case (clauses (A) and (B)) without stockholder approval.

(b) *Amendment and Termination of Awards*: The Administrator may amend, alter or terminate any Award granted under the Plan, prospectively or retroactively, but such amendment, alteration or termination of an Award shall not, without the consent of the recipient of an outstanding Award, materially adversely affect the rights of the recipient with respect to the Award.

(c) *Unilateral Authority of Administrator to Modify Plan and Awards*: Notwithstanding Section 15(a) and Section 15(b) herein, the following provisions shall apply:

(i) The Administrator shall have unilateral authority to amend the Plan and any Award (without Participant consent and without stockholder approval, unless such stockholder approval is required by applicable laws, rules or regulations) to the extent necessary to comply with applicable laws, rules or regulations or changes to applicable laws, rules or regulations (including but not limited to Code Section 409A, Code Section 422 and federal securities laws).

(ii) The Administrator shall have unilateral authority to make adjustments to the terms and conditions of Awards in recognition of unusual or nonrecurring events affecting the Corporation or any Affiliate, or the financial statements of the Corporation or any Affiliate, or of changes in accounting principles, if the Administrator determines that such adjustments are appropriate in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the Plan or necessary or appropriate to comply with applicable accounting principles.

***16. Restrictions on Awards and Shares***

The Corporation may impose such restrictions on Awards, shares and any other benefits underlying Awards hereunder as it may deem advisable, including without limitation restrictions under the federal securities laws, the requirements of any stock exchange or similar organization and any blue

sky, state or foreign securities laws applicable to such securities. Notwithstanding any other Plan provision to the contrary, the Corporation shall not be obligated to issue, deliver or transfer shares of Common Stock under the Plan, make any other distribution of benefits under the Plan, or take any other action, unless such delivery, distribution or action is in compliance with all applicable laws, rules and regulations (including but not limited to the requirements of the Securities Act). The Corporation may cause a restrictive legend to be placed on any certificate issued pursuant to an Award hereunder in such form as may be prescribed from time to time by applicable laws and regulations or as may be advised by legal counsel.

***17. Change in Control***

The Administrator shall (taking into account any Code Section 409A considerations) have sole discretion to determine the effect, if any, on an Award, including but not limited to the vesting, earning and/or exercisability of an Award, in the event of a Change in Control. Without limiting the effect of the foregoing, in the event of a Change in Control, the Administrator's discretion shall include, but shall not be limited to, the discretion to determine that an Award shall vest, be earned or become exercisable in whole or in part, shall be assumed or substituted for another award, shall be cancelled without the payment of consideration, shall be cancelled in exchange for a cash payment or other consideration, and/or that other actions (or no action) shall be taken with respect to the Award. The Administrator also has discretion to determine that acceleration or any other effect of a Change in Control on an Award shall be subject to both the occurrence of a Change in Control event and termination of employment or service of the Participant. Any such determination of the Administrator may be, but shall not be required to be, stated in an individual Award Agreement.

***18. Compliance with Code Section 409A***

(a) *General*: Notwithstanding any other provision in the Plan or an Award to the contrary, if and to the extent that Code Section 409A is deemed to apply to the Plan or any Award granted under the Plan, it is the general intention of the Corporation that the Plan and all such Awards shall, to the extent practicable, comply with Code Section 409A, and the Plan and any such Award shall, to the extent practicable, be construed in accordance therewith. Deferrals of shares or any other benefits distributable pursuant to an Award otherwise exempt from Code Section 409A in a manner that would cause Code Section 409A to apply shall not be permitted unless such deferrals are in compliance with Code Section 409A. Without in any way limiting the effect of the foregoing, (i) in the event that exemption from or compliance with Code Section 409A requires that any special terms, provisions or conditions be included in the Plan or any Award, then such terms, provisions and conditions shall, to the extent practicable, be deemed to be made a part of the Plan or Award, as applicable; and (ii) terms used in the Plan or an Award Agreement shall be construed in accordance with Code Section 409A if and to the extent required. Further, in the event that the Plan or any Award shall be deemed not to comply with Code Section 409A, then neither the Corporation, the Administrator nor its or their designees or agents shall be liable to any Participant or other person for actions, decisions or determinations made in good faith.

(b) *Specific Terms Applicable to Awards Subject to Code Section 409A*: Without limiting the effect of Section 18(a), above, and notwithstanding any other provision in the Plan to the contrary, the following provisions shall, to the extent required under Code Section 409A, apply with respect to Awards deemed to involve the deferral of compensation under Code Section 409A:

(i) Distributions: Distributions may be made with respect to Awards subject to Code Section 409A not earlier than upon the occurrence of one or more of the following events: (A) separation from service; (B) disability; (C) death; (D) a specified time or pursuant to a fixed

schedule; (E) a change in the ownership or effective control of the Corporation, or in the ownership of a substantial portion of the assets of the Corporation; or (F) the occurrence of an unforeseeable emergency. Each of the preceding distribution events shall be defined and interpreted in accordance with Code Section 409A.

(ii) Specified Employees: With respect to Participants who are "specified employees" (as defined in Code Section 409A), a distribution due to separation from service may not be made before the date that is six months after the date of separation from service (or, if earlier, the date of death of the Participant), except as may be otherwise permitted pursuant to Code Section 409A. The aggregate amount of payments the Participant would have received but for the application of this section shall be paid during the seventh month following separation from service; all remaining payments shall be made in their ordinary course or as may be otherwise permitted under Code Section 409A.

(iii) No Acceleration: Acceleration of the time or schedule of any payment under the Plan that is subject to Code Section 409A (or that would become subject to Code Section 409A as a result of such acceleration) is prohibited, except that, to the extent permitted by the Administrator, acceleration of the time and/or form of a payment, where such accelerations do not violate Code Section 409A, may be allowed.

(iv) Short-Term Deferrals: If and to the extent deemed necessary to comply with short-term deferral exemption under Code Section 409A, shares of Common Stock, cash payments or other benefits subject to an Award shall, upon vesting and/or earning of the Award, be issued and distributed to the Participant (or his beneficiary) no later than the later of (a) the 15th day of the third month following the end of the Participant's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture, or (b) the 15th day of the third month following the end of the Company's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture, or shall otherwise be made in accordance with Code Section 409A.

(v) Deferral Elections:

(A) In the sole discretion of the Administrator, a Participant may be permitted to make an election as to the time or form of any distribution from an Award, provided that, except as specified in (B), (C) and (D) below, such election is made and becomes irrevocable not later than the close of the taxable year preceding the taxable year in which the services for which the Award is granted are to be performed, or at such other time or times as may be permitted under Code Section 409A. Notwithstanding the foregoing, a Participant may cancel a deferral election upon (X) a hardship distribution pursuant to Code Section 401(k), or (Y) upon application for a distribution under section 18(b)(i)(F) (unforeseeable emergency).

(B) In the case of the first year in which the Participant becomes eligible to participate in the Plan, the election described in (A) may be made with respect to services to be performed after the election within 30 days after the date the Participant becomes eligible to participate in the Plan.

(C) In the case of any performance-based compensation (as that term is defined in Code Section 409A), where such compensation is based on services

performed over a period of at least 12 months, the election described in (A) may be made no later than six months before the end of the period.

(D) In the case of any Award subject to a substantial risk of forfeiture (as defined in Code Section 409A), the election described in (A) may be made within 30 days of the date the Participant first obtains a legally binding right to the Award, provided that the Award requires the Participant to perform at least 12 months of service after such election is made.

(vi) Changes to Elections: To the extent that the Administrator, in its sole discretion, permits a subsequent election to delay a payment or change the form of payment that has been specified under (A), (B), (C) or (D) above, the following provisions shall apply:

(A) Such election may not take effect until 12 months after the date on which the election is made;

(B) Where the payment is to be made for reasons other than death, disability or unforeseeable emergency, as those terms are defined in Section 18(b)(i), above, the first payment with respect to which such election is made must be deferred for a period of not less than five years from the date such payment would otherwise have been made; and

(C) Any election related to a payment based upon a specified term or pursuant to a fixed schedule, as such terms are defined in Section 18(b)(i), above, may not be made less than 12 months prior to the date of the first scheduled payment hereunder.

Notwithstanding anything else in this Section 18(b)(vi) to the contrary and consistent with Code Section 409A, (i) the Administrator may elect, or may allow the Participant to elect, on or before December 31, 2007, the time or form of payment of amounts subject to Code Section 409A, provided that any such election occurring in 2007 shall apply only to amounts that are not otherwise payable in 2007 and does not cause an amount to be paid in 2007 that would not otherwise be payable in that year; and (ii) the Administrator may elect, or may allow the Participant to elect, on or before December 31, 2008, the time or form of payment of amounts subject to Code Section 409A, provided that any such election occurring in 2008 shall apply only to amounts that are not otherwise payable in 2008 and does not cause an amount to be paid in 2008 that would not otherwise be payable in that year.

(vii) Termination of Awards Subject to Code Section 409A. As permitted by the Administrator in its sole discretion, and in accordance with Code Section 409A, the Corporation may terminate an Award that is subject to Code Section 409A and distribute benefits to Participants.

***19. General Provisions***

(a) *Stockholder Rights*: Except as otherwise determined by the Administrator (and subject to the provisions of Section 10(d) regarding Restricted Awards), a Participant and his legal representative, legatees or distributees shall not be deemed to be the holder of any shares subject to an Award and shall not have any rights of a stockholder unless and until certificates for such shares have been issued and delivered to him or them under the Plan. A certificate or certificates for shares of

Common Stock acquired upon exercise of an Option or SAR shall be promptly issued in the name of the Participant (or his beneficiary) and distributed to the Participant (or his beneficiary) as soon as practicable following receipt of notice of exercise and, with respect to Options, payment of the Option Price (except as may otherwise be determined by the Corporation in the event of payment of the Option Price pursuant to Section 7(d)(ii)(C)). Except as otherwise provided in Section 10(d) regarding Restricted Awards, a certificate for any shares of Common Stock issuable pursuant to a Restricted Award, Performance Award or Phantom Stock Award shall be promptly issued in the name of the Participant (or his beneficiary) and distributed to the Participant (or his beneficiary) after the Award (or portion thereof) has vested or been earned.

(b) *Withholding*: The Corporation shall withhold all required local, state, federal, foreign and other taxes and any other amount required to be withheld by any governmental authority or law from any amount payable in cash with respect to an Award. Prior to the delivery or transfer of any certificate for shares or any other benefit conferred under the Plan, the Corporation shall require any recipient of an Award to pay to the Corporation in cash the amount of any tax or other amount required by any governmental authority to be withheld and paid over by the Corporation to such authority for the account of such recipient. Notwithstanding the foregoing, the Administrator may establish procedures to permit a recipient to satisfy such obligation in whole or in part, and any local, state, federal, foreign or other income tax obligations relating to such an Award, by electing (the "election") to have the Corporation withhold shares of Common Stock from the shares to which the recipient is entitled. The number of shares to be withheld shall have a Fair Market Value as of the date that the amount of tax to be withheld is determined as nearly equal as possible to (but not exceeding) the amount of such obligations being satisfied. Each election must be made in writing to the Administrator in accordance with election procedures established by the Administrator.

(c) *Section 16(b) Compliance*: To the extent that any Participants in the Plan are subject to Section 16(b) of the Exchange Act, it is the general intention of the Corporation that transactions under the Plan shall comply with Rule 16b-3 under the Exchange Act and that the Plan shall be construed in favor of such Plan transactions meeting the requirements of Rule 16b-3 or any successor rules thereto. Notwithstanding anything in the Plan to the contrary, the Administrator, in its sole and absolute discretion, may bifurcate the Plan so as to restrict, limit or condition the use of any provision of the Plan to Participants who are officers or directors subject to Section 16 of the Exchange Act without so restricting, limiting or conditioning the Plan with respect to other Participants.

(d) *Code Section 162(m) Performance-Based Compensation*. To the extent to which Section 162(m) of the Code is applicable, the Corporation intends that compensation paid under the Plan to Covered Employees will, to the extent practicable, constitute "qualified performance-based compensation" within the meaning of Section 162(m), unless otherwise determined by the Administrator. Accordingly, Awards granted to Covered Employees which are intended to qualify for the performance-based exception under Code Section 162(m) shall be deemed to include any such additional terms, conditions, limitations and provisions as are necessary to comply with the performance-based compensation exemption of Section 162(m), unless the Administrator, in its discretion, determines otherwise.

(e) *Unfunded Plan; No Effect on Other Plans*:

(i) The Plan shall be unfunded, and the Corporation shall not be required to create a trust or segregate any assets that may at any time be represented by Awards under the Plan. The Plan shall not establish any fiduciary relationship between the Corporation and any Participant or other person. Neither a Participant nor any other person shall, by reason of the Plan, acquire any

right in or title to any assets, funds or property of the Corporation or any Affiliate, including, without limitation, any specific funds, assets or other property which the Corporation or any Affiliate, in their discretion, may set aside in anticipation of a liability under the Plan. A Participant shall have only a contractual right to the Common Stock or other amounts, if any, payable under the Plan, unsecured by any assets of the Corporation or any Affiliate. Nothing contained in the Plan shall constitute a guarantee that the assets of such entities shall be sufficient to pay any benefits to any person.

(ii) The amount of any compensation deemed to be received by a Participant pursuant to an Award shall not constitute compensation with respect to which any other employee benefits of such Participant are determined, including, without limitation, benefits under any bonus, pension, profit sharing, life insurance or salary continuation plan, except as otherwise specifically provided by the terms of such plan or as may be determined by the Administrator.

(iii) The adoption of the Plan shall not affect any other stock incentive or other compensation plans in effect for the Corporation or any Affiliate, nor shall the Plan preclude the Corporation from establishing any other forms of stock incentive or other compensation for employees or service providers of the Corporation or any Affiliate.

(f) *Applicable Law*: The Plan shall be governed by and construed in accordance with the laws of the State of Delaware, without regard to the conflict of laws provisions of any state, and in accordance with applicable federal laws of the United States.

(g) *Beneficiary Designation*: The Administrator may permit a Participant to designate in writing a person or persons as beneficiary, which beneficiary shall be entitled to receive settlement of Awards (if any) to which the Participant is otherwise entitled in the event of death. In the absence of such designation by a Participant, and in the event of the Participant's death, the estate of the Participant shall be treated as beneficiary for purposes of the Plan, unless the Administrator determines otherwise. The Administrator shall have sole discretion to approve and interpret the form or forms of such beneficiary designation. A beneficiary, legal guardian, legal representative or other person claiming any rights pursuant to the Plan is subject to all terms and conditions of the Plan and any Award Agreement applicable to the Participant, except to the extent that the Plan and/or Award Agreement provide otherwise, and to any additional restrictions deemed necessary or appropriate by the Administrator.

(h) *Gender and Number*: Except where otherwise indicated by the context, words in any gender shall include any other gender, words in the singular shall include the plural and words in the plural shall include the singular.

(i) *Severability*: If any provision of the Plan shall be held illegal or invalid for any reason, such illegality or invalidity shall not affect the remaining parts of the Plan, and the Plan shall be construed and enforced as if the illegal or invalid provision had not been included.

(j) *Rules of Construction*: Headings are given to the sections of this Plan solely as a convenience to facilitate reference. The reference to any statute, regulation or other provision of law shall be construed to refer to any amendment to or successor of such provision of law.

(k) *Successors and Assigns*: The Plan shall be binding upon the Corporation, its successors and assigns, and Participants, their executors, administrators and permitted transferees and beneficiaries.

(l) *Right of Offset*: Notwithstanding any other provision of the Plan or an Award Agreement, the Corporation may reduce the amount of any payment or benefit otherwise payable to or on behalf of a Participant by the amount of any obligation of the Participant to the Corporation that is or becomes due and payable.

(m) *Effect of Changes in Status*: Unless otherwise provided in an Award Agreement or determined by the Administrator, an Award shall not be affected by any change in the terms, conditions or status of the Participant's employment or service, provided that the Participant continues to be in the employ of, or in service to, the Corporation or an Affiliate. Without limiting the foregoing, the Administrator has sole discretion to determine (taking into account any Code Section 409A considerations), at the time of grant of an Award or at any time thereafter, the effect, if any, on Awards granted to a Participant if the Participant's status as an Employee, Director or Independent Contractor changes, including but not limited to a change from full-time to part-time, or vice versa, or if other similar changes in the nature or scope of the Participant's employment or service occur.

(n) *Fractional Shares:* Except as otherwise provided by the Plan or the Administrator, (i) the total number of shares issuable pursuant to the exercise, vesting or earning of an Award shall be rounded under general rounding principles to the nearest whole share (except where rounding down is required in order to preserve intended tax treatment or otherwise required by applicable law, rule or regulation), (ii) no fractional shares shall be issued, and (iii) no consideration shall be paid for any such fractional shares.

*[Signature page to follow]*

IN WITNESS WHEREOF, this Targacept, Inc. 2006 Stock Incentive Plan, as amended and restated through March 9, 2011, is, by the authority of the Board of Directors of the Corporation, executed in behalf of the Corporation, effective as of the 9th day of March, 2011.

**TARGACEPT, INC.**

By: /s/ J. Donald deBethizy
Name: J. Donald deBethizy
Title: President and CEO

ATTEST:

/s/ Peter A. Zorn
Peter A. Zorn
Secretary

[Corporate Seal]

**2012 DECLARATION OF AMENDMENT TO**
**2006 STOCK INCENTIVE PLAN**

THIS 2012 DECLARATION OF AMENDMENT is made by Targacept, Inc. (the "Corporation") effective as of the 7th day of December 2012 (the "Amendment Date") to the Corporation's 2006 Stock Incentive Plan, as amended and restated through March 9, 2011 (the "Plan"). Capitalized terms used herein and not otherwise defined shall have the meanings ascribed in the Plan.

**R E C I T A L S:**

WHEREAS, on the Amendment Date, the Board of Directors of the Corporation, acting upon the recommendation of its Governance and Nominating Committee, approved an increase to the number of shares of Common Stock to be subject to Annual Options granted thereafter from 7,500 to 12,500 and, in the case of Annual Options granted to the chairman of the Board, from 12,500 to 17,500; and

WHEREAS implementation of such increases requires amendment of the Plan, and the Corporation desires to evidence such amendment by this Declaration of Amendment.

NOW, THEREFORE, IT IS DECLARED that:

1. effective as of the Amendment Date, Section 8(d) of the Plan ("*Grant of Annual Options*") is hereby amended by (a) deleting "12,500" in the first sentence thereof and replacing it with "17,500" and (b) deleting "7,500" in the first sentence thereof and replacing it with "12,500"; and

2. the Plan shall be unchanged except as expressly set forth herein and shall remain in full force and effect.

IN WITNESS WHEREOF, this Declaration of Amendment is executed on behalf of the Corporation effective as of the Amendment Date.

TARGACEPT, INC.

By: /s/ Stephen A. Hill
Stephen A. Hill
President and Chief Executive Officer

Date: 12/11/12

ATTEST:

/s/ Peter A. Zorn
Peter A. Zorn
SVP, Legal Affairs, General Counsel and Secretary

[Corporate Seal]

**Exhibit 10.11**

**TARGACEPT, INC.**
**RETENTION AWARD AGREEMENT**

THIS AGREEMENT (the "**Agreement**") is made effective as of the day of 201 , by and between Targacept, Inc., a Delaware corporation (the "**Company**"), and , an employee of the Company (the "**Employee**").

R E C I T A L S :

WHEREAS it is critical that the Company retain its employees to facilitate the achievement of important Company goals and, accordingly, the Company desires to provide additional incentive to the Employee to remain employed by the Company and provide valuable services;

NOW, THEREFORE, in consideration of the various promises and undertakings set forth herein and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties agree as follows:

Section 1. Retention Benefit. If (a) the Employee is employed by the Company, any parent or subsidiary of the Company or any successor to the Company on September 30, 2013, or (b) the Company, any parent or subsidiary of the Company or any successor to the Company terminates the Employee's employment prior to September 30, 2013 for any reason other than for "Cause" (as that term is defined in the Targacept, Inc. 2006 Stock Incentive Plan, as amended and restated through March 9, 2011, as ), then the Company will pay the Employee the sum of ($ ) (the "**Retention Award**"). Such payment shall be made (without interest) within thirty (30) days following the date, if any, that that the condition set forth in either clause (a) or clause (b) above is met; provided that, in the case of clause (b) and notwithstanding anything herein to the contrary, no Retention Award shall be due or payable unless Employee shall have executed and delivered to the Company a Release within such thirty (30) day period. "Release" means a general waiver and release, in a form determined by the Company, discharging the Company, its affiliates and its and their respective officers, directors, employees, agents, attorneys and representatives and the heirs, predecessors, successors and assigns of all of the foregoing from any and all claims, actions, causes of action or other liability, whether known or unknown, contingent or fixed, arising out of or in any way related to the Retention Award (including, without limitation, any claims under the Agreement, other than the Company's obligation to pay the consideration as provided in this Agreement). The determination of whether a termination is for Cause has occurred shall be made by the Compensation Committee of the Company's Board of Directors (the "**Committee**") acting in good faith.

Section 2. No Right to Continued Employment; Forfeiture. Nothing contained in this Agreement shall be construed as conferring upon the Employee the right or imposing upon him the obligation to continue in the employment of the Company, nor shall it limit the right of the Company to terminate the Employee's employment at any time for any reason or for no reason. If the Employee's employment terminates other than in accordance with the conditions described in Section 1 (whether by the Company or the Employee, and whether voluntary or involuntary), the Employee will forfeit his right to any portion of the Retention Award.

Section 3 No Trust Fund. The obligation of the Company to make payments hereunder shall constitute a liability of the Company to the Employee. Such payments shall be made from the general funds of the Company. The Company shall not be required to establish or maintain any special or separate fund or otherwise to segregate assets to assure that such payments shall be made, and the Employee shall not have any interest in any particular assets of the Company by reason of its obligations hereunder. Nothing contained in this Agreement shall create or be construed as creating a trust of any kind or any other fiduciary relationship between the Company and the Employee or any other person. To the extent that any person acquires a right to receive payment from the Company, such right shall be no greater than the right of an unsecured creditor of the Company.

Section 4. Facility of Payments. If it appears that the Employee shall, at the time any payment hereunder is due, be incapacitated so that the recipient cannot legally receive or acknowledge receipt of the payments, then the Company at its option may make the payment to the legal guardian, attorney in fact, or other person with whom such recipient is residing, and such payment shall be in full satisfaction of the Company's obligations hereunder with respect to such payment.

Section 5. Administration by Committee. The Agreement shall be administered by the Committee. The Committee shall be responsible for the general administration and interpretation of the Agreement and for carrying out its provisions, except to the extent that the Committee delegates ministerial authority to a designee. The Committee shall have the authority to interpret and construe the provisions of the Agreement and to decide any dispute which may arise regarding the rights of the Employee or the Company hereunder, which determinations shall be binding and conclusive upon all interested persons.

Section 6. No Assignment or Transfer by the Employee. None of the rights, benefits, obligations or duties under this Agreement may be assigned or transferred by the Employee, except by will or under the laws of descent and distribution. Any purported assignment or transfer by any the Employee shall be void.

Section 7. Right of Offset. Notwithstanding any other provision of the Agreement, the Company may (subject to any considerations under Section 409A of the Internal Revenue Code of 1986, as amended (the "**Code**")), at any time reduce the amount of any payment or benefit otherwise payable to or on behalf of the Employee by the amount of any obligation of the Employee to the Company, and, by entering into this Agreement, the Employee shall be deemed to have consented to such reduction.

Section 8. Binding Agreement: This Agreement shall be binding upon and inure to the benefit of the Employee, his executors, administrators, heirs and next of kin, and the Company, its successors and assigns.

Section 9. Waiver. No term or condition of this Agreement shall be deemed to have been waived, nor shall there be any estoppel against the enforcement of any provision of this

Agreement, except by written instrument of the party charged with such waiver, and each such waiver shall operate only as to the specific term or condition waived and shall not constitute a waiver of such term or condition for the future or as to any act other than that specifically waived.

Section 10. Withholding; Payroll Taxes. To the extent required by law in effect at the time of any payment or accrual of benefits pursuant to the terms of this Agreement, the Company shall withhold from payments made hereunder (or other compensation payable to the Employee) the taxes required to withheld by the federal or any state or local government.

Section 11. Amendment; Termination. Except as otherwise provided in this Section 11, this Agreement may not be amended or terminated except by an instrument in writing signed by both parties. Notwithstanding the foregoing, the Company shall have unilateral authority to amend this Agreement to the extent necessary to comply with applicable laws, rules and regulations (including but not limited to Code Section 409A).

Section 12. Severability; Reformation. In case any one or more of the provisions or part of a provision contained in this Agreement shall for any reason be held to be invalid, illegal or unenforceable in any respect in any jurisdiction, such invalidity, illegality or unenforceability shall not affect the validity, legality or enforceability of this Agreement in any other jurisdiction or any other provision or part of a provision of this Agreement, but this Agreement shall be reformed and construed in such jurisdiction as if such invalid or illegal or unenforceable provision or part of such a provision had never been contained herein, and such provision or part thereof shall be reformed so that it will be valid, legal and enforceable in such jurisdiction to the maximum extent possible.

Section 13. Compliance with Recoupment and Other Policies or Agreements. As a condition to entering into this Agreement, the Employee agrees that he shall abide by all provisions of any compensation recovery policy and/or other similar policies maintained by the Company, each as in effect and applicable to the Employee from time to time. In addition, the Employee shall be subject to such compensation recovery, recoupment, forfeiture or other similar provisions as may apply at any time to the Employee under applicable law, rule or regulation.

Section 14. Governing Law. This Agreement shall be governed by and shall be construed and enforced in accordance with the laws of the State of North Carolina, without regard to the conflicts of laws provisions of any state.

Section 15. Compliance with Code Section 409A. The parties intend that this Agreement comply with, or be exempt from, Code Section 409A, and all rules, regulations, and other similar guidance issued thereunder, to the extent that they are reasonably determined to be subject to Code Section 409A. In the event that the Company (or a successor thereof) has any stock which is publicly traded on an established securities market or otherwise, distributions to the Employee if he is a “specified employee” (as defined under Code Section 409A), upon a separation from service may only be made on a date that is more than six months after the date of separation from service (or, if earlier than the end of the six-month period, the date of death of the specified employee) (with such payments being made during the seventh month following

separation from service), if and to the extent required under Code Section 409A. Further, (a) in the event that Code Section 409A requires that any special terms, provisions or conditions be included in the Agreement, then such terms, provisions and conditions shall, to the extent practicable, be deemed to be made a part of the Agreement, and (b) terms used in the Agreement shall be construed in accordance with Code Section 409A if and to the extent required. Further, in the event that the Award shall be deemed not to comply with Code Section 409A, then neither the Company, the Board nor its or their designees or agents shall be liable to any Employee or other person for actions, decisions or determinations made in good faith.

Section 16. Tax Consequences. The Company has made no warranties or representations to the Employee with respect to the tax consequences (including, without limitation, income tax consequences) related to this Agreement or the Retention Award, and the Employee is in no manner relying on the Company or its representatives for an assessment of such tax consequences. The Employee acknowledges that there may be adverse tax consequences upon the receipt of the Retention Award and that the he has been advised that he should consult with his own attorney, accountant and/or tax advisor regarding the decision to enter into this Agreement and the consequences thereof. The Employee also acknowledges that the Company has no responsibility to take or refrain from taking any actions in order to achieve a certain tax result for the Employee

Section 17. Entire Agreement. This Agreement represents the entire agreement of the parties with respect to the subject matter hereof and expressly supersedes all previous communications, understandings, commitments and agreements by or between the parties, whether written, oral or otherwise, related to the subject matter hereof.

Section 18. Gender. The use of any of the masculine, feminine or neuter gender herein shall be construed also to include each of the other genders.

*[signature page follows]*

IN WITNESS WHEREOF, this Agreement has been executed by and in behalf of the parties effective as of the day and year first above written.

**TARGACEPT, INC.**

By: _____

Title:

Printed Name: _____

Date executed: _____

Attest:

_____

Secretary

**EMPLOYEE**

_____ (SEAL)

Date executed: _____

**Exhibit 10.16**

**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 executive officers 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, for each performance objective, a percentage weighting, target criteria for achievement and, beginning with fiscal 2013, in some cases threshold and/or maximum criteria for achievement. For each annual performance objective that has threshold criteria, the weighting for the objective is not credited if the threshold criteria are not met and 50% of the weighting for the objective is credited if the threshold (but not the target or, if applicable, maximum) criteria are met; if the target (but not the maximum, if applicable) criteria are met for a performance objective, 100% of its weighting is credited; and for each annual performance objective that has maximum criteria, 150% of the weighting for the objective is credited if the maximum criteria are met; in each case subject to any discretionary adjustments that may be made by the Compensation Committee. As a result, the maximum weighting for all of the performance objectives in the aggregate can be up to 150%. The performance objectives typically relate to some of the following areas — the progression or advancement of the Company's product candidates, development program execution or outcomes, the enhancement of the Company's product portfolio, business development, alliance management, regulatory operations, capital or operational efficiency, human resources matters and communications matters.

Following the end of the fiscal year, the Compensation Committee determines the achievement level for the Program for that year. In making its determination, the Compensation Committee evaluates which achievement criteria have been met, if any, for each performance objective, the circumstances surrounding any performance objective or associated criteria that has not been met and whether to award all or any portion of the weighting ascribed to that performance objective(s), and whether to make any adjustment based on other Company accomplishments that occurred during the year.

For a group of employees that includes the Company's principal executive officer, principal financial officer and other named executive officers, 100% of the annual cash incentive bonus is determined based on the achievement level for the Program determined 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 received for that year times his or her assigned target bonus percentage times the achievement level for the Program determined by the Compensation Committee. For the Company's remaining employees, 50% of the annual cash incentive bonus is based on the achievement level for the Program determined by the Compensation Committee and the other 50% is based on individual performance.

**Exhibit 10.17**

**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 12,500 shares of the Company's common stock or, in the case of the chairman of the Board of Directors, an option to purchase 17,500 shares of the Company's common stock (an "Annual Option");
- each non-employee director receives an annual cash retainer of $35,000 payable in quarterly installments ($55,000 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 $10,000 ($20,000 in the case of the chairman of the committee); each member of the Compensation Committee receives an additional annual cash retainer of $7,500 ($15,000 in the case of the chairman of the committee); and each member of the Governance and Nominating Committee and each member of the Technology and Innovation Committee receives an additional annual cash retainer of $5,000 ($10,000 in the case of the chairman of the committee).

Each Initial Option vests and becomes exercisable (i) with respect to one-third of the shares subject to the Initial Option, on the earlier of the first anniversary of the grant date or the last business day before the annual meeting of stockholders that occurs in the next calendar year, provided that the recipient director remains in service on the vesting date, and (ii) with respect to the remaining two-thirds of the shares subject to the Initial Option on a pro rata quarterly basis over the next two years, if the recipient director remains in service as a director during such periods.

Each Annual Option is granted on the fifth business day after the date of the stockholders meeting at which directors are elected, if the recipient director remains in service as a director as of the grant date, and vests and becomes exercisable in full on the earlier of the first anniversary of the grant date or the last business day before the annual meeting of stockholders that occurs in the next calendar year, provided that the recipient director remains in service as a director on the vesting 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 following Registration Statements:

- Registration Statement (Form S-8 No. 333-133882) pertaining to the Targacept, Inc. 2000 Equity Incentive Plan,
- Registration Statement (Form S-8 No. 333-160331 and Form S-8 No.333-133881) pertaining to the Targacept, Inc. 2006 Stock Incentive Plan,
- Registration Statement (Form S-3 No. 333-171346) of Targacept, Inc., and
- Registration Statement (Form S-8 No. 333-185888) of Targacept, Inc;

of our reports dated March 15, 2013, with respect to the financial statements of Targacept, Inc. and the effectiveness of internal control over financial reporting of Targacept, Inc. included in this Annual Report (Form 10-K) of Targacept, Inc. for the year ended December 31, 2012.

/s/ Ernst & Young LLP

Raleigh, North Carolina
March 15, 2013

**EXHIBIT 31.1**

**CERTIFICATION 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**

I, Stephen A. Hill, 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(s) 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) 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

(d) 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(s) 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 15, 2013

By: /S/ STEPHEN A. HILL

**Stephen A. Hill**
**President and Chief Executive Officer**
**(Principal Executive Officer)**

**EXHIBIT 31.2**

**CERTIFICATION 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**

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(s) 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) 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

(d) 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(s) 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 15, 2013

BY: /S/ ALAN A. MUSSO

**Alan A. Musso**
**Senior Vice President, Finance and Administration, Chief Financial Officer and Treasurer**
**(Principal Financial and Accounting Officer)**

**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 year ended December 31, 2012 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Stephen A. Hill, 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, to my knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; 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 15, 2013

By: /s/ STEPHEN A. HILL

**Stephen A. Hill**
**President and Chief Executive Officer**
**(Principal 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 year ended December 31, 2012 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Alan A. Musso, Senior Vice President, Finance and Administration, Chief Financial Officer 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, to my knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; 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 15, 2013

BY: /S/ ALAN A. MUSSO

**Alan A. Musso**
**Senior Vice President, Finance and Administration, Chief Financial Officer and Treasurer**
**(Principal Financial and Accounting Officer)**