BIODELIVERY SCIENCES INTERNATIONAL INC
Form 10-K
March 16, 2015
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2014

¨ **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 001-31361

BioDelivery Sciences International, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**35-2089858**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
4131 ParkLake Avenue, Suite #225	
Raleigh, NC	**27612**
(Address of principal executive offices)	**(Zip Code)**

Issuer s telephone number: 919-582-9050

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

Title of each class	**Name of exchange on which registered**
Common stock, par value $.001	**Nasdaq Capital Market**

Securities registered pursuant to Section 12(g) of the 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 x

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 x

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files) Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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, or a non-accelerated filer or a smaller reporting company. See definition of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨	Accelerated filer x

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 x

The aggregate market value of the voting and non-voting common equity held by non-affiliates as of June 30, 2014 was approximately $310,944,998 based on the closing sale price of the company s common stock on such date of $12.07 per share, as reported by the NASDAQ Capital Market.

As of March 12, 2015, there were 52,320,866 shares of company common stock issued and 52,305,375 shares of company common stock outstanding.

Table of Contents

BioDelivery Sciences International, Inc.

Annual Report on Form 10-K

For the fiscal year ended December 31, 2014

TABLE OF CONTENTS

Unless we have indicated otherwise, or the context otherwise requires, references in this Report to BDSI, the Company, we, us and our or similar terms refer to BioDelivery Sciences International, Inc., a Delaware corporation and its consolidated subsidiaries.

Table of Contents

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Report and the documents we have filed with the Securities and Exchange Commission (which we refer to herein as the SEC) that are incorporated by reference herein contain forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended (or the Securities Act) and Section 21E of the Securities Exchange Act of 1934, as amended (or the Exchange Act), that involve significant risks and uncertainties. Any statements contained, or incorporated by reference, in this Report that are not statements of historical fact may be forward-looking statements. When we use the words anticipate, believe, could, estimate, expect, intend, ma predict, project, will and other similar terms and phrases, including references to assumptions, we are identifying forward-looking statements. Forward-looking statements involve risks and uncertainties which may cause our actual results, performance or achievements to be materially different from those expressed or implied by forward-looking statements.

A variety of factors, some of which are outside our control, may cause our operating results to fluctuate significantly. They include:

our plans and expectations regarding the timing and outcome of research, development, commercialization, manufacturing, marketing and distribution efforts relating to our BEMA® (as defined below) drug delivery technology platform and any of our approved products or product candidates;

the domestic and international regulatory process and related laws, rules and regulations governing our technologies and our approved and proposed products and formulations, including: (i) the timing, status and results of our or our commercial partners filings with the U.S. Food and Drug Administration and its foreign equivalents, (ii) the timing, status and results of non-clinical work and clinical studies, including regulatory review thereof and (ii) the heavily regulated industry in which we operate our business generally;

our ability to enter into strategic partnerships for the development, commercialization, manufacturing and distribution of our products and product candidates;

our ability, or the ability of our commercial partners, to actually develop, commercialize, manufacture or distribute our products and product candidates, including for BUNAVAIL®, which is the first product we are self-commercializing;

our ability to generate commercially viable products and the market acceptance of our BEMA® technology platform and our proposed products and product candidates;

our ability to finance our operations on acceptable terms, either through the raising of capital, the incurrence of convertible or other indebtedness or through strategic financing or commercialization partnerships;

our expectations about the potential market sizes and market participation potential for our approved or proposed products;

the protection and control afforded by our patents or other intellectual property, and any interest patents or other intellectual property that we license, of our or our partners ability to enforce our rights under such owned or licensed patents or other intellectual property;

the outcome of ongoing or potential future litigation (and related activities, including inter partes reviews and inter partes reexaminations) or other claims or disputes relating to our business, technologies, products or processes;

our expected revenues (including sales, milestone payments and royalty revenues) from our products or product candidates and any related commercial agreements of ours;

the ability of our manufacturing partners to supply us or our commercial partners with clinical or commercial supplies of our products in a safe, timely and regulatory compliant manner and the ability of such partners to address any regulatory issues that have arisen or may in the future arise;

our ability to retain members of our management team and our employees; and

competition existing today or that will likely arise in the future.

The foregoing does not represent an exhaustive list of risks that may impact the forward-looking statements used herein or in the documents incorporated by reference herein. Please see Risk Factors for additional risks which could adversely impact our business and financial performance and related forward-looking statements.

Moreover, new risks regularly emerge and it is not possible for our management to predict all risks, nor can we assess the impact of all risks on our business or the extent to which any risk, or combination of risks, may cause actual results to differ from those contained in any forward-looking statements. All forward-looking statements included in this Report are based on information available to us on the date hereof. Except to the extent required by applicable laws or rules, we undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements contained throughout this Report and the documents we have filed with the SEC.

Table of Contents

PART I

Item 1. Description of Business.

Overview

We are a specialty pharmaceutical company that is developing and commercializing, either on our own or in partnerships with third parties, new applications of approved therapeutics to address important unmet medical needs using both proven and new drug delivery technologies. We have developed and are continuing to develop pharmaceutical products aimed principally in the areas of pain management and addiction. We were incorporated in the State of Indiana in 1997 and were reincorporated as a Delaware corporation in 2002.

Our approved products and certain of our product candidates utilize the novel, patent protected and proprietary *BioErodible MucoAdhesive* (or BEMA®) drug delivery technology, a small, erodible polymer film for application to the buccal mucosa (the lining inside the cheek). Our first U.S. Food and Drug Administration (which we refer to as the FDA) approved product, ONSOLIS® (fentanyl buccal soluble film), as well as our approved product BUNAVAIL® (buprenorphine and naloxone buccal film) and our product candidate, BELBUCA (formerly referred to as BEMA® Buprenorphine), utilize our BEMA® technology.

We have worked with other delivery technologies in the past, and as part of our corporate growth strategy, we have licensed, and will continue to seek to acquire or license, additional drug delivery technologies or drugs utilizing the delivery or other technologies of other companies. Clonidine Topical Gel, which we licensed from Arcion Therapeutics (or Arcion) in 2013, and our 2015 agreement with Evonik Corporation (or Evonik) to develop a buprenorphine depot injection formulation, do not utilize the BEMA® technology and allowed us to diversify our portfolio while maintaining a focus in pain and addiction. As we gain access to such technologies, we seek to formulate these technologies with proven, FDA approved therapeutics and utilize our development and commercialization experience to, either by ourselves or through partnerships, navigate the resulting products through the regulatory review process and ultimately bring them to the marketplace.

Our current development strategy focuses primarily on our ability to utilize the FDA s 505(b)(2) approval process to obtain more timely and efficient approval of new formulations of previously approved, active therapeutics incorporated into our drug delivery technology. Because the 505(b)(2) approval process is designed to address new formulations of previously approved drugs, we believe it has the potential to be more cost efficient and expeditious and have less regulatory approval risk than other FDA approval approaches.

An overview of our approved products and key products in development or awaiting approval is set out below:

BELBUCA (BEMA® Buprenorphine) for Chronic Pain

BELBUCA is a partial mu-opioid agonist and a potential treatment for the management of pain severe enough to require daily, around the clock, long-term opioid treatment for which alternative treatment options are inadequate. As described further below, our commercial partner for this product has filed a New Drug Application (or NDA) with the FDA for BELBUCA and we are awaiting the outcome of the FDA s review.

In January 2012, we announced the signing of a worldwide licensing and development agreement for BELBUCA (which we refer to herein as the Endo Agreement) with Endo Pharmaceuticals, Inc. (or Endo) under which we granted to Endo the exclusive, worldwide rights to develop and commercialize BELBUCA for the treatment of chronic pain.

The financial terms of our agreement with Endo include: (i) a $30 million upfront, non-refundable license fee, which we received in January 2012; (ii) $95 million in potential milestone payments based on achievement of pre-defined intellectual property, clinical development and regulatory events (some of which we have received); (iii) $55 million in potential sales threshold payments upon achievement of designated sales levels; and (iv) a tiered, mid- to upper-teen royalty on net sales of BELBUCA in the United States and a mid- to high-single digit royalty on net sales of BELBUCA outside the United States. Endo is one of the premier companies in the area of pain management and has demonstrated significant achievements in the pain space, particularly with the development, launch and commercialization of a portfolio of pain therapeutics including Opana® ER, Lidoderm® and Voltaren® Gel. We believe BELBUCA is an excellent fit with Endo s pain portfolio and will, if approved, add a Schedule III opioid to their branded pain franchise. BELBUCA would complement Endo s pain therapeutics portfolio providing the company with an opportunity to offer a ladder of pain products, aligned with pain severity and opioid scheduling. In particular, BELBUCA would potentially be aligned with the needs of pain specialists and primary care physicians who seek an alternative to Schedule II opioids for the treatment of moderate to severe chronic pain that is not adequately controlled with commonly prescribed first-line therapies (e.g., NSAIDs).

One of the key intellectual property milestones under our Endo Agreement was achieved in February 2012, when the U.S. Patent and Trademark Office (or USPTO) issued a Notice of Allowance regarding one of our patent applications (No. 13/184306) which, once the patent was granted in April 2012, extended the exclusivity of the BEMA® drug delivery technology for BELBUCA (as well as BUNAVAIL®, as discussed below) from 2020 to 2027. As a result, we received a milestone payment from Endo in the

Table of Contents

amount of $15 million in May 2012, and also related to the issuance of the patent, will receive an additional milestone payment of $20 million at the time of approval of a New Drug Application (or NDA) by the FDA for BELBUCA for the treatment of chronic pain. Such amounts are included in the aforementioned $95 million in potential milestone payments based on intellectual property and clinical development and regulatory events.

In May 2012, in close collaboration with Endo, we initiated two Phase 3 clinical studies one in opioid naïve and one in opioid experienced populations. The Phase 3 clinical trials were enriched-enrollment, double-blind, randomized withdrawal studies to evaluate the efficacy and safety of BELBUCA in the treatment of chronic lower back pain in opioid naive and opioid experienced populations. Patients titrated to a well-tolerated, effective dose were randomized to either continue on that dose of BELBUCA , or receive placebo (BEMA® film with no active drug), with treatment continuing for 12 weeks. The primary efficacy endpoint was the mean change in the daily average pain numerical rating scale (NRS-Pain) scores from baseline (just prior to randomization) to week twelve of the double-blind treatment period. Pain was self-reported daily on an 11-point numeric rating scale (daily NRS; 0=no pain, 10=worst possible pain).

Interim analyses were conducted as part of the Phase 3 protocol in both the opioid naïve and opioid experienced studies to allow for adjustments to the sample size in order to maintain appropriate study power to detect statistically significant differences between BELBUCA and placebo. The analyses were conducted by an independent biostatistician. We and Endo announced in September 2013 that, as a result of the interim analyses, no sample size adjustment would be necessary to the opioid naïve study and that additional patients would be added to the ongoing opioid experienced study. The outcomes of the interim analyses were significant because they utilized actual study data to confirm or adjust sample sizes, and importantly, maintain probability of a successful outcome.

On January 23, 2014, we announced with Endo positive top-line results from the Phase 3 efficacy study of BELBUCA in opioid- naïve subjects. The trial successfully met its primary efficacy endpoint in demonstrating that BELBUCA resulted in significantly ($p<0.005$) improved chronic pain relief compared to placebo. Additional secondary endpoints were supportive of the efficacy of BELBUCA compared to placebo. The most commonly reported adverse events in patients treated with BELBUCA compared to placebo were nausea (10% vs. 8%, respectively), vomiting (4% vs. 2%, respectively) and constipation (4% vs. 2%, respectively). The locking of the database for the opioid naïve study triggered a $10 million milestone payment from Endo per the terms of the license agreement, which we received in February 2014.

On July 7, 2014, we announced with Endo positive top-line results from the Phase 3 efficacy study of BELBUCA in opioid- experienced subjects. The trial successfully met its primary efficacy endpoint in demonstrating that BELBUCA resulted in significantly ($p<0.0001$) improved chronic pain relief compared to placebo. Additional secondary endpoints were supportive of the efficacy of BELBUCA compared to placebo. The most commonly reported adverse events in patients treated with BELBUCA compared to placebo were nausea (7.5% vs. 7.4%, respectively) and vomiting (5.5% vs. 2.3%, respectively). Locking of the database for the opioid experienced study triggered an additional $10 million milestone payment from Endo per the terms of the license agreement, which we received July 2014.

On December 23, 2014, we and Endo announced the NDA submission for BELBUCA , which was accepted by FDA in February 2015. Acceptance of the filing of the NDA by FDA triggers an additional $10 million milestone payment from Endo, to be received within 60 days of acceptance. BELBUCA is subject to a ten month FDA review, which could result in an approval in the fourth quarter of 2015 and allow for product launch in early 2016.

BUNAVAIL® (buprenorphine and naloxone) buccal film

We believe that the widespread use of buprenorphine for the treatment of opioid dependence and the need for improved means of delivery to address existing administration challenges present an additional commercial opportunity. Therefore, we developed a BEMA® formulation of buprenorphine and naloxone specifically for the treatment of opioid dependence. The product combines a high dose of buprenorphine along with an abuse deterrent agent, naloxone. BUNAVAIL® provides us with an opportunity to compete in the growing opioid dependence market which, according to Symphony Health, approached $1.8 billion in sales in the U.S in 2014.

In September 2012, we announced the positive outcome of the pivotal pharmacokinetic study comparing BUNAVAIL® to Suboxone® sublingual tablets. The study was designed to compare the relative bioavailability of buprenorphine and naloxone between BUNAVAIL® and the reference product, Suboxone® tablets. The results demonstrated that the two key pharmacokinetic parameters, maximum drug plasma concentration (Cmax) and total drug exposure (AUC), for buprenorphine were comparable to Suboxone® sublingual tablet, and that the same parameters for naloxone were similar or less than Suboxone® tablet. This was followed by initiation of the safety study requested by FDA, assessing the safety and tolerability of BUNAVAIL® in patients converted from a stable dose of Suboxone® (buprenorphine/naloxone) sublingual tablets or films. A total of 249 patients were enrolled in the study, (191 patients completed) which completed in December 2012. Results of the study showed a very favorable safety and tolerability profile along with strong study subject retention and high dose form acceptability ratings. Data showed that over 91% of patients who switched from Suboxone® film or tablets considered the taste of BUNAVAIL® to be very pleasant, pleasant or neutral and over 82%

Table of Contents

rated the ease of use of BUNAVAIL® as very easy, easy or neutral. The study also showed a decrease in the incidence of constipation symptoms from 41% at baseline, before conversion of patients from Suboxone tablets or films to BUNAVAIL®, to 13% following 12 weeks of treatment with BUNAVAIL®.

On July 31, 2013, we submitted the NDA for BUNAVAIL® to the FDA for review, and on June 6, 2014, we announced the FDA approval of BUNAVAIL for the maintenance treatment of opioid dependence as part of a complete treatment plan to include counseling and psychosocial support.

Following thorough review and analysis of a variety of commercialization strategies, which included entertaining commercial partnerships, a decision was made to commercialize BUNAVAIL® utilizing both internal and external resources. In March 2014, we announced we had entered into an agreement with Quintiles to support the launch and commercialization of BUNAVAIL®. Under terms of the agreement, Quintiles provides a range of services to support the commercialization of BUNAVAIL® in the U.S., including recruiting and training a field sales force. Separately, we entered into an agreement with Ashfield Market Access to provide managed markets and trade support for BUNAVAIL®. Ashfield Market Access, which is led by industry veterans including those who led GlaxoSmithKline s managed markets group for more than 20 years, took responsibility for executing a payer strategy aimed at maximizing patient access to BUNAVAIL®.

On November 3, 2014, we announced the availability of BUNAVAIL® in the U.S. where it is being supported by a 60-person field sales force and a full marketing effort targeting the nearly 5,000 physicians who are responsible for approximately 90% of prescriptions for buprenorphine products for the treatment of opioid dependence, according to Symphony Health.

ONSOLIS® (fentanyl buccal soluble film)

On July 16, 2009, we announced the U.S. approval of our first product, ONSOLIS® (fentanyl buccal soluble film). ONSOLIS® is indicated for the treatment of breakthrough pain (i.e., pain that breaks through the effects of other medications being used to control persistent pain) in opioid tolerant patients with cancer. In May 2010, regulatory approvals were granted for Canada, and in October 2010, approval was obtained in the European Union (which we refer to herein as E.U.) through the E.U. s Decentralized Procedure, with Germany acting as the reference member state. ONSOLIS® is marketed in Europe under the trade-name BREAKYL .

The FDA approval of ONSOLIS®, together with our satisfactory preparation of launch supplies of ONSOLIS®, triggered the payment to us by our commercial partner, Meda AB, a leading international specialty pharmaceutical company based in Sweden (which we refer to herein as Meda), of approval milestones aggregating $26.8 million. The first national approval of BREAKYL in the E.U. resulted in a milestone payment of $2.5 million from Meda. A second milestone payment of $2.5 million was subsequently realized at the time of first commercial sale in the E.U. in October 2012. We began receiving royalties from Meda on net sales of ONSOLIS® in the U.S. and Canada following launch and from BREAKYL following launch in the E.U. Our royalty revenue from this product remains below original projections due to certain regulatory conditions in the U.S., which are discussed below.

We granted commercialization and distribution rights for ONSOLIS® on a worldwide basis (except in South Korea and Taiwan) to Meda. Meda s U.S. subsidiary, Meda Pharmaceuticals, based in Somerset, New Jersey, is a specialty pharmaceutical company that develops, markets and sells branded prescription therapeutics. Meda secured access to additional markets through acquisition of European businesses from Valeant Pharmaceuticals International, Inc., which we refer to herein as Valeant and a joint venture with Valeant covering Australia, Mexico and Canada.

In 2010, we secured commercialization rights for ONSOLIS® for the remaining worldwide territories through execution of licensing agreements with KUNWHA Pharmaceutical Co., Ltd. (or Kunwha), for South Korea and TTY Biopharm Co., Ltd. (or TTY) for Taiwan where the product will be marketed as PAINKYL .

Although we have generated licensing-related and other revenue to date from the commercial sales of an approved product ONSOLIS®/BREAKYL such revenue has been minimal to date due to multiple factors, including a highly restrictive Risk Evaluation and Mitigation Strategy (REMS) imposed by the FDA and certain formulation issues described below. The lack of approved REMS programs for our direct competitors resulted in an un-level playing field, which created an unfavorable selling environment for ONSOLIS® into 2012. In the E.U., BREAKYL began to be launched on a country by country basis starting in the fourth quarter of 2012.

On December 29, 2011, the FDA approved a class-wide REMS program covering all transmucosal fentanyl products under a single risk management program. The program, which is referred to as the Transmucosal Immediate Release Fentanyl (TIRF) REMS Access Program, was designed to ensure informed risk-benefit decisions before initiating treatment with a transmucosal fentanyl product, and while patients are on treatment, to ensure appropriate use. The TIRF REMS program was implemented in March 2012. The approved program covers all marketed transmucosal fentanyl products under a single program which will enhance patient safety while limiting the potential administrative burden on prescribers and their patients. One common program also ended the disparity in prescribing requirements for ONSOLIS® compared to similar products and provided ONSOLIS® with the opportunity for retail and inpatient facility access.

Table of Contents

On March 12, 2012, we announced the postponement of the U.S. re-launch of ONSOLIS® following the initiation of the class-wide REMS until the product formulation could be modified to address two appearance-related issues. Such appearance-related issues involved the formation of microscopic crystals and a fading of the color in the mucoadhesive layer, raised by the FDA during an inspection of our North American manufacturing partner for ONSOLIS®, Aveva Drug Delivery Systems, Inc. (or Aveva). While the appearance issues do not affect the product s underlying integrity, safety or performance, the FDA believes that the fading of the color in particular may potentially confuse patients, necessitating a modification of the product and its specification before it can be manufactured and distributed. The source of microcrystal formation and the potential for fading of ONSOLIS® was found to be specific to a buffer used in its formulation. We modified the formulation and as of the date of this report have 12 months of stability data on the reformulated product that shows no signs of microcrystal formation or color changes.

On January 27, 2015, we announced that we had entered into an assignment and revenue sharing agreement with Meda to return back to us the marketing authorizations for ONSOLIS® for the U.S. and the right to seek marketing authorizations for ONSOLIS® in Canada and Mexico. Once the NDA has been returned, we will have the right to work directly with the FDA and submit a prior approval supplement that responds to FDA questions and requests and will hopefully lead to the re-introduction of the product. FDA s review of the application may take up to 6 months; therefore, it is possible to have a decision before the end of 2015.

Clonidine Topical Gel

In March 2013, we announced our entry into a worldwide Exclusive License Agreement (which we refer to as the Arcion Agreement) with privately held Arcion, under which we will develop and commercialize Clonidine Topical Gel (formerly ARC4558) for the treatment of painful diabetic neuropathy (or PDN) and potentially other indications. Under the terms of the agreement, we made an upfront payment of $2 million to Arcion in the form of unregistered shares of our common stock. Additional financial terms of the licensing agreement include a milestone payment to Arcion of $2.5 million in unregistered shares of our common stock upon acceptance by the FDA of a NDA for Clonidine Topical Gel and a cash payment to Arcion of between $17.5 and $35 million upon NDA approval, depending on certain regulatory and commercial considerations. In addition, the licensing agreement includes sales milestones and low single-digit royalties on net worldwide sales.

We believe that the PDN market is highly under-served by existing products and therefore there is a strong scientific rationale for developing a topical treatment for PDN that delivers analgesia in a way that avoids systemic side effects. Evidence has shown that clonidine stimulates an inhibitory receptor in the skin associated with pain fibers. Arcion has assessed its effectiveness in reducing pain in PDN in a double-blind, placebo-controlled, Phase 2 study where the primary study endpoint was the change in pain intensity over a 3 month treatment period in diabetic foot pain. A significant treatment difference was seen in the planned subset analysis of diabetic patients who had documented evidence of functioning pain receptors in the skin of the lower leg (p=0.01, n=63) thus, at a minimum, supporting the effectiveness of topical clonidine in diabetic patients with functioning pain receptors of the skin. In the overall population that included patients without functioning nerve receptors , there was a trend favoring topical Clonidine Topical Gel (p=0.07, n= 182), though the overall results did not reach statistical significance.

Oral medications that are approved for the treatment of PDN include anticonvulsants such as Lyrica (pregabalin), the antidepressant Cymbalta® (duloxetine) and the opioid Nucynta® ER (tapentadol ER), with sales for the treatment of neuropathic pain totaling over $3 billion in the U.S. according to Datamonitor. These treatments are modestly effective in relieving symptoms and their use can be limited by adverse effects and drug interactions.

We met with representatives of the FDA on November 21, 2013 to discuss the development program for Clonidine Topical Gel for the treatment of PDN. The FDA agreed with the proposed clinical program which included two

placebo-controlled studies and one long term safety study in patients suffering from painful diabetic neuropathy, the number of treated subjects required for the safety assessment and the plan for data integration of previously performed and planned clinical studies. The discussion provided us with the input and clarity needed to move the program directly to Phase 3. It also appears that the FDA recognizes the need for new treatment options for PDN by confirming Fast Track designation for the program that could potentially lead to a priority review.

In early April 2014, we announced enrollment of the first patient in the Phase 3 clinical study of Clonidine Topical Gel for PDN, and in early August 2014, we announced that we completed a pre-specified interim analysis of the study. The interim analysis was performed on data from the first 50% of patients who completed the study. The purpose of the interim analysis was to allow for a sample size adjustment if necessary to maintain appropriate statistical power to detect a treatment effect between Clonidine Topical Gel and placebo. As a result of the interim analysis, a total of approximately 80 additional patients were to be added to the trial in an effort to maintain 90% percent power to detect a statistically significant difference between Clonidine Topical Gel and placebo. The analysis was conducted by an independent biostatistician.

If the initial placebo controlled study meets its primary endpoint, the results for which are anticipated to be available by the end of the first quarter of 2015, and we initiate the second placebo controlled study in early 2015, we could be in a position to submit an NDA in 2016.

Table of Contents

Buprenorphine Depot Injection

In 2014, we entered into an exclusive agreement with Evonik to develop and commercialize a proprietary, injectable microparticle formulation of buprenorphine potentially capable of providing 30 days of continuous therapy following a single subcutaneous injection. Microsphere-based, long acting, buprenorphine injectable depot has the ability to change the treatment paradigm in opioid dependence. Such a dosage form has the opportunity to improve therapy compliance through continuous delivery of drug for up to 30 days and addresses challenges regarding patient adherence to long-term buprenorphine treatment, which is critical to successfully manage opioid dependence and the potential for misuse and diversion.

While we plan to pursue an indication for the maintenance treatment of opioid dependence, we have also secured the rights and plans to develop a product for the treatment of chronic pain in patients requiring continuous opioid therapy. As part of the agreement, we will have the right to license the product(s) following the attainment of Phase 1 ready formulations. At that point, Evonik could receive downstream payments for milestones related to regulatory filings and subsequent NDA approvals as well as product royalties. Evonik has the exclusive rights to develop the formulation and manufacture the product(s).

We plan to submit an Investigational New Drug application (or IND) for this product candidate to FDA in the second half of 2015.

Additional Overview Information

From our inception through December 31, 2014, we have recorded accumulated losses totaling approximately $205.5 million. Our historical operating losses have resulted principally from our research and development activities, including clinical trial activities for our product candidates and general and administrative expenses. Ultimately, if we secure additional approvals from the FDA and other regulatory bodies throughout the world for our product candidates, our goal will be to augment our current sources of revenue and, as applicable, deferred revenue (principally licensing fees), with sales of such products or royalties from such sales, on which we may pay royalties or other fees to our licensors and/or third-party collaborators as applicable.

We intend to finance our research and development, commercialization and distribution efforts and our working capital needs primarily through:

- commercializing our approved products such as BUNAVAIL®;
- partnering with other pharmaceutical companies such as Meda and Endo to assist in the distribution of our products like ONSOLIS® and BELBUCA , for which we would expect to receive an upfront payment, milestones and royalty payments; and
- securing proceeds from public and private financings and other strategic transactions.

We have based our estimates of development costs, market size estimates, peak annual sales projections and similar matters described below and elsewhere in this Report on our market research, third party reports and publicly available information which we consider reliable. However, readers are advised that the projected dates for filing and approval of our INDs or NDAs with the FDA or other regulatory authorities, our estimates of development costs, our

projected sales and similar metrics regarding BUNAVAIL®, ONSOLIS®, BELBUCA , Clonidine Topical Gel, Buprenorphine Depot Injection or any other product candidates discussed below and elsewhere in this Report are merely estimates and subject to many factors, many of which may be beyond our control, which will likely cause us to revise such estimates. Readers are also advised that our projected sales figures do not take into account the royalties and other payments we will need to make to our licensors and strategic partners. Our estimates are based upon our management s reasonable judgments given the information available and their previous experiences, although such estimates may not prove to be accurate.

The BEMA® Drug Delivery Technology

Our BEMA® drug delivery technology consists of a small, bi-layered erodible polymer film for application to the buccal mucosa (the lining inside the cheek). BEMA® films have the capability to deliver a rapid, reliable dose of drug across the buccal mucosa for time-critical conditions such as breakthrough cancer pain or in situations where gastrointestinal absorption of an oral drug is not practical or reliable, or in facilitating the administration of drugs with poor oral bioavailability.

We believe that the BEMA® technology permits control of two critical factors allowing for better dose-to-dose reproducibility: (i) the contact area for mucosal drug delivery, and (ii) the time the drug is in contact with that area, known as residence time. In contrast to competing transmucosal delivery systems like lozenges, buccal tablets and matrix-based delivery systems placed under the tongue or sprayed in the oral cavity, BEMA® products are designed to:

- adhere to buccal mucosa in seconds and dissolve in minutes;

Table of Contents

permit absorption without patients being required to move the product around in the mouth for absorption, thus avoiding patient intervariability;

provide a reproducible delivery rate, not susceptible to varying or intermittent contact with oral membranes; and

dissolve completely, leaving no residual product or waste and avoiding patient removal, and the possibility for diversion or disposal of partially used product.

We currently own the BEMA® drug delivery technology. We previously licensed the BEMA® drug delivery technology on an exclusive basis from Atrix Laboratories (previously known as QLT USA, Inc., now known as TOLMAR Therapeutics, Inc., which we refer to herein as Tolmar).

Overview of Specialty Pharmaceuticals and the 505(b)(2) Regulatory Pathway

Our corporate focus is specialty pharmaceuticals with characteristics that provide substantial points of differentiation from existing products. Our product portfolio is based on the application of drug delivery technologies and/or new dosage forms/indications to existing drugs for the creation of novel products. We then seek proprietary protection and FDA approval, and subsequently commercialize these products ourselves or through partners. We believe that research and development efforts focused on novel dose forms of FDA approved drugs is less risky than attempting to discover new drugs, sometimes called new chemical entities (known as NCEs). Our corporate focus came to initial fruition with the FDA s approval of ONSOLIS® (fentanyl buccal soluble film) in 2009 and was replicated in 2014 with the approval of BUNAVAIL® (buprenorphine/naloxone buccal film). It is our goal to replicate this success with our current product candidates, and to identify new product candidates suitable for this development strategy that would add significant commercial value to us.

An important part of our strategy is the utilization of FDA s 505(b)(2) NDA process for approval. Under the 505(b)(2) process, we are able to seek FDA approval of a new dosage form, dosage regimen or new indication of an FDA approved drug . This regulation enables us to partially rely on the FDA s previous findings of safety and effectiveness for the drug, including clinical and nonclinical testing, and thereby reduce, although not eliminate, the need to engage in these costly and time consuming activities. A typical development program for a 505(b)(2) submission will include:

seven, 14 or 28-day multiple dose toxicity studies in a single species of animals,

pharmacokinetic evaluation of the new dosage form in humans,

stability data of the drug substance,

description of drug product components,

description and validation of manufacturing process,

one year stability data on three commercial scale batches of drug product, and

depending on the drug product, may include:

(i) one or more placebo controlled clinical studies in humans to establish the efficacy of the product, and/or

(ii) a long term clinical study to establish the safety of the product in the intended patient population.

This drug development and regulatory approval process is less extensive and lengthy than for a NCE and, as a result, we believe, is a more cost effective way to bring new product candidates to market.

We have and intend to continue to target drugs that have established markets and an opportunity to introduce a new form of delivery of that product in order to meet an unmet market need. As a result of employing well known drugs in novel technologies or new dosage forms/indications, we believe health care providers will be familiar with the drugs and accustomed to prescribing them. As with ONSOLIS®, BELBUCA , BUNAVAIL® and Clonidine Topical Gel, our drug candidates have been through the regulatory process with safety and efficacy established for an indication, a formulation and a dose range. Consequently, our clinical trials need to demonstrate the safety and efficacy of our products in the chosen patient population.

Endo Licensing Agreement for BELBUCA (BEMA® Buprenorphine)

On January 6, 2012, we announced the signing of a world-wide licensing and development agreement for BELBUCA with Endo. Under terms of the agreement, Endo will be responsible for the manufacturing, distribution, marketing and sales of BELBUCA on a worldwide basis. Endo will commercialize BELBUCA outside the U.S. through its own efforts or through regional partnerships. In the U.S., both companies will collaborate on the planning and finalization of the Phase 3 clinical development program and regulatory strategy for BELBUCA for chronic pain. We will maintain responsibility for the conduct of planned clinical studies leading up to the submission of the NDA. Endo will have the responsibility of submitting the NDA and managing the interactions with the FDA.

Table of Contents

In aggregate, the agreement is worth up to $180 million to us if all milestones or thresholds are met, which includes an upfront non-refundable license fee of $30 million (received January 2012), as well as intellectual property, development, regulatory and commercial milestone and sales threshold payments. Additionally, we will receive a tiered mid to upper teen royalty on U.S. net sales of BELBUCA and a tiered mid to upper single-digit royalty on sales outside the U.S. One of the key intellectual property milestones under our Endo Agreement was achieved when, in April 2012, the USPTO granted US Patent No. 8,147,866 (issued from US Patent Application No. 13/184,306), which will extend the exclusivity of the BEMA® drug delivery technology for BELBUCA (as well as BUNAVAIL® discussed below) from 2020 to 2027. As a result (and included in the aforementioned $180 million if all milestones or thresholds are met), we received a milestone payment in the amount of $15 million in May 2012, and have become eligible for an additional milestone payment of $20 million which will be paid at the time of approval of a NDA by the FDA for BELBUCA . Additionally, we achieved another milestone with the locking of the database for our Phase 3 opioid naive clinical study on January 17, 2014. For the achievement of this milestone, per the terms of the agreement, we were due a milestone payment in the amount of $10 million, which was received February 2014 (which is included in the aforementioned $180 million if all milestones or thresholds are met) within thirty (30) days of the database lock. On June 25, 2014, the database for the pivotal Phase 3 efficacy study of BELBUCA in opioid-experienced patients was locked. The locking of the database triggered a $10 million milestone payment from Endo, which was received July 2014. On December 23, 2014, we and Endo announced the submission of a NDA for BELBUCA to the FDA, which was accepted February 23, 2015, which triggers a $10 million milestone payment due from Endo to us.

Meda Licensing Agreements for ONSOLIS®

North American Agreement. On September 5, 2007, we entered into a definitive License and Development Agreement with Meda and our subsidiary Arius pursuant to which we and Arius agreed to grant to Meda an exclusive commercial license to market, sell, and, following regulatory approval, continue development of ONSOLIS® in the United States, Mexico and Canada (which we refer to as the Meda North American License).

Pursuant to such license agreement, we have received or will receive:

a $30.0 million milestone payment (received in 2007).

a $29.8 million milestone payment for the approval of ONSOLIS® by the FDA and provision of commercial supplies of ONSOLIS® in the U.S. (received in 2009).

a double digit royalty on net sales of ONSOLIS® in the covered territories, subject to certain third party royalty payment costs and adjustments, as well as other adjustments in the event of certain specific supply disruptions. The license agreement provides for certain guaranteed minimum annual royalties to us during the second through seventh years following the product s first commercial sale, which occurred in the fourth quarter of 2009.

sales milestones equaling an aggregate of $30 million will be payable at:

$10.0 million when and if annual sales meet or exceed $75.0 million;

$10.0 million when and if annual sales meet or exceed $125.0 million; and

$10.0 million when and if annual sales meet or exceed $175.0 million.

Also, pursuant to the Meda North American License, we have been granted certain rights to co-promote ONSOLIS® using our own sales force, with financial support by Meda for such efforts. In addition, Meda is subject to certain minimum sales representative calls and advertising and promotional expenditure requirements under the North American license agreement and has agreed to support all future costs of clinical development, such as additional indications for ONSOLIS® that do not involve studies in support of the NDA.

European Agreement. In 2006, we announced collaboration with Meda to develop and commercialize BEMA® Fentanyl (marketed as BREAKYL in Europe). Under terms of the agreement, we granted Meda rights to the European development and commercialization of BREAKYL , in exchange for an upfront fee of $2.5 million and a $2.5 million milestone payment (received in 2008) for completion of Phase 3 clinical trials. We have also received a double digit royalty on net sales and additional milestone payments of $2.5 million upon approval and $2.5 million upon launch in the first country in the European territory (received in 2012). Meda has managed the regulatory submission in Europe that led to approval in October 2010. Meda will exclusively commercialize BREAKYL in Europe.

In 2009, we received a $3 million payment in exchange for amending the European agreement to provide Meda the worldwide rights to ONSOLIS®, with the exception of Korea and Taiwan. The sales royalties to be received by us will be the same for all territories as agreed to for Europe. In addition, various terms of the European agreements have been modified to reflect the rights and obligations of both us and Meda in recognition of the expansion of the scope of the European agreements.

Table of Contents

Assignment and Revenue Sharing Agreement. On January 23, 2015, we entered into an assignment and revenue sharing agreement with Meda (which we refer to as the Assignment Agreement), under which Meda will transfer back to us the marketing authorizations for ONSOLIS® for the United States and the right to seek marketing authorizations for ONSOLIS® in Canada and Mexico.

Under the Assignment Agreement, for a period of up to approximately one year, we shall have the right and shall use commercially reasonable efforts to work directly with the FDA to attempt to resolve certain previously disclosed issues relating to ONSOLIS® in the United States and seek, and attempt to negotiate a definitive license agreement with, one or more new commercial partners for ONSOLIS® in the United States, Canada and Mexico (each a Subject Country and collectively, the Subject Countries) (such an agreement, a Replacement License and such a partner, a Replacement Licensee).

Following the effective date of the Assignment Agreement, Meda s rights and obligations related to the development and commercialization of ONSOLIS® in the Subject Countries shall be suspended. Prior to the entry by us into a Replacement License, we and Meda will negotiate in good faith a form of definitive termination agreement addressing in further detail the termination of the Meda North American License and its effects (which we refer to as the Termination Agreement). Pursuant to the Assignment Agreement, any Termination Agreement is required to include provisions requiring us to share with Meda various percentages of revenue received by the Company under any Replacement License for ONSOLIS® after, subject to certain limitations, first deducting from such revenue payments required to be made by us under that certain Clinical Development and License Agreement, dated July 14, 2005, as amended, between the us, our subsidiary, Arius Two, Inc., and CDC V, LLC.

In the event that we have not identified a Replacement Licensee and entered into a Replacement License by a certain agreed upon date, Meda will have the right, but not the obligation, to demand that the marketing authorizations, and the rights to pursue marketing authorizations, for ONSOLIS® in the Subject Countries revert back to Meda, with the full reinstatement of all of Meda s rights and obligations under the Meda North American License. Notwithstanding the foregoing, Meda s rights to terminate the Meda North American License remain unaffected by the Assignment Agreement. Subject to any such reversion of rights back to Meda or earlier termination, the Assignment Agreement shall terminate on the earlier of (i) the termination of the Meda North American License or (ii) on February 28, 2016 without Meda s exercising its right to cause reactivation or our execution of a Replacement License with a Replacement Licensee.

Key Collaborative and Supply Relationships

We are and have been a party to collaborative agreements with corporate partners, contractors, universities and government agencies. Research collaboration may result in new inventions which are generally considered joint intellectual property unless invented solely by individuals we employ, or by third party transfer to us by contract. Our collaboration arrangements are intended to provide us with access to greater resources and scientific expertise in addition to our in-house capabilities. We also have supply arrangements with several of the key component producers of our delivery technology. Our collaborative and supply relationships include:

Endo. We believe that our agreement with Endo is currently one of our most important third party agreements. For a description of our agreements with Endo, please see Endo Pharmaceutical Licensing Agreement for BELBUCA above.

Meda. We believe that our agreements with Meda are currently one of our most important third party agreements. For a description of our agreements with Meda, please see Meda Licensing Agreements for ONSOLIS® above.

Aveva Drug Delivery Systems. Effective October 17, 2005, we entered into an agreement with Aveva pursuant to which Aveva acts as our North American supplier of ONSOLIS® for clinical trials and commercial sale. Under the terms of this agreement, Aveva will be the sole supplier of ONSOLIS® for the United States, Mexico and Canada.

Our supply agreement with Aveva runs for a term of four years from the first commercial sale of ONSOLIS® (October 2009) and can be renewed for subsequent two year terms. Either we or Aveva can terminate the agreement on advanced written notice. On October 9, 2014, Aveva sent us written notice of their intent not to renew our supply agreement. Therefore, our supply agreement with Aveva will expire on October 15, 2015. We will seek alternative manufacturing arrangements for ONSOLIS® in the U.S. in the event we are able to secure a new commercial partner for the product.

On March 12, 2012, we announced the postponement of the U.S. re-launch of ONSOLIS® following the initiation of the class-wide REMS until the product formulation could be modified to address two appearance-related issues. Such appearance-related issues involved the formation of microscopic crystals and a fading of the color in the mucoadhesive layer, raised by the FDA during an inspection of our North American manufacturing partner for ONSOLIS®, Aveva. While the appearance issues do not affect the product s underlying integrity, safety or performance, the FDA believes that the fading of the color in particular may potentially confuse patients, necessitating a modification of the product and its specification before it can be manufactured and distributed. The source of microcrystal formation and the potential for fading of ONSOLIS® was found to be specific to a buffer used in its formulation. We modified the formulation and as of the date of this report have 12 months of stability data on the reformulated product that shows no signs of microcrystal formation or color changes.

Table of Contents

LTS Lohmann Therapie-Systeme AG. Effective December 15, 2006, we entered into a Process Development Agreement with LTS Lohmann Therapie-Systeme AG (which we refer to herein as LTS), pursuant to which LTS will undertake process development, scale-up activities and supply BREAKYL to us for European clinical trials. Under the agreement, LTS has granted us a license under European Patent No. 0 949 925, in regard to BREAKYL in the E.U.

On September 13, 2012, we executed a Manufacturing, Supply, and License Agreement, effective April 26, 2012, with LTS, under which LTS will manufacture and supply us our BREAKYL product for distribution outside of the U.S. and Canada. We are required to supply BREAKYL product to Meda, Kunwha, and TTY pursuant to our obligations under certain license and supply agreements under which Meda, Kunwha, and TTY develop and commercialize the BREAKYL product. In conjunction with the agreement, LTS has waived all royalties on products that they produce. This does not preclude royalties that we owe to LTS if we produce BREAKYL with another company.

ARx. Effective July 30, 2014, we entered into an agreement with ARx, LLC. Pursuant to which ARx acts as a supplier of BUNAVAIL® laminate or bulk product for the United States. Our supply agreement with ARx runs for a term from July 30, 2014 until December 31, 2019 and can be renewed for additional terms by mutual agreement.

Sharp. Effective March 6, 2014, we entered into an agreement with Sharp Corporation to punch or cut the BUNAVAIL® laminate or bulk product into individual dosage units and package them to supply the finished BUNAVAIL® film products. Our supply agreement with Sharp runs for an initial term from March 6, 2014 until December 31, 2016 and can be extended by mutual agreement for subsequent one year terms.

Quintiles. In March 2014, we announced we had entered into an agreement with Quintiles to support the launch of BUNAVAIL®. Under terms of the agreement, Quintiles provides a range of services to support the commercialization of BUNAVAIL® in the U.S., including recruiting and training a field sales force. Our agreement with Quintiles shall continue until terminated, and the agreement is terminable upon notice by either party and also in cases of breach of the agreement by either party.

We also have relationships with third party contract research organizations that assist us with the management of our clinical trials.

In pursuing potential commercial opportunities, we intend to seek and rely upon additional collaborative relationships with corporate partners. Such relationships may include initial funding, milestone payments, licensing payments, royalties, access to proprietary drugs or potential applications of our drug delivery technologies or other relationships. Our agreements with Endo and Meda are examples of these types of relationships, and we will continue to seek other similar arrangements.

Relationship with CDC IV, LLC

On July 14, 2005, we entered into a Clinical Development and License Agreement (which we refer to as the CDLA), with the predecessor of CDC IV, LLC (which we refer to herein as CDC), which provided funds to us for the development of ONSOLIS®. On February 16, 2006, we announced that, as a result of our achievement of certain milestones called for under the CDLA, CDC made its initial $2 million payment to us. On May 16, 2006, we issued CDC 2 million shares of our common stock in return for accelerating the funding of the $4.2 million balance of $7

million of aggregate commitment under the CDLA and for eliminating the then required $7 million milestone repayment to CDC upon the approval by the FDA of ONSOLIS®.

Under the CDLA, as amended, CDC is entitled to receive a low-double digit royalty based on net sales of ONSOLIS®. The CDLA includes minimum royalties of $375,000 per quarter beginning in the second full year following commercial launch. The minimum provision came into effect in 2011. The royalty term and minimum payments end upon the latter of expiration of the patent or generic entry into any particular country.

The term of the CDLA lasts until the CDLA is terminated. Either we or CDC may terminate the CDLA for uncured breach or upon bankruptcy-like events, in each case following written notice. CDC may terminate the CDLA, following applicable cure periods, if we: (i) default on indebtedness in excess of $1 million which was accelerated or for which payment has been demanded, or (ii) fail to satisfy a judgment greater than $500,000.

During 2006 and 2007, we were a party to disputes with CDC. On September 5, 2007, in connection with CDC s consent to the Meda North American licensing transaction, we and CDC entered into a Dispute Resolution Agreement (or DRA) pursuant to which we and CDC agreed to waive and dismiss with prejudice all current disputes between us and CDC. As a condition to CDC s entry into

Table of Contents

the DRA and its consent to the Meda North American licensing transaction, we and CDC entered into a Royalty Purchase and Amendment Agreement, dated September 5, 2007 (or the RPAA) pursuant to which: (i) we granted CDC a right of first refusal on our financings, which replaced a right of first negotiation on financings previously held by CDC (which we refer to as the ROFR) and (ii) we granted CDC a 1% royalty on sales of the next BEMA® product, which will be BUNAVAIL®, including an active pharmaceutical ingredient other than fentanyl, to receive FDA approval. The ROFR terminated in accordance with its terms as of February 28, 2014 because, as provided for in the RPAA, we maintained a volume weighted average stock price of $9.00 per share for ten (10) trading days during any twenty (20) consecutive trading day period.

In connection with the 1% royalty grant as previously mentioned: (i) CDC shall have the option to exchange its royalty rights to BUNAVAIL® in favor of royalty rights to a substitute BEMA® product, (ii) we shall have the right, no earlier than six (6) months prior to the initial commercial launch of BUNAVAIL®, to propose in writing and negotiate the key terms pursuant to which it would repurchase the royalty from CDC, (iii) CDC s right to the royalty shall immediately terminate at any time if annual net sales of BUNAVAIL® equal less than $7.5 million in any calendar year following the third (3rd) anniversary of initial launch of the product and CDC receives $18,750 in three (3) consecutive quarters as payment for CDC s 1% royalty during such calendar year and (iv) CDC shall have certain information rights with respect to BUNAVAIL®. The amount of royalties which we may be required to pay (including estimates of the minimum royalties) is not presently determinable because product sales estimates cannot be reasonably determined and the regulatory approvals of the product for sale is not possible to predict. As such, we expect to record such royalties, if any, as cost of sales.

On May 12, 2011, we entered into an Amendment to the CDLA with CDC and NB Athyrium LLC (or Athyrium). Under the terms of the CDLA Amendment, among other matters, the parties agreed to increase the royalty rate to be received by CDC/Athyrium retroactively to the initial launch date of ONSOLIS® and, accordingly, we recorded $0.3 million as additional cost of product royalties for the year ended December 31, 2011. In addition, certain terms of the CLDA were amended and restated to clarify that royalty payments by us under the CDLA will be calculated based on Meda s sales of ONSOLIS®, whereas previous royalty payments by us to CDC were calculated based on sales of ONSOLIS® by us to Meda. The difference between these two calculations resulted in a $1.1 million overpayment by us which was recorded as a prepayment. As a result, we did not pay any of the quarterly royalty payments (including any 2011 payments) due to CDC/Athyrium until the December 31, 2011 royalty calculation, which we paid during the first quarter of 2012

Research and Development

The significant majority of our research and development relating to our BEMA® technology is conducted through third parties in collaboration with us.

Research and development expenses include salaries and benefits for personnel involved in our research and development activities and direct and third party development costs, which include costs relating to the formulation and manufacturing of our product candidates, costs relating to non-clinical studies, including toxicology studies, and clinical trials, and costs relating to compliance with regulatory requirements applicable to the development of our product candidates. For the years ended December 31, 2014, 2013 and 2012, we spent approximately $34.3 million, $53.3 million and $35.4 million, respectively, on research and development, and such expenses represented approximately 47%, 81% and 78%, respectively, of our total operating expenses for such fiscal years.

Endo is responsible for reimbursing us for certain research and development clinical trial expenses that exceed $45 million, as detailed in our License and Development Agreement that was executed on January 5, 2012. For the years ended December 31, 2014 and 2013, we have incurred $12.7 million and $2.8 million, respectively, in such research

and development expenses that are reimbursable by Endo to us. These reimbursable expenses are the primary activity within the reimbursable revenue account in the accompanying consolidated statement of operations as of December 31, 2014 and 2013.

Table of Contents

Market Overview for ONSOLIS®, BELBUCA , BUNAVAIL® and Our Product Candidates

The following table summarizes the status of our marketed product and our current product candidates and product concepts:

Product/Formulation	Indication	Development Status	Commercial Status
ONSOLIS®/BREAKYL / PAINKYL (U.S./E.U./Taiwan trade names, respectively)	Breakthrough cancer pain in opioid tolerant patients	Approval: U.S. in July 2009; Canada in May 2010; E.U. in October 2010 and Taiwan in July 2013	Partnered outside the U.S., Canada and Mexico
BELBUCA	Moderate to severe chronic pain	NDA accepted February 2015	Partnered worldwide with Endo
BUNAVAIL®	Treatment of opioid dependence	Approval: June 2014	In-house commercialization
Clonidine Topical Gel	Treatment of painful diabetic neuropathy	Phase 3 program in process	In-house commercialization for specialty indications possible; primary care rights expected to be partnered
Buprenorphine Depot Injection	Opioid dependence and chronic pain	IND submission anticipated in late 2015	Not partnered

The pharmaceutical industry and the therapeutic areas in which we compete are highly competitive and subject to rapid and substantial regulatory and technological changes. Developments by others may render our BEMA® technology, our marketed products and any proposed drug products and formulations under development noncompetitive or obsolete, or we may be unable to keep pace with technological developments or other market factors. Technological competition in the industry from pharmaceutical and biotechnology companies, universities, governmental entities and others diversifying into the field is intense and is expected to increase.

Below are some examples of companies seeking to develop potentially competitive technologies, though the examples are not all-inclusive. Many of these entities have significantly greater research and development capabilities than do we, as well as substantially more sales and marketing, manufacturing, financial and managerial resources. These entities represent significant competition for us. In addition, acquisitions of, or investments in, competing pharmaceutical or biotechnology companies by large corporations could increase such competitors research, financial, sales and marketing, manufacturing and other resources. Such potential competitive technologies may ultimately prove to be safer, more effective, or less costly than any product candidates that we are currently developing or may be able to develop. Additionally, our competitive position may be materially affected by our ability to develop or successfully commercialize our drugs and technologies before any such competitor. Other external factors may also impact the ability of our products to meet expectations or effectively compete, including pricing pressures, healthcare reform and other government interventions as well as limitations on access that may be placed upon us through managed care organizations or through competitive contracting with payers.

There have been a growing number of companies developing products utilizing various thin film drug delivery technologies. While numerous over-the-counter pharmaceutical products have been brought to market in thin film formulations, few containing prescription products have been introduced in the U.S. Among the products to receive FDA approval are ONSOLIS® and BUNAVAIL® (BDSI), Suboxone® film (Indivior) and Zuplenz® (Galena). Leading companies in the development and manufacture of thin film technologies include LTS, ARx LLC and MonoSol Rx LLC (or MonoSol). In addition, a number of companies are developing improved versions of existing products using oral dissolving, nasal spray, aerosol, sustained release injection and other drug delivery technologies. We believe that potential competitors are seeking to develop and commercialize technologies for buccal, sublingual or mucosal delivery of various therapeutics or groups of therapeutics. While our information concerning these competitors and their development strategy is limited, we believe our technology can be differentiated because the BEMA® technology provides for a rapid and consistent delivery, high drug bioavailability and convenient use based on how the BEMA® technology adheres to the buccal membrane and dissolves. Our clinical trials across a number of BEMA® products have demonstrated that the technology is an effective means of drug delivery that is well tolerated and offers convenience to patients.

ONSOLIS®

According to the National Cancer Institute, there are approximately 12.5 million people in the United States diagnosed with or living with cancer. Cancer patients often suffer from a variety of symptoms including pain as a result of their cancer or cancer treatment. Pain is a widely prevalent symptom in cancer patients, and an estimated 50% to 90% of those with cancer also suffer from what is referred to as breakthrough cancer pain or BTCP . Following rapid onset that peaks in three to five minutes, BTCP episodes

Table of Contents

can last several minutes to an hour, and usually occur several times per day. BTCP can be difficult to treat due to its severity, rapid onset and the often unpredictable nature. Physicians typically treat BTCP with a variety of short-acting opioid medications, including morphine and fentanyl. A number of formulations of fentanyl are available employing a variety of drug delivery technologies, all which provide rapid onset and relatively short duration of action to address the fast onset and short duration of BTCP.

For ONSOLIS®, in the breakthrough cancer pain area, the market has become increasingly crowded and more competitive in recent years. The principal competitor has traditionally been Teva Pharmaceutical Industries Ltd. (NASDAQ:TEVA), which completed its acquisition of Cephalon, Inc. in October 2011. Teva markets both lozenge (Actiq®) and effervescent buccal tablet (Fentora®) formulations of fentanyl. Over the last year, newer products entries, particularly Subsys® (fentanyl sublingual spray) from Insys) have gained significant market share. Additional competitors include Galena Biopharma which licensed from Orexo and subsequently relaunched the sublingual tablet formulation of fentanyl (Abstral®) and DepoMed, which licensed a nasal spray formulation of fentanyl (Lazanda®) from Archimedes. In addition, multiple generic formulations of Actiq® are currently available.

The transmucosal fentanyl class has faced significant challenges following safety issues stemming from inappropriate use of Fentora® and the subsequent Dear Doctor letter (Cephalon Press Release, September 2007). Furthermore, the FDA imposed a requirement that REMS be required for all transmucosal fentanyl products. The class-wide REMS requirement includes education, healthcare provider and patient registration, and other elements to assure safe use. The FDA has the authority to remove from the market products that do not abide by the mandated REMS. In order for ONSOLIS® to be approved and launched, a REMS program needed to be accepted by the FDA and put in place prior to launch. In October 2009, ONSOLIS® was launched in the U.S. with an accompanying restrictive REMS program.

Despite the requirement that all transmucosal fentanyl products have an approved REMS, the FDA did not reach agreement with Teva on a REMS program for Fentora® or Actiq® until July 21, 2011, nearly two years after the approval of ONSOLIS®. Teva announced initiation of their REMS program in mid-October 2011. The absence of a REMS program for competing fentanyl products resulted in an un-level competitive environment and a highly unfavorable selling environment for ONSOLIS®.

The FDA eventually abandoned individual REMS programs through the creation of a consortium consisting of all manufacturers of transmucosal fentanyl products. The goal of the group was to develop one single REMS program covering all products in the class. On December 29, 2011, the FDA approved a REMS program covering all transmucosal fentanyl products. The program, which is referred to as the Transmucosal Immediate Release Fentanyl (TIRF) REMS Access Program, was designed to ensure informed risk-benefit decisions before initiating treatment with a transmucosal fentanyl product, and while patients are on treatment, to ensure appropriate use. The approved program covers all marketed transmucosal fentanyl products under a single program which is meant to enhance patient safety while limiting the potential administrative burden on prescribers and their patients. One common program ended the disparity in prescribing requirements for ONSOLIS® compared to similar products.

In 2014, the overall market for transmucosal fentanyl products for breakthrough pain according to Symphony Health, totaled $437 million in the U.S. The first approved product for the management of breakthrough cancer pain was Actiq® (oral transmucosal fentanyl citrate) which, according to Symphony Health, generated $12 million in sales in 2014. Total sales for generic versions of Actiq®, available from multiple manufacturers including Covidien, Teva and Actavis, totaled $56 million over the same period. Fentora® utilizes an effervescent tablet which is administered buccally. Fentora® was approved and launched in late 2006 and according to Symphony Health, generated $118 million in sales in 2014.

In December 2008, ProStrakan announced receipt of marketing authorization from the German regulatory authorities for their fentanyl sublingual tablet (under the brand name Abstral®; licensed from Orexo AB) which was subsequently launched in a number of countries. In January 2010, Abstral® was approved in the U.S. by the FDA, and Prostrakan launched Abstral® in the second quarter of 2011. In June 2012, Orexo announced that they would re-acquire the rights to Abstral® in the U.S. and subsequently licensed U.S. rights to Galena Biopharma. Galena relaunched Abstral® in 2014 and cumulative sales totaled $20 million at year end.

In the U.S., additional products have been approved by the FDA utilizing other delivery technologies to administer fentanyl. These products include intranasal Lazanda®, which was approved in June 2011, and a fentanyl sublingual spray formulation from Insys known as Subsys®, which received FDA approval in January 2012. Subsys®, which was launched in early 2012, was the first sublingual spray formulation of fentanyl, and the first product shown to relieve pain within five minutes. The rapid onset of action, coupled with aggressive promotion and a significant co-pay support program, has led to rapid growth. In 2014, Subsys® achieved a prescription market share in excess of 36%, or $217 million in sales.

Other potent pain products are also in development, including ARX-02 from AcelRx Pharmaceuticals, Inc. (NASDAQ:ACRX) which has a nano-tab drug/device delivery system containing sufentanil for the treatment of breakthrough pain. While we have limited information regarding this and potential other competitors and their development status and strategy, we believe that our technology may be differentiated because unlike these potential competitors, ONSOLIS® has a predefined residence time on the buccal membrane providing for consistent drug delivery from dose to dose. We believe that all of the competitive formulations of fentanyl will have

Table of Contents

intra-dose variability, meaning the patient may not get the same response each time the product is administered. In addition, it is our belief that the other competitive products may have tolerability issues and a higher level of potential abuse based on how they are delivered.

The chart below lists products or products in development that we believe may compete directly with ONSOLIS®.

Product	Company	Description	Status
Actiq® (oral transmucosal fentanyl citrate)	Teva/Generics	Fentanyl lozenge	Marketed (generics available)
Fentora® (fentanyl buccal tablet)	Teva	Effervescent buccal tablet	Marketed
Abstral® (fentanyl sublingual tablet)	Galena Biopharma	Sublingual tablet	Marketed
Lazanda® (fentanyl nasal spray)	DepoMed	Nasal spray	Marketed
Subsys® (fentanyl sublingual spray)	INSYS Therapeutics	Sublingual spray	Marketed
Fastanix/NAL 1239	NAL Pharmaceuticals	Orally dissolving film	Proposed ANDA
ARX-02	AcelRx Pharmaceuticals	Nanotab containing sufentanil	Phase 2 (U.S.)

In Europe, the total market for transmucosal fentanyl products continues to grow with the availability of new formulations, including ONSOLIS (marketed as BREAKYL in Europe by Meda). Multiple formulations of fentanyl have recently been approved and launched in Europe for the treatment of breakthrough cancer pain, including Abstral®, Effentora®, and Instanyl® (intranasal fentanyl spray).

BELBUCA (*BEMA® Buprenorphine) for chronic pain*

Chronic pain is often defined as any pain lasting more than 12 weeks. Whereas acute pain is a normal sensation that alerts us to possible injury, chronic pain persists often for months or even longer. Chronic pain may arise from an initial injury, such as back sprain, or there may be an ongoing cause, such as an illness. Sometimes there is no clear cause. According to the National Institutes of Health, approximately 100 million people in the U.S. are living with chronic pain.

BELBUCA is intended to meet the need for a new narcotic and would be used for chronic pain, including lower back, osteoarthritis and rheumatoid arthritis. Compared to currently marketed products and products under development, we believe that BELBUCA will be differentiated based on the following features:

- efficacy similar to morphine, but unlike morphine, is a Schedule III narcotic. Such regulatory designation indicates it is less prone to abuse and addiction and more convenient for physicians to prescribe (with prescription refills possible), pharmacists to dispense, and patients to obtain;

- broad applicability across a wide spectrum of patients with varying types of moderate to severe pain, and can be used as a sole-therapy or in combination with less potent analgesics such as non-steroidal anti-inflammatory drugs (NSAIDS);

longer half life which allows for less frequent dosing, thus potentially increasing patient compliance;

established safety profile (based on other dosage forms currently in the marketplace both in the U.S. and Europe) compared to agents in development; and

improved tolerability, including a lower incidence of constipation and, based on its Schedule III designation, a lower propensity for addiction and abuse versus other opioid analgesics.

The BEMA® delivery system may enable us to provide this opioid in a form suitable for ambulatory care and, because of the safety advantage associated with this opioid, we believe that BELBUCA could be an ideal next step product for patients with incomplete pain relief on non-narcotic analgesics.

The pain market is well established, with many pharmaceutical companies marketing innovative products as well as generic versions of older, non-patent protected products. In 2014, according to data from Symphony Health, the U.S. opioid market exceeded $10 billion in annual sales. Due to the ability of BELBUCA to potentially participate in the chronic pain market, we estimate that BELBUCA for chronic pain has the potential to exceed $500 million in annual peak sales. BELBUCA is currently under review by FDA for the management of pain severe enough to require daily, around-the-clock, long-term opioid treatment and for which alternative treatment options don t exist. A number of products may be competitors to BELBUCA . A potential focus will be to position BELBUCA as a step up from NSAIDs instead of, or prior to, the common practice of prescribing hydrocodone containing

Table of Contents

combinations or the more addictive Schedule II narcotics. Indications for such use include pain associated with lower back and severe arthritis conditions. Marketed competitors for these indications include Tramadol (Ultram® ER from PriCara and Ryzolt® from Purdue), hydrocodone containing combination and extended release (Zohydro®) formulations, Butrans® (buprenorphine transdermal patch from Purdue) and the potent opioids such as OxyContin® from Purdue, Avinza® from Pfizer, Kadian® from Actavis and Nucynta® ER from DepoMed and others. Other competition includes multiple generic opioid formulations, new chemical entities in clinical development with different mechanisms of action and various combination formulations. We also believe that other companies may be exploring the use of buprenorphine in other delivery technologies, though we believe such products lag significantly behind BELBUCA . This includes a sublingual spray formulation of buprenorphine from Insys which is being developed for the treatment of acute pain.

Additionally, abuse deterrent formulations of pain products are currently being marketed, in clinical development or under FDA review. These formulations, such as Embeda® and, Exalgo®, as well as new formulations of OxyContin® and Opana® ER use a variety of technologies to try and minimize abuse. New abuse deterrent formulations include Targiniq® ER (oxycodone/naloxone) and Hysingla ER (hydrocodone). Abuse deterrent products are likely to play an unclear but increasingly important role in prescribing, potentially even replacing the original product. An advantage of BELBUCA is that the compound, buprenorphine, may be inherently less likely to cause abuse and addiction given the lower propensity for the product to cause euphoria and is the current basis of its CIII classification.

The first buprenorphine formulation for the treatment of chronic pain was approved in 2010. Purdue Pharmaceuticals received FDA approval for Butrans® (buprenorphine transdermal system) in July. Butrans® is indicated for the management of moderate to severe chronic pain and delivers buprenorphine transdermally (through the skin) over a period of seven days. The approval of Butrans® signaled the interest and approvability of new formulations of buprenorphine. It is our view that the flexibility of dosing with a BEMA® formulation, wider range of doses and ease of use will make it a preferred formulation for a significant number of patients with chronic pain conditions. Butrans® was launched in early 2011. Sales of Butrans® in 2014 totaled over $192 million and continue to steadily grow. While limited information is available, other formulations of buprenorphine may also be in early stages of development for the treatment of pain.

In August 2014, the U.S. Drug Enforcement Administration (DEA) published in the Federal Register their final ruling moving hydrocodone combination products (such as Vicodin, Lortab, Norco, etc.) from Schedule III to the more-restrictive Schedule II, as recommended by the Assistant Secretary for Health of the U.S. Department of Health and Human Services (HHS) and as supported by the DEA s own evaluation of relevant data. As a result of the ruling, hydrocodone containing products are now classified in the same category (Schedule II) as morphine and oxycodone. As a result of the change to Schedule II, access to these products will be more restricted. Among other changes, written prescriptions will be required and refills will not be permitted. The ruling also conveyed findings that hydrocodone combination products have a higher risk of abuse and addiction compared to Schedule III products. The ruling went into full effect in October 2014.

We recognized early the value of buprenorphine in the treatment of pain. Buprenorphine is one of the few remaining Schedule III opioids and has a lower risk of abuse and addiction compared to Schedule II opioids and thus will have fewer restrictions on dispensing. BELBUCA has the opportunity to provide a Schedule III option for the treatment of chronic pain and thus helping to replace the void left from the hydrocodone combination products. We believe the actions taken to restrict the use of hydrocodone combination products may markedly increase the utility and appeal of BELBUCA as it now addresses an important unmet medical need for Schedule III options.

In addition to direct competitors, there are other factors that impact the market for pain products in general. The significant pricing pressures and availability of generic products in the U.S. and other regions are likely to have

increasing influence on the pharmaceutical market, including pain products. Additionally, opioids continue to garner increased scrutiny based on the growing problem of prescription drug abuse and addiction. It remains unclear what steps, if any beyond the reclassification of hydrocodone, the FDA or other government agencies may take to address the problem of opioid abuse and addiction. However, in July 2012 the FDA approved a class-wide REMS program for the extended release and long-acting opioids. The class-wide REMS program consists of a REMS-compliant educational program offered by an accredited provider of continuing medical education, patient counseling materials and a medication guide. BELBUCA is anticipated to fall within the existing class-wide REMS program.

BUNAVAIL®

In June 2014, BUNAVAIL® was approved by the FDA for the maintenance treatment of opioid dependence. BUNAVAIL® contains the partial opioid agonist buprenorphine, which binds to the same receptors as opiate drugs but has a higher affinity, slower onset and is both less addictive and less lethal in overdose. Naloxone, an opioid antagonist, is included as an abuse deterrent. When used as directed, the naloxone is swallowed and minimally absorbed; however, if misused (ie, dissolved and injected), the naloxone rapidly precipitates withdrawal symptoms.

Table of Contents

Maintenance treatment with buprenorphine reduces the typical cravings and withdrawal symptoms associated with coming off opioid prescription painkillers and heroin. This allows the individual suffering from an addiction to opioids along with counseling and support to work toward recovery. On average, treatment lasts a couple months, reflecting relatively high dropout rates, but a significant number of people remain on buprenorphine treatment chronically, with nearly one-quarter of patients still on therapy after nine months. BUNAVAIL® provides an alternative treatment utilizing the advanced BEMA drug delivery technology. BUNAVAIL® provides the highest bioavailability of any buprenorphine-containing product for opioid dependence, allowing for effective treatment with half the dose compared to Suboxone film. Additionally, BUNAVAIL® offers convenient and discrete buccal administration and avoids the need for patients to avoid talking and swallowing during administration. Data has also demonstrated an excellent tolerability profile with a 68% reduction in the incidence of constipation in a Phase 3 trial in patients converted from Suboxone® sublingual tablets or film to BUNAVAIL® at the end of 12 weeks.

The total market for buprenorphine containing products for opioid dependence approached $1.8 billion in 2014. The market has grown significantly as a result of the rapidly escalating problem of prescription opioid misuse and abuse, a recent resurgence of heroin use, the growing number of physicians treating opioid dependence, and the inclusion of addiction treatment as an essential benefit in the Affordable Care Act. We estimate that BUNAVAIL® for the maintenance treatment of opioid dependence has the potential to achieve from between $200 to $250 million in annual peak sales.

The products currently marketed for this indication include Suboxone®, a sublingual film formulation of buprenorphine and naloxone, a sublingual tablet, Zubsolv®, and generic formulations of both buprenorphine and buprenorphine/naloxone tablets. Suboxone® film, the market leader, achieved sales of nearly $1.2 billion in the U.S. in 2014. While maintaining its dominance as the market leader in the U.S., Suboxone® film experienced a decline in sales and share due to increased use of generics and the availability of newer formulation of buprenorphine/naloxone. In December 2014, Reckitt Benckiser Group PLC, the manufacturer of Suboxone® sublingual tablets and films, announced that they completed the spin-off of that company s pharmaceutical business (including the Suboxone® brand) under the name Indivior PLC in order to allow the consumer goods group to focus on its consumer health and hygiene products. The Indivior business will focus on addiction treatment and closely related areas including opioid overdose, cocaine overdose and alcohol dependence. In September 2012, Reckitt Benckiser announced that it had notified the FDA that they would be voluntarily discontinuing the distribution of Suboxone® tablets in the U.S. and subsequently halted further shipments in March 2013. The decision made by Reckitt Benckiser was reportedly due to accumulating data demonstrating significantly lower rates of accidental pediatric exposure with Suboxone® films compared with their tablet formulation due to the child-resistant, unit-dose packaging of the film versus a multi-dose bottle for the tablets. Additionally, Reckitt Benckiser filed a Citizens Petition to request that the FDA require all manufacturers of buprenorphine-containing products for the treatment of opioid dependence to implement public health safeguards including child-resistant, unit-dose packaging to reduce the risk of pediatric exposure. FDA subsequently rejected the Citizens Petition in February 2013, which allowed for the approval of the first generic formulations of Suboxone® tablets.

The actions taken by Reckitt Benckiser as well as patient preference for a film formulation of Suboxone® resulted in significant conversion of the Suboxone® market to the branded film formulation. In 2013, the sublingual film formulation of Suboxone® accounted for over 95% of total Suboxone® prescription sales.

Generic buprenorphine/naloxone tablet formulations were launched in early 2013 by Actavis and Amneal Pharmaceuticals and were followed by additional entrants including a generic formulation from Teva. The remaining prescription volume for Suboxone® tablets was rapidly converted to generics; however, the impact of generic buprenorphine/naloxone tablets on Suboxone® film sales has been somewhat limited to date. In 2014, generic buprenorphine/naloxone tablets accounted for 18% of total buprenorphine/naloxone sales. It is anticipated that

additional generics may enter the market, though the timing is unclear.

In terms of additional competition, Phase 3 trials were completed for Probuphine, a subcutaneous depot delivery system containing buprenorphine from Titan Pharmaceuticals (OTCBB:TTNP). Results of clinical studies demonstrated efficacy and safety, and Probuphine was submitted for FDA review in October 2012. Probuphine was anticipated to address the needs of the subset of patients undergoing treatment for opioid dependence who are unable to maintain compliance with alternative formulations or those who may be at high risk for diversion. In December 2012, Titan announced the signing of a license agreement with Braeburn Pharmaceuticals Sprl. The license grants Braeburn exclusive commercialization rights in the United States and Canada. In April 2013, the FDA issued a Complete Response Letter for Probuphine and requested additional data regarding its efficacy. An additional Phase 3 study assessing the efficacy and safety of Probuphine was initiated in April 2014. In November 2014, Titan announced completion of enrollment in their ongoing Phase 3 study of Probuphine and expects to complete the study by the middle of 2015, allowing for a resubmission of their NDA in late 2015. Given the need for surgical implantation and removal, Probuphine is not expected to be a significant competitive threat to BUNAVAIL®.

A sublingual tablet, referred to as Zubsolv® or OX219, was approved by FDA in July 2013 and subsequently launched in September 2013. Zubsolv® is a sublingual formulation of buprenorphine/naloxone using Orexo s proprietary sublingual drug delivery technology. Orexo is a specialty pharmaceutical company with headquarters in Sweden. Orexo is developing treatments using their proprietary sublingual drug delivery technology, which includes the marketed product Abstral® that delivers fentanyl for the treatment of breakthrough cancer pain. In July 2013 Orexo announced the establishment of a commercial partnership with Publicis Healthcare Solutions. In May 2014, Orexo announced a new partnership with InVentiv Health for Zubsolv in the U.S.

Table of Contents

The sales efforts for Zubsolv® are supported by a contract sales organization (Inventive Health) and the product is being marketed predominantly based on its claims of improved taste and faster dissolve time compared to Suboxone®. Sales for Zubsolv® in 2014 totaled approximately $52 million in the U.S and a prescription market share of just over 3%.

While limited information is available, other formulations of buprenorphine may also be in early stages of development for the treatment of opioid dependence, including an oral capsule (NTC-510) from Nanotherapeutics, Inc. Three Phase 1 studies have been completed to date (two Phase 1a single dose pharmacokinetic studies and one Phase 1b, multidose pharmacokinetic study). It has been demonstrated that NTC-510 administered orally achieves appropriate serum buprenorphine concentrations for analgesia and could potentially be dosed once daily. Also in development is a sublingual spray formulation of buprenorphine/naloxone from Insys which completed a Phase 1 study and buprenorphine hemiadipate (RBP-6300) from Indivior, an oral abuse-deterrent formulation of buprenorphine using Capsugel drug delivery technology.

While we anticipate that the market for buprenorphine/naloxone products for the treatment of opioid dependence will get increasingly more competitive, we believe a BEMA® formulation of buprenorphine/naloxone has significant appeal given its buccal administration, enhanced delivery of buprenorphine, convenience, and lack of taste issues. We also believe that the increased number of companies promoting the use of buprenorphine containing-products for opioid dependence has the potential to create greater awareness and help to further expand what is already a significant and growing market.

Clonidine Topical Gel

In March 2013, we announced that we had entered into a worldwide licensing agreement with privately held Arcion, where we will develop and commercialize Clonidine Topical Gel (formerly ARC4558) for the treatment of PDN and potentially other indications. The PDN market is highly under-served by existing products and there is a strong scientific rationale for developing a topical treatment for PDN that delivers analgesia in a way that avoids systemic side effects.

Evidence has shown that clonidine stimulates an inhibitory receptor in the skin associated with pain fibers. Arcion has developed a patented topical gel formulation of clonidine and has assessed its effectiveness in reducing pain in PDN in a double-blind, placebo-controlled, Phase 2 study where the primary study endpoint was the change in pain intensity over a 3 month treatment period in diabetic foot pain. A significant treatment difference was seen in the planned subset analysis of diabetic patients who had documented evidence of functioning pain receptors in the skin of the lower leg (p=0.01, n=63) thus, at a minimum, supporting the effectiveness of topical clonidine in diabetic patients with functioning pain receptors of the skin. In the overall population that included patients without functioning nerve receptors , there was a trend favoring Clonidine Topical Gel (p=0.07, n= 182), though the overall results did not reach statistical significance.

Nearly 26 million people in the U.S. have diabetes according to the American Diabetes Association. A substantial number of these people have neuropathy as manifest by impaired sensation and pain in the extremities, most commonly the feet. Patients with PDN often experience debilitating pain symptoms that affect day-to-day functioning and quality of life. How diabetes causes a length-dependent neuropathy is unknown. In the prior double-blind, randomized, controlled trial approximately 50% of the patients with PDN demonstrated functional nociceptors in the skin in the painful region as revealed by a response to topical capsaicin. Clonidine is thought to relieve pain by decreasing the abnormal excitability of these functional nociceptors. Currently available oral treatments are modestly effective in relieving symptoms and are limited by systemic side effects and drug interactions. There are no topical products approved for the treatment of this painful condition.

Along with antidepressants, antiepileptic drugs (AEDs) are often used as a first-line therapy for PDN. The most commonly prescribed AEDs for PDN are gabapentin and pregabalin (Lyrica). The choice between them is mostly influenced by physicians preference for the more-favorable dosing attributes (less-frequent daily dosing, faster titration) of pregabalin in balance with price and accessibility. AEDs are commonly associated with side effects including somnolence, dizziness, and weight gain. If first-line AED or antidepressant monotherapy fails to provide acceptable pain relief, physicians initiate combination therapy. If AED/antidepressant combination therapy is not effective, physicians typically add a dual-acting opioid such as tramadol. For more-severe pain, physicians may add or switch to tapentadol ER (Nucynta ER), which is the first and only dual-acting opioid analgesic to gain approval for PDN in the U.S. If pain persists with the addition of tramadol or tapentadol, physicians often switch to a more potent opioid analgesic (e.g., oxycodone) while maintaining AED and/or antidepressant therapy. Although some experts acknowledge that strong opioids can be quite effective for PDN, they generally reserve this drug class for refractory cases and/or those with high pain intensity. For some PDN patients, particularly those experiencing highly localized pain, physicians may prescribe the lidocaine 5% patch (Lidoderm). Pain specialists generally consider that lidocaine is particularly beneficial for localized pain, and many physicians prefer it to oral agents because it does not cause systemic side effects and is easy to administer. In many cases, the patch is used in combination with an oral first-line AED and/or antidepressant therapy.

Table of Contents

Oral medications that are approved for the treatment of PDN include anticonvulsants such as Lyrica (pregabalin), the antidepressant Cymbalta® (duloxetine) and the opioid Nucynta® ER (tapentadol ER), with sales for the treatment of neuropathic pain totaling over $3 billion in the U.S. according to Datamonitor. These treatments are modestly effective in relieving symptoms and their use can be limited by adverse effects and drug interactions. Additional oral formulations in development include an extended release formulation of pregabalin from Pfizer.

Acorda Therapeutics is developing a concentrated (20%) topical liquid formulation of capsaicin (NP-1998 [formerly NGX-1998]) for the treatment of neuropathic pain. The product was formerly in development by NeurogesX, which licensed all U.S. rights as well as those of its 8% capsaicin patch (Qutenxa) to Accorda in July 2013. Acorda is planning to launch a Phase 3 clinical trial of NP-1998 in painful HIV (human immunodeficiency virus) peripheral neuropathy as the first potential indication for NP-1998. The company is also exploring the potential for additional indications, including painful diabetic neuropathy. In 2011, NeurogesX completed a Phase 2 trial in post herpetic neuralgia and results from the trial confirmed efficacy and safety. Teva and Xenon Pharmaceuticals are developing TV-45070 (formerly XEN402), a subtype selective ion channel inhibitor. TV-45070 has potentially broad application in nociceptive pain, including inflammatory pain, and neuropathic pain indications. TV-45070 is partnered with Teva in a milestone, royalty and co-promotion partnership. Using a topical (ointment) formulation of TV-45070, Teva has initiated a 300-patient Phase 2b clinical trial in osteoarthritis, or OA, of the knee, and data are expected in the third quarter of 2015. Teva is also developing topical TV-45070 in neuropathic pain indications, and is currently planning a Phase 2b clinical trial in patients with postherpetic neuralgia.

Buprenorphine Depot Injection

Despite the availability of effective treatments, including BUNAVAIL® buccal film, challenges remain regarding patient adherence to long-term buprenorphine treatment, which is critical to successfully manage opioid dependence. This has led to interest in alternative delivery systems for buprenorphine. One such opportunity is the development of an injectable, long-acting, depot formulation. Microsphere-based, long acting, buprenorphine injectable depot has the ability to change the treatment paradigm in opioid dependence and pain management. Such a dosage form provides improved therapy compliance through continuous delivery of drug for up to 30 days. In 2014, we entered into an exclusive agreement with Evonik to develop and commercialize a proprietary, injectable microparticle formulation of buprenorphine potentially capable of providing 30 days of continuous therapy following a single subcutaneous injection. While we plan to pursue an indication for the maintenance treatment of opioid dependence, we have also secured the rights and plans to develop a product for the treatment of chronic pain in patients requiring continuous opioid therapy. As part of the agreement, we will have the right to license the product(s) following the attainment of Phase 1 ready formulations. At that point, Evonik could receive downstream payments for milestones related to regulatory filings and subsequent NDA approvals as well as product royalties. Evonik has the exclusive rights to develop the formulation and manufacture the product(s).

Additional long-acting depot formulations of buprenorphine are also in develop including one from Indivior, RBP-6000, which uses Atrigel technology and is currently in Phase 2 development and a product licensed by Braeburn Pharmaceuticals in November 2014 utilizing a technology licensed from Camurus. The product referred to as CAM2038 from Camurus is being developed as both a 1-week and 1-month subcutaneous injection.

Licenses, Intellectual Property and Proprietary Information

Our intellectual property strategy is intended to maximize protection of our proprietary technologies and know-how and to further expand targeted opportunities by extension of our patents, trademarks, license agreements and trade secrets portfolio. In addition, an element of our strategic focus provides for varying specific royalty or other payment obligations by our commercial partners as our applicable intellectual property portfolio changes or business activity

reaches certain thresholds.

However, patent positions of biotechnology and pharmaceutical organizations are considered to be uncertain and involve complex legal and technical issues. There is considerable uncertainty regarding the breadth of claims in patent cases which results in varied degrees of protection. While we believe that our intellectual property position is sound, it may be that our pending patent applications will not be granted or that our awarded claims may be too narrow to protect the products against competitors. It is also possible that our intellectual property positions will be challenged or that patents issued to others prior to our patent issuance may preclude us from commercializing our products. It is also possible that other parties could have or could obtain patent rights which may cover or block our products or otherwise dominate our patent position.

BEMA® Technology

The drug delivery technology space is congested, although we do not believe that our BEMA® products are in conflict with, dominated by, or infringing any external patents and we do not believe that we require licenses under external patents for our BEMA® based products in the United States, it is possible, however, that a court of law in the United States or elsewhere might determine

Table of Contents

otherwise. If a court were to determine that we were infringing other patents and that those patents were valid, we might be required to seek one or more licenses to commercialize our products or technologies. We may be unable to obtain such licenses from the patent holders. If we were unable to obtain a license, or if the terms of the license were onerous, there may be a material adverse effect upon our business plan to commercialize these products.

This potential exists in our present litigation with MonoSol. MonoSol claimed in a litigation initiated in late 2010 that our confidential and trade secret manufacturing process for ONSOLIS® infringes their patented manufacturing process for thin films. We do not believe that we have infringed these claims. Moreover, we believe that the original claims in MonoSol patents 588, 292 and 891 are invalid or overbroad, and, in connection with inter partes and ex parte reexamination proceedings we have brought before the USPTO, the USPTO has either rejected and cancelled all claims, amended the original claims to make them narrower, or issued narrower, new claims replacing the broader original claims for each of the 588, 292 and 891 patents respectively. We also believe that the manufacturing processes for our product candidates, including BEMA® Buprenorphine and BUNAVAIL® do not infringe MonoSol s patents, at least because they do not meet the limitations of the original, amended or new claims of MonoSol s patents. We maintain our manufacturing processes for our BEMA® products and product candidates as trade secrets. Based on our examination of these patents, we do not believe our manufacturing processes infringe MonoSol s patents. On March 7, 2012, the court granted our motion to stay the case pending outcome of the reexamination proceedings in the USPTO. On July 3, 2012, the USPTO issued an ex parte reexamination certificate on the 891 patent, in which all original claims were amended to make them narrower. On August 26, 2012, the USPTO issued an ex parte reexamination certificate on the 292 patent, in which all the original broader claims were replaced with narrower, new claims. As for the 588 patent, at the conclusion of the reexamination proceedings (and its appeals process), on April 17, 2014, the Patent Trial and Appeal Board (or PTAB) of the USPTO issued a Decision on Appeal affirming the Examiner s rejection (and confirming the invalidity) of all the claims of the 588 Patent. MonoSol did not request a rehearing by the May 17, 2014 due date for making such a request and did not further appeal the Decision to the Federal Court of Appeals by the June 17, 2014 due date for making such an appeal. Subsequently, on August 5, 2014, the USPTO issued a Certificate of Reexamination cancelling the 588 Patent claims.

On March 1, 2011, we were granted a patent extending the exclusivity of the BEMA® drug delivery technology in Canada to 2027. The Canadian Patent No. 2,658,585 provides additional patent protection for ONSOLIS® and BELBUCA . In April 2012, the USPTO granted US Patent No. 8,147,866 (issued from US Patent Application No. 13/184,306), which will extend the exclusivity of the BEMA® drug delivery technology for BELBUCA and BUNAVAIL® in the United States from 2020 to 2027. In April 2014, the USPTO granted US Patent No. 8,703,177 (issued from US Patent Application No. 13/590,094), which will extend the exclusivity of the BEMA® drug delivery technology for BUNAVAIL® in the United States to at least 2032.

We own various patents and patent applications relating to the BEMA® technology. US Patent No. 6,159,498 (expiration date October 2016), US Patent No. 7,579,019 (expiration date January 22, 2020), US Patent No. 8,147,866 (expiration date July 23, 2027), Canadian Patent No. 2,658,585 (expiration date July 2027) and EP 0 973 497 (expiration date October 2017) are of particular value to our business and technology platform relating to the BEMA® delivery technology. On February 16, 2010, we filed a complaint with the United States Federal District Court for the District of Columbia, requesting the USPTO be required to further extend the patent term for US 7,579,019 from 835 days to 1,191 days. In March 2011, we prevailed in this case, and the patent expiration date of US Patent No. 7,579,019 is now extended from January 31, 2019 to January 22, 2020.

On January 22, 2014, MonoSol filed a Petition for Inter Partes Review (or IPR) on US Patent No. 7,579,019 with the USPTO. In the Petition, MonoSol is requesting an inter partes review because it is asserting that the claims of US Patent No. 7,579,019 are alleged to be unpatentable over certain prior art references. The USPTO instituted the IPR on the 019 Patent. The IPR could invalidate or validate in whole or in part, this patent. Accordingly, we are defending our

US Patent No. 7,579,019 vigorously in the IPR proceedings.

With respect to trademarks, BDSI®, BEMA® and BUNAVAIL® are registered trademarks of BioDelivery Sciences International, Inc. ONSOLIS® and BREAKYL are trademarks owned by Meda Pharmaceuticals, Inc. PAINKYL is a trademark owned by TTY Biopharm.

Clonidine Gel Product

On March 26, 2013, we entered into the Arcion Agreement with Arcion pursuant to which Arcion agreed to grant to us an exclusive commercial world-wide license, with rights of sublicense, under certain patent and other intellectual property rights of Arcion to develop, manufacture, market, and sell gel products containing clonidine (or a derivative thereof), alone or in combination with other active ingredients, for topical administration for the treatment of painful diabetic neuropathy and other indications (the Clonidine Gel Products).

Per the Arcion Agreement, we have exclusive rights to various patents pertaining to the Clonidine Gel Products. US Patent No. 6,147,102 (expiration date October 26, 2019), US Patent No. 6,534,048 (expiration date October 26, 2019), US Patent No. 8,026,266 (expiration date September 30, 2029) and their corresponding patents in other countries (*e.g.*, Australia, Canada, Germany, *etc*.) are of particular value to our business and technology platform relating to the Clonidine Gel Products.

Table of Contents

Although we do not believe that our Clonidine Gel Products are in conflict with, dominated by, or infringing any external patents and we do not believe that we require licenses under external patents for Clonidine Gel Products, it is possible, however, that a court of law in the United States or elsewhere might determine otherwise. If a court were to determine that we were infringing other patents and that those patents were valid, we might be required to seek one or more licenses to commercialize our products or technologies. We may be unable to obtain such licenses from the patent holders. If we were unable to obtain a license, or if the terms of the license were onerous, there may be a material adverse effect upon our business plan to commercialize these products.

Buprenorphine Depot Injection Product

On October 27, 2014, we entered into a definitive Development and Exclusive License Option Agreement (which we refer to as the Evonik Development Agreement) with Evonik pursuant to which Evonik agreed to grant two exclusive options to acquire exclusive worldwide licenses, with rights of sublicense, to certain patents and other intellectual property rights of Evonik to develop and commercialize certain injectable, extended release products containing buprenorphine (which we refer to as Buprenorphine Depot Injection Products). If such options are exercised, such licenses would be memorialized in a definitive license agreement.

Although we do not believe that any Buprenorphine Depot Injection Products would be in conflict with, dominated by, or infringing any external patents and we do not believe that we require licenses under external patents for Buprenorphine Depot Injection Products, it is possible, however, that a court of law in the United States or elsewhere might determine otherwise. If a court were to determine that we were infringing other patents and that those patents were valid, we might be required to seek one or more licenses to commercialize our products or technologies. We may be unable to obtain such licenses from the patent holders. If we were unable to obtain a license, or if the terms of the license were onerous, there may be a material adverse effect upon our business plan to commercialize these products.

Manufacturing

We rely on third-party manufacturers, packagers, and analytical testing laboratories to produce commercial product and developmental products for research, product development, and clinical supplies. We are currently party to the following manufacturing arrangements for different companies:

BUNAVAIL®

Effective July 30, 2014, we entered a Supply Agreement with ARx for manufacturing, and effective March 6, 2014, we entered a Supply Agreement with Sharp for packaging for BUNAVAIL® commercial supplies, respectively. Both companies underwent successful FDA preapproval inspections and will be subject to annual quality audits. Both our contracts are also supported by a quality assurance agreement requiring our counterparties to adhere to product quality standards and cGMP manufacturing and packaging requirements.

ONSOLIS®

Effective October 17, 2005, we entered into an agreement with Aveva pursuant to supply ONSOLIS® for clinical trials and commercial sale. Under the terms of this agreement, Aveva is the sole supplier of ONSOLIS® for the United States and Canada. The current agreement expires on October 15, 2015. On October 9, 2014, Aveva sent us written notice of their intent not to renew our supply agreement. Therefore, our supply agreement with Aveva will expire on October 15, 2015. We will seek alternative manufacturing arrangements for ONSOLIS® in the U.S. in the event we are able to secure a new commercial partner for the product.

On March 12, 2012, we announced the postponement of the U.S. re-launch of ONSOLIS® following the initiation of the class-wide REMS with two appearance issues raised by FDA during an inspection of Aveva s manufacturing facility. Specifically, the FDA identified the formation of microscopic crystals and a fading of the color in the mucoadhesive layer during the 24-month shelf life of the product. ONSOLIS® has been subsequently reformulated with 12 months of available stability data on the reformulated product.

In February 2015, we re-acquired the rights to the ONSOLIS® NDA from Meda. With the resolution of the appearance issue and 12 months of stability on the reformulated product, we plan to submit a prior approval supplement for this formulation by the end of the first quarter of 2015 seeking its approval which expected by the end of the third quarter of 2015.

Table of Contents

BREAKYL

Effective December 15, 2006, we entered into a process development agreement and a commercial Supply Agreement on April 26, 2012, both with LTS. Under the terms of this supply agreement, LTS is the exclusive manufacturer of BEMA® Fentanyl for all countries with exception of the United States and Canada. LTS continues to manufacture BREAKYL for MEDA since it was first launched in the E.U. in September 2012.

BELBUCA (BEMA® Buprenorphine)

Effective January 5, 2012, we entered a license and development agreement with Endo for BELBUCA. Over the past two years, the technical operations and supply activities have been gradually transitioned from BDSI to Endo. As a result of the licensing and developmental agreement, all of the commercial supply agreements will be negotiated by and the responsibility of Endo.

Clonidine Topical Gel

Effective October 22, 2014, we entered into a master service agreement with Ei LLC for formulation, analytical and manufacturing services, clinical supplies, packaging and product release for the Clonidine Topical Gel. We have also made similar arrangements with Frontage and Tapemark for bulk manufacture for initial clinical trial supplies and individual dose units packaging, respectively.

Buprenorphine Depot Injection

Effective October 27, 2014, we entered into an exclusive agreement with Evonik to develop and commercialize a proprietary long acting, sustained release, biodegradable microparticle buprenorphine formulation capable of providing 30 days of continuous therapy following a subcutaneous injection. Through the agreement, we also secured the license to Evonik-owned intellectual property related to products for the maintenance treatment of opioid dependence and for the treatment of chronic pain.

Sales and Marketing

Following, and assuming, completion of clinical development and regulatory approval for each candidate product, we will pursue one of several approaches (or a combination thereof) for marketing and selling our products. These include licensing the products to appropriate partners so that they can market and distribute the products for us, co-promotions where we would share in the sales promotion, or use of our own recently established contract sales organization. We have already utilized this strategy with regard to our approved product, ONSOLIS®/ BREAKYL with our licensing agreements with Meda world-wide except Taiwan (TTY) and South Korea (Kunwha) and our worldwide license and development agreement with Endo for BELBUCA for chronic pain.

This strategy was further implemented in 2014 with the creation of our own exclusive contract sales force for the launch of BUNAVAIL®. This existing sales force now provides us with the means to sell BUNAVAIL® but also affords us the opportunity to consider selling other products in our own portfolio or those in-licensed. Using our own sales force provides us with significantly more control over commercialization efforts and makes us capable of selling our own products in specialty pharmaceutical markets while leaving with partners promotional responsibilities for the large primary care audiences.

For BUNAVAIL®, we completed our plans to self-commercialize the product in early 2014 and successfully launched our contract sales force in September.

ONSOLIS®/BREAKYL

European Union

In September 2006, we secured an exclusive licensing and supply agreement with Meda for the commercialization rights for BEMA® Fentanyl in the E.U., which is being marketed in Europe under the trade name BREAKYL . The agreement between Meda and us specifies that Meda is responsible for all post-approval clinical studies and label expansion trials. BREAKYL received marketing authorization from the European regulatory authorities in October 2010 and has been launched in over thirteen European countries including Germany, France and the U.K.

North America

In September 2007, we secured an exclusive licensing and supply agreement with Meda for the commercialization rights for ONSOLIS®, under which Meda was responsible for the sales, marketing and distribution of ONSOLIS® in the U.S., Canada and Mexico. The agreement specified that ONSOLIS® was to be detailed in the primary position for a specified duration among target prescribers

Table of Contents

ONSOLIS® was commercially launched in the United States in mid-October 2009 following approval by the FDA in July 2009. Under the Meda agreement, ONSOLIS® commercial efforts were supported by a therapeutic specialty sales force assembled by Meda to target oncologists and pain management specialists treating breakthrough cancer pain. A specialty sales force consisting of experienced and well trained sales representatives were put in place to promote ONSOLIS® to target healthcare providers.

ONSOLIS® was approved by the Canadian regulatory authorities in May 2010, and is the first product approved in Canada for the management of breakthrough cancer pain. Meda Valeant Pharma Canada Inc., a joint venture between Meda and Valeant Canada Limited is responsible for promotion of ONSOLIS® in Canada. ONSOLIS® was launched in Canada in the third quarter of 2011.

On March 12, 2012, we announced the postponement of the U.S. re-launch of ONSOLIS® following the initiation of the class-wide REMS until the product formulation could be modified to address two appearance-related issues. Such appearance-related issues involved the formation of microscopic crystals and a fading of the color in the mucoadhesive layer, raised by the FDA during an inspection of our North American manufacturing partner for ONSOLIS®, Aveva. While the appearance issues do not affect the product s underlying integrity, safety or performance, the FDA believes that the fading of the color in particular may potentially confuse patients, necessitating a modification of the product and its specification before it can be manufactured and distributed. The source of microcrystal formation and the potential for fading of ONSOLIS® was found to be specific to a buffer used in its formulation. We modified the formulation and as of the date of this report have 12 months of stability data on the reformulated product that shows no signs of microcrystal formation or color changes.

On January 27, 2015, we announced that we had entered into the Assignment Agreement with Meda to return to us the marketing authorizations for ONSOLIS® for the U.S. and the right to seek marketing authorizations for ONSOLIS® in Canada and Mexico, back to us. Once the NDA has been returned, we will have the right to work directly with the FDA and submit a prior approval supplement that responds to FDA questions and requests and will hopefully lead to the re-introduction of the product. FDA s review of the application may take up to six months; therefore, we could receive a decision before the end of 2015.

Additional Territories

On January 2, 2009, we entered into amendments to our agreements with Meda to grant Meda worldwide commercialization rights for ONSOLIS®/BREAKYL with the exception of Taiwan and South Korea. The sales royalties to be received by us will be the same for all territories as agreed to for Europe.

In 2010, licensing agreements were secured in Taiwan and South Korea providing the opportunity for commercialization in all territories globally. In May 2010, we announced a commercial partnership with Kunwha for the exclusive rights to develop and commercialize ONSOLIS® in the Republic of Korea. The agreement results in potential milestone payments of up to $1.275 million, which included the upfront payment of $0.3 million and royalties based on net sales. In October 2010, a commercial partnership with TTY was announced, providing commercialization rights for Taiwan. This agreement results in potential milestone payments of up to $1.3 million along with royalties based on sales and included an upfront payment of $0.3 million.

In November 2011, we announced that TTY had submitted a NDA for marketing authorization of BEMA® Fentanyl to the Taiwan Food and Drug Administration. This triggered a milestone payment to us of approximately $0.3 million, which was received November 2011. In July 2013, we announced the regulatory approval of BEMA® Fentanyl in Taiwan, where the product will be marketed under the brand name PAINKYL . The approval in Taiwan resulted in a milestone payment of $0.3 million to us, which was received in the third quarter 2013.

We believe that utilizing commercial partners to market and sell ONSOLIS®/BREAKYL relieves us of the burden associated with a significant increase in expenditures or headcount otherwise associated with a commercial launch of a first product. Additionally, we believe our commercial partnerships for ONSOLIS®/BREAKYL allows internal efforts to be focused on the development of our pipeline of products.

BELBUCA (BEMA® Buprenorphine) for Chronic Pain

We announced the signing of a world-wide licensing and development agreement for BELBUCA with Endo in January 2012. Under terms of the agreement, Endo will be responsible for the manufacturing, distribution, marketing and sales of BELBUCA on a worldwide basis.

Endo is one of the premier companies in the area of pain management and has demonstrated significant success in the pain space particularly with the development, launch and commercialization of a portfolio of pain therapeutics including Opana® ER,

Table of Contents

Lidoderm® and Voltaren® Gel. Endo s long experience in pain includes a strong sales and marketing capability, with sales representatives that are established in the offices of many high value healthcare practitioners who are high prescribers of opioids and other pain products.

We believe that BELBUCA is an excellent fit to Endo s pain portfolio and will, if approved by the FDA, provide Endo with an additional pain product that can be aligned with other products in their portfolio based on factors such as pain severity and opioid scheduling. Endo will be responsible for all sales and marketing at the time of launch and will focus their promotional and educational efforts on high volume prescribers of opioids and other analgesics, which includes predominantly pain management specialists and primary care physicians. Endo will commercialize BELBUCA outside the U.S. through its own efforts or through regional partnerships. We believe that BELBUCA would potentially be aligned with the needs of pain specialists and primary care physicians who seek an alternative to Schedule II opioids for the treatment of moderate to severe chronic pain that is not adequately controlled with commonly prescribed first-line therapies (e.g. NSAIDs).

BUNAVAIL®

During 2013, we engaged in the process of assessing a variety of strategic options for the commercialization of BUNAVAIL® in the U.S. The options we explored included commercial partnerships, co-promotion arrangements, leading commercial efforts internally through the use of contract resources, or a combination of the aforementioned strategic options. Outside the U.S., we will likely pursue partnerships.

Following a thorough assessment of commercialization options for BUNAVAIL®, we identified BUNAVAIL® as an attractive product to build a commercial presence capable of supporting both BUNAVAIL® and our other future products. Additionally, the self-commercialization of BUNAVAIL® supports our longer term vision to become a fully integrated pharmaceutical company. The dynamics of the opioid dependence market made self-commercialization a feasible and attractive option. In total, approximately 90% of all prescriptions are written by approximately 5,000 physicians which include primary care physicians, psychiatrists, addiction medicine specialists and pain specialists, with most concentrated in the eastern third of the U.S. and the west coast, allowing for coverage of a majority of the prescriber base with a modest sized sales force. Sales force sizing estimates suggest that a field sales force of approximately 60 could reach most of the identified target audience with the necessary frequency. Additionally, the relatively small prescriber base along with the limited number of competitors results in relatively modest marketing expenditures. And finally, the high awareness and physician acceptance of buprenorphine for the treatment of opioid dependence lessens the need for costly educational and promotional programs.

Plans to self-commercialize BUNAVAIL® were completed in early 2014. We chose to utilize internal resources to provide the strategic direction and oversight of specialized contractor resources. In March 2014, we entered into an agreement with Quintiles to support the launch of BUNAVAIL®. Under terms of the agreement, Quintiles provides a range of services to support the commercialization of BUNAVAIL® in the U.S., including recruiting and training a field sales force. Separately, we entered into an agreement with Ashfield Market Access to provide managed markets and trade support for BUNAVAIL®. Ashfield Market Access, which is led by industry veterans including those who led GlaxoSmithKline s managed markets group for more than 20 years, took responsibility for executing a payer strategy aimed at maximizing patient access to BUNAVAIL®.

We began our efforts at the 2014 annual meeting of the American Society of Addiction Medicine (ASAM) with deployment of a contract Medical Science Liaison (MSL) team under the oversight of Medical Affairs. Following ASAM, the MSL team focused on introducing physicians to the BEMA® technology.

Under full oversight of BDSI, recruitment and hiring of our specialty addiction sales force was completed during the third quarter of 2014. A highly experienced sales force with significant experience in the areas of pain and addiction medicine was deployed. Approximately 60% of representatives hold ten or more years of pharmaceutical sales experience and nearly 90% with five or more years of experience. Three-quarters of the field force previously had prior experience in the areas of pain management or addiction medicine.

On November 3, 2014, we announced the availability of BUNAVAIL® in the U.S. where it is being supported by a 60-person field sales force and a full marketing effort targeting the nearly 5,000 physicians who are responsible for approximately ninety percent of prescriptions for buprenorphine products for the treatment of opioid dependence. The launch was also supported by a full marketing effort aimed at increasing product awareness including advertising and promotion, direct mail and email, a speakers programs and a number of initiatives, including a copay support program, to minimize access issues.

We recognize the competitive nature of the opioid dependence market and will continuously evaluate the size and structure of our sales force relative to our competitors. As appropriate for our business, we will consider the deployment of additional sales territories and representatives. While we recognize that we may not be able to support a sales force the size of an established competitor such as Indivior (formerly Reckitt Benckiser), we believe we can maintain a competitive share of voice through both personal and non-personal selling efforts. We also believe that BUNAVAIL® offers distinct and important benefits over other products in the opioid dependence market which will allow it to successfully compete in the long term.

Table of Contents

Government Regulation

The nonclinical and clinical development, manufacturing and marketing of any drug product, is subject to significant regulation by governmental authorities in the United States and other countries. Complying with these regulations involves considerable time, expense and uncertainty.

In the United States, drugs are subject to rigorous federal regulation and, to a lesser extent, state regulation. The Federal Food, Drug and Cosmetic Act, as amended, and the regulations promulgated thereunder, and other federal and state statutes and regulations govern, among other things, the testing, manufacture, safety, efficacy, labeling, storage, record keeping, approval, advertising and promotion of our drugs. Drug development and approval within this regulatory framework is difficult to predict, requires a number of years and involves the expenditure of substantial resources. Moreover, ongoing legislation by Congress and rule making by the FDA presents an ever-changing landscape where we could be required to undertake additional activities before any governmental approval to market our products is granted.

The steps required before a pharmaceutical product may be marketed in the United States include:

1. small scale manufacturing of the product;

2. laboratory and nonclinical tests for safety of the product;

3. submission of an IND to the FDA for the product which must become effective before human clinical trials can commence;

4. larger scale manufacturing of the product;

5. clinical trials to characterize the efficacy and safety of the product in the intended patient population;

6. submission of an NDA to the FDA; and

7. approval of the NDA by the FDA.

In addition to obtaining FDA approval for each product, each product-manufacturing establishment must be registered with, and approved by, the FDA. Manufacturing establishments are subject to biennial inspections by the FDA and must comply with the FDA s Good Manufacturing Practices and with other federal and local regulations.

Nonclinical Trials

Nonclinical testing includes laboratory evaluations of the active drug substance and formulation, as well as tissue culture and animal studies to assess the safety and potential efficacy of the investigational product. Nonclinical tests must be conducted by laboratories that comply with FDA Good Laboratory Practices regulations. Nonclinical testing

is inherently risky and the results can be unpredictable or difficult to interpret. The results of nonclinical testing are submitted to the FDA as part of an IND and are reviewed by the FDA prior to the commencement of clinical trials. Unless the FDA places a clinical hold on an IND, clinical studies may begin thirty (30) days after the IND is submitted.

We have relied and intend to continue to rely on third party contractors to perform nonclinical trials.

Clinical Trials

Clinical trials involve administration of the investigational product to healthy volunteers and/or to patients under the supervision of a qualified investigator. Clinical trials must be conducted in accordance with Good Clinical Practices following protocols acceptable to FDA that detail the objectives of the study, the parameters to be used to monitor safety and the efficacy and the planned evaluation of results. Each protocol must be submitted to the FDA prior to its conduct. Further, each clinical study must be conducted under the auspices of an independent institutional review board that protects the rights and welfare of the study subjects. The drug product used in clinical trials must be manufactured according to Good Manufacturing Practices.

Clinical trials are typically conducted in three sequential phases, but the phases may overlap and not all phases may be necessary when developing investigational products that will utilize the FDA s 505(b)(2) approval process. Phase 1 studies are typically performed in normal healthy volunteers to assess the safety (adverse side effects), absorption, metabolism, bio-distribution, excretion, and food and drug interactions of the investigational drug product. Additional studies may be performed to assess abuse potential as well as limited measures of pharmacologic effect. Phase 2 is the proof of principle stage and involves studies in a limited number of patients in order to:

assess the potential efficacy of the product for specific, targeted indications;

Table of Contents

identify the range of doses and dose regimens likely to be effective for the indication; and

identify possible adverse events and safety risks.

When there is evidence that the product may be effective and has an acceptable safety profile in Phase 2 evaluations, Phase 3 trials are undertaken to establish the clinical efficacy and safety profile of the product within a larger population at geographically dispersed clinical study sites. Phase 3 frequently involves randomized controlled trials and, whenever possible, studies are conducted in a manner so that neither the patient nor the investigator knows what treatment is being administered. We, or the FDA, may suspend clinical trials at any time if it is believed that the individuals participating in such trials are being exposed to unacceptable health risks.

We have in the past and will continue to rely upon third party contractors to advise and assist us in the preparation of our INDs and the conduct of clinical trials that will be conducted under the INDs.

New Drug Application and FDA Approval Process

The results of the pharmaceutical and manufacturing development work, nonclinical studies and clinical studies are submitted to the FDA in the form of an NDA for approval to market and sell the product. The testing and approval process is likely to require substantial time and effort. In addition to the results of nonclinical and clinical testing, the NDA applicant must submit detailed information about chemistry, manufacturing and controls that will describe how the product is made, packaged, labeled, and tested through the manufacturing process. The manufacturing process continues to develop throughout the period of clinical trials such that at the time of the NDA, it has been demonstrated that there is control of the process and the product can be made consistently at commercial scale.

The NDA review process involves FDA investigation into the details of the manufacturing process, as well as the design and analysis of each of the nonclinical and clinical studies. This review includes inspection of the manufacturing facility, the data recording process for the clinical studies, the record keeping at a sample of clinical trial sites and a thorough review of the results for each nonclinical and clinical study. Through this review, the FDA reaches a decision about the risk-benefit profile of a product candidate. If the benefit outweighs the risk, the FDA begins negotiation with the company on the content of an acceptable package insert and an associated REMS plan if required.

The NDA review process is affected by a number of factors, including the severity of the disease, the availability of alternative treatments, and the risks and benefits demonstrated in clinical trials. Consequently, there is a risk that approval may not be granted on a timely basis, if at all. The FDA may deny approval of an NDA if applicable regulatory criteria are not satisfied. Moreover, if regulatory approval of a product is granted, such approval may entail limitations on the indicated uses for which it may be marketed, require additional testing or information, or require post-marketing testing (Phase 4) and surveillance to monitor the safety of a company s product if it does not believe the NDA contains adequate evidence of its safety. Finally, product approvals may be withdrawn if compliance with regulatory standards is not maintained or health problems are identified that would alter the risk-benefit analysis for the product. Post-approval studies may be conducted to explore the use of the product for new indications or populations such as pediatrics.

Among the conditions for NDA approval is the requirement that any prospective manufacturer s quality control and manufacturing procedures conform to Good Manufacturing Practices and the specifications approved in the NDA. In complying with standards set forth in these regulations, manufacturers must continue to expend time, money and effort in the area of quality control and quality assurance to ensure full technical compliance. Manufacturing establishments, both foreign and domestic, also are subject to inspections by or under the authority of the FDA and by

other federal, state or local agencies. Additionally, in the event of non-compliance, the FDA may issue warning letters and/or seek criminal and civil penalties, enjoin manufacture, seize product or revoke approval.

Risk Evaluation and Mitigation Strategy

In March 2008, new legislation designated as the Food and Drug Administration Amendments Act of 2007 (the FDAAA) took effect. This legislation strengthened the FDA s authority over drug safety and directs the FDA to develop systems aimed at managing the risk-benefit ratio of a drug, with a particular focus on post-approval safety. FDAAA authorized the FDA to require and enforce a Risk Evaluation and Mitigation Strategy, or REMS, if the FDA determines that it is necessary to ensure that the benefits of a drug outweigh the potential risks. The legislation also provides the FDA with increased authority to require REMS at any point in a drug product s lifecycle based on new safety information.

A REMS is defined by the FDA as a strategy to manage a known or potential serious risk associated with a drug or biological product. The FDA s assessment of whether to require a REMS as a condition for approval considers factors such as the size of the population likely to use the drug, the seriousness of the disease or condition that is to be treated by the drug, the expected benefit, and the seriousness of any known or potential adverse events that may be related to the drug. A REMS may be conveyed through the use of a number of tools including a Medication Guide for distribution when the drug is dispensed, a communication plan to physicians to convey potential risks, and elements to ensure safe use. These elements may include provisions that healthcare providers who prescribe the drug and pharmacists who dispense the drug have particular training, experience or special certifications; that the drug be

Table of Contents

dispensed only in certain healthcare settings; that the drug be dispensed to patients with evidence of safe-use conditions; and/or that patients must be enrolled in a registry. Under the FDAAA, the FDA has also been granted enforcement authority over violations of the REMS provisions. The FDA may impose civil monetary penalties, the drug or biological product can be deemed misbranded, and/or the FDA may obtain injunctive relief against further distribution of the product.

On December 29, 2011, the FDA approved a class-wide REMS program covering all transmucosal fentanyl products under a single risk management program. ONSOLIS® is subject to this REMS.

Additionally, FDA has implemented a class-wide REMS covering the extended release and long acting opioid class. The class-wide REMS program consists of a REMS-compliant educational program offered by an accredited provider of continuing medical education, patient counseling materials and a medication guide. BELBUCA is anticipated to fall within the existing class-wide REMS program. The cost and implementation of the extended release and long-acting opioid REMS is shared among multiple companies in the category.

There also continues to be a REMS in place for buprenorphine for the treatment of opioid dependence. BUNAVAIL® is included in this existing REMS that is far less cumbersome than the ONSOLIS® REMS and includes a medication guide and healthcare professional and patient education.

International Approval

Whether or not FDA approval has been obtained, approval of a product by regulatory authorities in foreign countries must be obtained prior to the commencement of commercial sales of the drug in such countries. The requirements governing the conduct of clinical trials and drug approvals vary widely from country to country, and the time required for approval may be longer or shorter than that required for FDA approval. Although there are some procedures for unified filings for certain European countries, in general, each country at this time has its own procedures and requirements.

Other Regulation

In addition to regulations enforced by the FDA, we are also subject to United States regulation under the Controlled Substances Act, the Occupational Safety and Health Act, the Environmental Protection Act, the Toxic Substances Control Act, the Resource Conservation and Recovery Act and other present and potential future federal, state, local or similar foreign regulations. Our research and development may involve the controlled use of hazardous materials, chemicals and radioactive compounds. Although we believe that our safety procedures for handling and disposing of such materials comply with the standards prescribed by state and federal regulations, the risk of accidental contamination or injury from these materials cannot be completely eliminated. In the event of any accident, we could be held liable for any damages that result and any such liability could exceed our resources.

Employees

As of March 12, 2015, we have 29 full-time employees. Thirteen are involved in our clinical development program and operations, eleven handle our administration, accounting and legal and five handle our internal sales and marketing. Advanced degrees and certifications of our staff include three Ph.Ds, two Pharm.Ds, one M.D., three CPAs, six MBAs, two MSs and one JD. None of our employees are covered by collective bargaining agreements. From time to time, we also employ independent contractors to support our engineering and administrative functions. We consider relations with all of our employees to be good. Each of our employees has entered into confidentiality, intellectual property assignment and non-competition agreements with us.

Available Information

Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended (which we refer to herein as the Exchange Act), are filed with the SEC. Such reports and other information that we file with the SEC are available free of charge on our website at http://bdsi.investorroom.com/sec_filings when such reports are available on the SEC website. The public may read and copy any materials that we file with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Room 1580, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at http://www.sec.gov. The contents of these websites are not incorporated into this filing. Further, the foregoing references to the URLs for these websites are intended to be inactive textual references only.

Table of Contents

Item 1A. RISK FACTORS

Investing in our common stock involves a high degree of risk. Before purchasing our common stock, you should carefully consider the following risk factors as well as all other information contained in this Report, including our consolidated financial statements and the related notes. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that we are unaware of, or that we currently deem immaterial, also may become important factors that affect us. If any of the following risks occur, our business, financial condition or results of operations could be materially and adversely affected. In that case, the trading price of our common stock could decline, and you may lose some or all of your investment.

Risks Relating to Our Business

We have incurred significant losses since inception, have relatively limited working capital and have only generated minimal revenues from actual products sales. As such, you cannot rely upon our historical operating performance to make an investment decision regarding our company.

From our inception in January 1997 and through December 31, 2014, we have recorded significant losses. Our accumulated deficit at December 31, 2014 was approximately $205.5 million. As of December 31, 2014, we had working capital of approximately $49 million, but we do not generate meaningful recurring revenue or cash flow and thus use our working capital to maintain our operations. Our ability to generate revenue and achieve profitability depends upon our ability, alone or with others, to complete the development of our product candidates and product concepts, obtain the required regulatory approvals and manufacture, market and sell our products if approved. We may be unable to achieve any or all of these goals.

Although we have generated licensing-related and other revenue to date, we have only recently begun to generate revenue from the commercial sales of our approved products ONSOLIS® and BUNAVAIL® and such revenue has been minimal to date. In the case of ONSOLIS®, sales have been adversely affected by: (i) the lack of a uniform REMS program at the time of the launch of ONSOLIS®, and (ii) certain post-FDA approval appearance issues associated with ONSOLIS® which have led to the temporary suspension of manufacturing and marketing of ONSOLIS® in the US and Canada. In the case of BUNAVAIL®, sales have been minimal as we have only recently commenced the commercial launch of the product and are subject to the risks of launching a new product. There is a risk that we will be unable to generate sustained and predictable revenues from product sales.

Since our inception, we have engaged primarily in research and development, licensing technology, seeking grants, raising capital and recruiting scientific and management personnel. Since 2005, we have also focused on clinical and commercialization activities, originally relating to ONSOLIS® and more recently with BELBUCA , BUNAVAIL® and Clonidine Topical Gel. This relatively limited operating history may not be adequate to enable you to fully assess our ability to develop and commercialize our technologies and proposed formulations or products, obtain FDA approval and achieve market acceptance of our proposed formulations or products and respond to competition. We may be unable to fully develop, obtain regulatory approval for, commercialize, manufacture, market, sell and derive material revenues from our product candidates or product concepts in the timeframes we project, if at all, and our inability to do so would materially and adversely impact our viability as a company.

There are risks associated with the recent launch of our BUNAVAIL® product. We thus cannot accurately predict the volume or timing of any future sales of our recently launched BUNAVAIL® product, making the timing of any revenues therefrom difficult to predict.

In 2014, we commenced the commercial launch of BUNAVAIL®, which represented the commencement of the first self-commercialization effort for our company. As such, our ability to establish and increase sales of BUNAVAIL® is

important to us, both for the revenue it may generate as well as to demonstrate our capabilities as an integrated specialty pharmaceutical company as opposed to a research and development organization. The commercial launch of any product is subject to significant risks, and particularly so for us given the size and relative experience of our company with commercial operations. In addition, we may be faced with lengthy customer evaluation and formulary and managed care approval processes associated with the launch of BUNAVAIL®. Consequently, we may incur substantial expenses and devote significant management effort and expense in developing customer trial and adoption of BUNAVAIL® which may or have an adverse impact on our ability to generate revenue from sales of this product. We must obtain as approval for commercial insurance and government reimbursement in order to initiate high volume sales of BUNAVAIL®, which approval is subject to risk, potential delays and contract terms, and which may not actually occur or may occur with less favorable terms. The sales of BUNAVAIL are also dependent on the effectiveness of our selling and promotional efforts as well as influenced by competitive activity, new product approvals, pricing pressure and generic entrants. As such, we cannot accurately predict the volume or timing of any future sales of BUNAVAIL®, and our inability to commercialize this product would likely have an adverse effect on our results of operations and public stock price.

Table of Contents

We have limited experience as a company in self-commercializing pharmaceutical products, which heightens the risks related to our self-commercialization of BUNAVAIL®.

To date, we have partnered our products with larger pharmaceutical companies, who have taken primary responsibility for development and commercialization activities for such products. We are presently self-commercializing BUNAVAIL®. As a company, prior to our commercialization of BUNAVAIL®, we had never been primarily responsible for manufacturing, supply chain, sales and marketing efforts for one of our products, and therefore our efforts with BUNAVAIL® are our initial efforts in this regard. Given this lack of experience, there is a risk that we may be unable to adequately execute, either on our own or through third parties, one or more elements of our commercial plans for BUNAVAIL®. If this were to occur, we may not achieve anticipated revenues from BUNAVAIL®, which would have a material adverse effect on our results of operations, cash flow, reputation and stock price.

If our competitors are successful in obtaining approval for Abbreviated New Drug Applications for products that have the same active ingredients as our BUNAVAIL® product, sales of our BUNAVAIL® product may be adversely affected.

Our competitors may submit for approval certain Abbreviated New Drug Applications (or ANDAs) which provide for the marketing of a drug product that has the same active ingredients in the same strengths and dosage form as a drug product already listed with the FDA, and which has been shown to be bioequivalent to such FDA-listed drug. Drugs approved in this way are commonly referred to as generic versions of a listed drug, and can often be substituted by pharmacists under prescriptions written for an original listed drug. Any applicant filing an ANDA is required to certify to the FDA that the new product subject to the ANDA will not infringe an already approved product s listed patents or that such patents are invalid (otherwise known as a Paragraph IV Certification).

A number of our competitor companies have filed Paragraph IV Certifications challenging the patent for Suboxone® film, the market leader in the field in which we expect to generate sales of BUNAVAIL®. To the extent that any company is successful in challenging the validity of certain patents covering Suboxone® film under a Paragraph IV Certification, it could result in FDA approval of a drug that is lower in price to Suboxone® film. Such a new drug could make it more difficult for BUNAVAIL® to gain any significant market share in an increasingly generic marketplace, which would have a material adverse effect on our results of operations, cash flow, reputation and stock price.

Until we are able to generate recurring and predictable revenues for commercial operations, we will likely need to raise additional capital from time to time to continue our operations or expand our business, and our failure to do so would significantly impair our ability to fund our operations, develop our technologies and product candidates, attract commercial partners, retain key personnel or promote our products.

Our operations have been funded almost entirely by external financing and not from commercial revenues. Such financing has historically come primarily from license and royalty fees, the sale of common and preferred stock and convertible debt to third parties, related party loans and, to a lesser degree, from grants and bank loans. At December 31, 2014, we had cash of approximately $70.5 million. Depending on BUNAVAIL® sales and receiving the Endo milestone payment, we may not need to raise capital to fund our foreseeable business activities. However, even without the Endo milestone and any business adjustments, we have sufficient cash into early 2016, although this assumes that we do not accelerate the development of other opportunities available to us, engage in an extraordinary transaction or otherwise face unexpected events, costs or contingencies, any of which could affect our cash requirements.

Depending on the timing and receipt of milestone payments from our commercial partnership with Endo and given our anticipated cash usage and lack of significant revenues, there is a risk that we will need to raise additional capital in the future to fund our anticipated operating expenses and progress our business plans. This will include in large part the need to fund the launch of BUNAVAIL and our current and potential new development activities. As a result, we may require significant additional capital to further our planned activities. If additional financing is not available when required or is not available on acceptable terms, we may be unable to fund our operations and planned growth, develop or enhance our technologies, take advantage of business opportunities or respond to competitive market pressures. Any negative impact on our operations may make raising additional capital more difficult or impossible and may also result in a lower price for our shares.

We may have difficulty raising any needed additional capital.

We may have difficulty raising needed capital in the future as a result of, among other factors, our lack of material revenues from sales, as well as the inherent business risks associated with our company and present and future market conditions. Our business currently only generates a small amount of revenue from product sales, and such current sources of revenue will likely not be

Table of Contents

sufficient to meet our present and future capital requirements. Therefore, given that we plan to continue to expend substantial funds on commercialization activities (including those relating to BUNAVAIL®) as well as potentially on other strategic initiatives, there is a risk that we will require additional capital to fund these activities. If adequate funds are unavailable, we may be required to delay, reduce the scope of or eliminate one or more of our research, development or commercialization programs, product launches or marketing efforts, any of which may materially harm our business, financial condition and results of operations.

Our long term capital requirements are subject to numerous risks.

Our long term capital requirements are expected to depend on many factors, including, among others:

- the number of potential products we have in development;
- progress and cost of our research and development programs;
- progress with non-clinical studies and clinical trials;
- time and costs involved in obtaining regulatory (including FDA) clearance and addressing regulatory and other issues that may arise post-approval (such as we have experienced with ONSOLIS®);
- costs involved in preparing, filing, prosecuting, maintaining and enforcing patent, trademark and other intellectual property claims;
- costs of developing sales, marketing and distribution channels and our ability to sell our products;
- costs involved in establishing manufacturing capabilities for commercial quantities of our products;
- costs we may incur in acquiring new technologies or products;
- competing technological and market developments;
- market acceptance of our products;
- costs for recruiting and retaining employees and consultants;

costs for training physicians; and

legal, accounting, insurance and other professional and business related costs.

We may consume available resources more rapidly than currently anticipated, resulting in the need for additional funding sooner than anticipated. We may seek to raise any necessary additional funds through equity or debt financings, collaborative arrangements with corporate partners or other sources, which may have a material effect on our current or future business prospects.

Our additional financing requirements could result in dilution to existing stockholders.

The additional financings which we have undertaken and which we will likely in the future require, have and may be obtained through one or more transactions that have diluted or will dilute (either economically or in percentage terms) the ownership interests of our stockholders. Further, we may not be able to secure such additional financing on terms acceptable to us, if at all. We have the authority to issue additional shares of common stock and preferred stock, as well as additional classes or series of ownership interests or debt obligations which may be convertible into any one or more classes or series of ownership interests. We are authorized to issue 75 million shares of common stock and 5 million shares of preferred stock. Such securities may be issued without the approval or other consent of our stockholders.

Table of Contents

Our Credit Agreement with MidCap Financial SBIC, LP (or MidCap) contains restrictions that limit our flexibility in operating our business. We may be required to make a prepayment or repay the outstanding indebtedness earlier than we expect under our Credit Agreement if a prepayment event or an event of default occurs, including a material adverse change with respect to us, which could have a materially adverse effect on our business.

In July 2013, we entered into a Credit Agreement with MidCap whereby we received a loan in the aggregate amount of $20 million. The agreement contains various covenants that limit our ability to engage in specified types of transactions. These covenants limit our ability to, among other things:

- incur or assume certain debt;
- merge or consolidate or acquire all or substantially all of the capital stock or property of another entity;
- change the nature of our business;
- change our organizational structure or type;
- amend, modify or waive any of our organizational documents;
- license, transfer or dispose of certain assets;
- grant certain types of liens on our assets;
- make certain investments;
- pay cash dividends;
- enter into material transactions with affiliates; and
- amend or waive provisions of material agreements in certain manners.

The restrictive covenants of the Credit Agreement could cause us to be unable to pursue business opportunities that we or our stockholders may consider beneficial. A breach of any of these covenants could result in an event of default under the Credit Agreement. An event of default will also occur if, among other things, a material adverse change in our business, operations or condition occurs, or a material impairment of the prospect of our repayment of any portion of the amounts we owe under the Credit Agreement occurs. In the case of a continuing event of default under the agreement, MidCap could elect to declare all amounts outstanding to be immediately due and payable and terminate

all commitments to extend further credit, proceed against the collateral in which we granted MidCap a security interest under the Credit Agreement, or otherwise exercise the rights of a secured creditor. Amounts outstanding under the Credit Agreement are secured by all of our existing and future assets (excluding certain intellectual property).

We may not have enough available cash or be able to raise additional funds on satisfactory terms, if at all, through equity or debt financings to make any required prepayment or repay such indebtedness at the time any such prepayment event or event of default occurs. In such an event, we may be required to delay, limit, reduce or terminate our product development or commercialization efforts or grant to others rights to develop and market product candidates that we would otherwise prefer to develop and market ourselves. Our business, financial condition and results of operations could be materially adversely affected as a result.

Until we enter into a replacement license agreement for the marketing of ONSOLIS® in North America, we will not receive revenues from our ONSOLIS® product.

In January of 2015, we entered into a definitive assignment agreement under which Meda transferred back to us the rights to marketing authorizations in the United States for ONSOLIS®**.** As a result, we must find a new strategic partner with whom we intend to enter into a potential replacement license. There is no assurance that we will find a replacement licensee for the ONSOLIS® marketing authorizations in a timely manner, or at all. If we fail to find a replacement licensee, we will not receive any royalty from revenues associated with the sale of ONSOLIS®, as contemplated by the original Meda license. In addition, we may be required to market the product without any assistance from a third party that specializes in the marketing within the product category and may be better equipped to effect a higher volume of sales. We may expend significant resources to these efforts without any assurance that such marketing efforts will yield any substantial revenue stream.

Table of Contents

Moreover, in the event that we cannot identify a replacement licensee by a certain agreed upon date, Meda will have the right, but not the obligation, to demand that the marketing authorizations, and the rights to pursue marketing authorizations, for ONSOLIS® in North America revert back to Meda, with the full reinstatement of all of Meda s rights and obligations under the Meda license. Such reinstatement would be in the full discretion of Meda and we cannot provide any assurance that Meda will exercise its option to reinstate the license. If we cannot find a replacement licensee, and Meda does not choose to reinstate its license, our revenue and results of operations may be adversely affected.

Acceptance of our technologies, product candidates or products in the marketplace is uncertain and failure to achieve market acceptance will prevent or delay our ability to generate material revenues.

Our future financial performance will depend, to a large extent, upon the introduction and physician and patient acceptance of our technologies, product candidates and products. Even if approved for marketing by the necessary regulatory authorities, our technologies, product candidates and products may not achieve market acceptance.

The degree of market acceptance for our products and product candidates will depend upon a number of factors, including:

- regulatory clearance of marketing claims for the uses that we are developing;
- demonstration of the advantages, safety and efficacy of our products and technologies;
- pricing and reimbursement policies of government and third-party payers such as insurance companies, health maintenance organizations and other health plan administrators;
- ability to attract corporate partners, including pharmaceutical companies, to assist in commercializing our products;
- regulatory programs such as the class-wide REMS for ONSOLIS® or market (including competitive) forces that may make it more difficult for us to penetrate a particular market segment; and
- ability to timely and effectively manufacture and market our products.

Physicians, various other health care providers, patients, payers or the medical community in general may be unwilling to accept, utilize or recommend any of our approved products or product candidates. If we are unable to obtain regulatory approval, or are unable (either on our own or through third parties) to manufacture, commercialize and market our proposed formulations or products when planned, we may not achieve any market acceptance or generate revenue.

All of these risks are particularly true for BUNAVAIL®, which will be our first product that we have commercialized ourselves.

If we are unable to convince physicians as to the benefits of our products or product candidates, we may incur delays or additional expense in our attempt to establish market acceptance.

Use of our products and, if approved, our product candidates will require physicians to be informed regarding the intended benefits of our products and product candidates. The time and cost of such an educational process may be substantial. Inability to carry out this physician education process may adversely affect market acceptance of our proposed formulations or products. We may be unable to timely educate physicians regarding our intended pharmaceutical formulations or products in sufficient numbers to achieve our marketing plans or to achieve product acceptance. Any delay in physician education may materially delay or reduce demand for our formulations or products. In addition, we may expend significant funds toward physician education before any acceptance or demand for our products or product candidates are created, if at all. Nonetheless, even with our best efforts, certain physicians may never prescribe our product.

We have been and expect to be significantly dependent on our collaborative agreements for the development, manufacturing and sales of our products and product candidates, which expose us to the risk of reliance on the performance of third parties.

In conducting our research and development activities, we currently rely, and expect to continue to rely, on numerous collaborative agreements with third parties such as manufacturers, contract research organizations, contract sales organizations, commercial partners, universities, governmental agencies and not-for-profit organizations for both strategic and financial resources. Key among these agreements are our commercialization agreement with Endo, our agreements relating to Clonidine Topical Gel and

Table of Contents

Buprenorphine Depot Injection, and our manufacturing development and supply agreements with Aveva, which is expiring on October 15, 2015, and LTS relating to ONSOLIS® and with LTS relating to BREAKYL . For BUNAVAIL®, we have manufacturing and supply arrangements in place.

The termination of these relationships, or failure to perform by us or our partners (who are subject to regulatory, competitive and other risks) under their applicable agreements or arrangements with us, or our failure to secure additional agreements for our product candidates, including a new licensing agreement for marketing rights in North America with respect to ONSOLIS®, would substantially disrupt or delay our research and development and commercialization activities, including our in-process and anticipated clinical trials and commercial sales. Any such loss would likely increase our expenses and materially harm our business, financial condition and results of operation.

The risks associated with reliance on key third parties was demonstrated in 2010 when Aveva experienced certain adverse equipment and regulatory issues leading to the temporary stoppage of manufacturing of all products at that site, which left us exposed to delays in our and our partners commercial plans. In addition, in March 2012 Meda temporarily suspended distribution of ONSOLIS® following discussions with the FDA regarding issues with the product s appearance. Specifically, the FDA raised concerns about two cosmetic issues that may have originated from the formulation used in the manufacturing of ONSOLIS® following an inspection of Aveva, which manufactures ONSOLIS® on our behalf. On March 12, 2012, we announced the postponement of the U.S. and Canadian re-launch of ONSOLIS® until the product formulation can be modified to address these issues. Therefore, ONSOLIS® is not currently being marketed in the U.S. and Canada and the relaunch and additional manufacturing of ONSOLIS® has been postponed until such product issues have been resolved. Any future manufacturing interruptions or related supply issues could have a material adverse effect on our company.

Under our license option agreement with Evonik, we are responsible for paying certain costs relating to the development, formulation and commercialization of buprenorphine for the treatment of opioid dependence. In addition, under our licensing and development agreement with Endo, we are responsible for supporting the clinical development of BELBUCA for pain by conducting certain specified clinical trials in the United States. Our inability to adequately project or control our costs under these agreements could have a material adverse effect on our potential profits from such agreements.

We depend upon key personnel who may terminate their employment with us at any time, and we will need to hire additional qualified personnel.

Our ability to achieve our corporate objectives will depend to a significant degree upon the continued services of key management, technical and scientific personnel, particularly our senior executive officers such as our President and Chief Executive Officer Mark Sirgo. Our management and other employees may voluntarily terminate their employment with us at any time. The loss of the services of these or other key personnel, or the inability to attract and retain additional qualified personnel, could result in delays to product development or approval, loss of sales and diversion of management resources. In addition, we depend on our ability to attract and retain other highly skilled personnel, including research scientists. Competition for qualified personnel is intense, and the process of hiring and integrating such qualified personnel is often lengthy. We may be unable to recruit such personnel on a timely basis, if at all, which would negatively impact our development and commercialization programs. Additionally, we do not currently maintain key person life insurance on the lives of our executives or any of our employees. This lack of insurance means that we may not have adequate compensation for the loss of the services of these individuals.

We may be unable to manage our growth effectively.

After focusing our efforts for many years on clinical development of products, our business strategy now contemplates growth and expansion as we continue our evolution into a fully integrated specialty pharmaceutical company. For example, as we in-license or acquire additional product candidates, we will likely have to expand existing operations in order to conduct additional clinical trials, increase our contract manufacturing capabilities, hire and train new personnel to handle the marketing and sales of our products and assist patients in obtaining reimbursement for the use of our products. We may also need to grow to support our commercial activities for BUNAVAIL® or other approved products. This growth may place significant strain on our management and financial and operational resources. Successful growth is also dependent upon our ability to implement appropriate financial and management controls, systems and procedures. Our ability to effectively manage growth depends on our success in attracting and retaining highly qualified personnel, for which the competition may be intense. If we fail to manage these challenges effectively, our business could be harmed.

Table of Contents

We are exposed to product liability, non-clinical and clinical liability risks which could place a substantial financial burden upon us, should lawsuits be filed against us.

Our business exposes us to potential product liability and other liability risks that are inherent in the testing, manufacturing and marketing of pharmaceutical formulations and products. We expect that such claims are likely to be asserted against us at some point. In addition, the use in our clinical trials of pharmaceutical formulations and products and the subsequent sale of these formulations or products by us or our potential collaborators may cause us to bear a portion of or all product liability risks. A successful liability claim or series of claims brought against us could have a material adverse effect on our business, financial condition and results of operations.

We currently have a general liability/product liability policy which includes coverage for our clinical trials and our commercially marketed products. Annual aggregate limits include $2 million for general liability, with $1 million for each occurrence; product liability is $15 million for aggregate and $15 million per occurrence with excess liability in the amount of an additional $5 million; umbrella liability is $5 million aggregate and $5 million per occurrence. It is possible that this coverage will be insufficient to protect us from future claims. Under our agreements, Meda is required to carry comprehensive general product liability and tort liability insurance, each in amounts not less than $2 million per incident and US $10 million annual aggregate and to name us as an additional insured thereon. However, we or our commercial partners may be unable to obtain or maintain adequate product liability insurance on acceptable terms, if at all, and there is a risk that our insurance will not provide adequate coverage against our potential liabilities. Furthermore, our current and potential partners with whom we have collaborative agreements or our future licensees may not be willing to indemnify us against these types of liabilities and may not themselves be sufficiently insured or have sufficient assets to satisfy any product liability claims. Claims or losses in excess of any product liability insurance coverage that may be obtained by us or our partners could have a material adverse effect on our business, financial condition and results of operations.

Moreover, product liability insurance is costly, and due to the nature of the pharmaceutical products underlying ONSOLIS®, BUNAVAIL® and our product candidates, we or our partners may not be able to obtain such insurance, or, if obtained, we or our partners may not be able to maintain such insurance on economically feasible terms. If a product or product candidate related action is brought against us, or liability is found against us prior to our obtaining product liability insurance for any product or product candidate, or should we have liability found against us for any other matter in excess of any insurance coverage we may carry, we could face significant difficulty continuing operations.

We are presently a party to lawsuits by a third parties who claims that our products, methods of manufacture or methods of use infringe on their intellectual property rights, and we may be exposed to these types of claims in the future.

We are presently, and may continue to be, exposed to litigation by third parties based on claims that our technologies, processes, formulations, methods, or products infringe the intellectual property rights of others or that we have misappropriated the trade secrets of others. This risk is exacerbated by the fact that the validity and breadth of claims covered in pharmaceutical patents is, in most instances, uncertain and highly complex. Any litigation or claims against us, whether or not valid, would result in substantial costs, could place a significant strain on our financial and human resources and could harm our reputation. Such a situation may force us to do one or more of the following:

incur significant costs in legal expenses for defending against an intellectual property infringement suit;

delay the launch of, or cease selling, making, importing, incorporating or using one or more or all of our technologies and/or formulations or products that incorporate the challenged intellectual property, which would adversely affect our revenue;

obtain a license from the holder of the infringed intellectual property right, which license may be costly or may not be available on reasonable terms, if at all; or

redesign our formulations or products, which would be costly and time-consuming.

With respect to our BEMA® delivery technology, the drug delivery device technology space is competitive. There is a risk that a court of law in the United States or elsewhere could determine that ONSOLIS® or another of our BEMA® based products is in conflict with or covered by external patents. This risk presently exists in our litigation with MonoSol which was filed by MonoSol in November 2010, wherein MonoSol claims that our and our partner s trade secret manufacturing process for ONSOLIS® is infringing upon MonoSol s patented manufacturing process, as well as a similar litigation with Reckitt Benckiser, Inc., RB Pharmaceuticals Limited, and MonoSol relating to our BUNAVAIL® product which was filed in October 2013. If the courts in these cases were to rule against us and our partner in that case, we could be forced to license technology from MonoSol or otherwise incur liability for damages, which could have a material adverse effect on our ability for us or our partners to market and sell ONSOLIS® or BUNAVAIL®.

Table of Contents

We have been granted non-exclusive license rights to European Patent No. 949 925, which is controlled by LTS to market ONSOLIS® and BELBUCA within the countries of the European Union. We are required to pay a low single digit royalty on sales of products that are covered by this patent in the European Union. We have not conducted freedom to operate searches and analyses for our other proposed products. Moreover, the possibility exists that a patent could issue that would cover one or more of our products, requiring us to defend a patent infringement suit or necessitating a patent validity challenge that would be costly, time consuming and possibly unsuccessful.

Our lawsuit with MonoSol has caused us to incur significant legal costs to defend ourselves, and we would be subject to similar costs if we are a party to similar lawsuits in the future. Furthermore, if a court were to determine that we infringe any other patents and that such patents are valid, we might be required to seek one or more licenses to commercialize our BEMA® products (including, without limitation, ONSOLIS®). We may be unable to obtain such licenses from the patent holders, which could materially and adversely impact our business.

If we are unable to adequately protect or enforce our rights to intellectual property or secure rights to third-party patents, we may lose valuable rights, experience reduced market share, assuming there is any market share, or incur costly litigation to, enforce, maintain or protect such rights.

Our ability to license, enforce and maintain patents, maintain trade secret protection and operate without infringing the proprietary rights of others will be important to our commercializing any formulations or products under development. The current and future development of our drug delivery technologies is contingent upon whether we are able to maintain licenses and access patented technologies. Without these licenses, the use of technologies would be limited and the sales of our products could be prohibited. Therefore, any disruption in access to the technologies could substantially delay the development and sale of our products.

The patent positions of biotechnology and pharmaceutical companies, including ours, which involve licensing agreements, are frequently uncertain and involve complex legal and factual questions. In addition, the coverage claimed in a patent application can be significantly reduced before the patent is issued. Consequently, our patents, patent applications and licensed rights may not provide protection against competitive technologies or may be held invalid if challenged or could be circumvented. Our competitors may also independently develop drug delivery technologies or products similar to ours or design around or otherwise circumvent patents issued to, or licensed by, us. In addition, the laws of some foreign countries may not protect our proprietary rights to the same extent as U.S. law.

We also rely upon trade secrets, technical know-how and continuing technological innovation to develop and maintain our competitive position. We require our employees, consultants, advisors and collaborators to execute appropriate confidentiality and assignment-of-inventions agreements with us. These agreements provide that materials and confidential information developed or made known to the individual during the course of the individual s relationship with us is to be kept confidential and not disclosed to third parties except in specific circumstances and assign the ownership of relevant inventions created during the course of employment to us. These agreements may be breached, and in some instances, we may not have an appropriate remedy available for breach of the agreements. Furthermore, our competitors may independently develop substantially equivalent proprietary information and techniques, reverse engineer, or otherwise gain access to our proprietary technology. We may be unable to meaningfully protect our rights in trade secrets, technical know-how and other non-patented technology.

In addition, we may have to resort to costly and time consuming litigation to protect or enforce our rights under certain intellectual property, or to determine their scope, validity or enforceability. Enforcing or defending our rights will be expensive, could cause significant diversion of our resources and may not prove successful. Any failure to enforce or protect our rights could cause us to lose the ability to exclude others from using our technologies to develop or sell competing products.

We are dependent on third party suppliers for key components of our delivery technologies, products and product candidates.

Key components of our drug delivery technologies, products and product candidates may be provided by sole or limited numbers of suppliers, and supply shortages or loss of these suppliers could result in interruptions in supply or increased costs. Certain components used in our research and development activities, such as the active pharmaceutical component of our products, are currently purchased from a single or a limited number of outside sources. The reliance on a sole or limited number of suppliers could result in:

delays associated with research and development and non-clinical and clinical trials due to an inability to timely obtain a single or limited source component;

inability to timely obtain an adequate supply of required components; and

reduced control over pricing, quality and timely delivery.

Table of Contents

Our relationships with our manufacturers and suppliers are particularly important to us and any loss of or material diminution of their capabilities due to factors such as regulatory issues, accidents, acts of God or any other factor would have a material adverse effect on our company. Such risks were demonstrated when certain manufacturing issues were experienced at Aveva in 2010-2011 and when, subsequently and separately, the FDA identified certain product appearance issues with ONSOLIS®, which resulted in the March 2012 postponement of the U.S. and Canadian relaunch of the product until such issues are resolved. Any loss of or interruption in the supply of components from our suppliers or other third party suppliers would require us to seek alternative sources of supply or require us to manufacture these components internally, which we are currently not able to do.

If the supply of any components is lost or interrupted, product or components from alternative suppliers may not be available in sufficient quality or in volumes within required time frames, if at all, to meet our or our partners needs. This could delay our ability to complete clinical trials, obtain approval for commercialization or commence marketing or cause us to lose sales, force us into breach of other agreements, incur additional costs, delay new product introductions or harm our reputation. Furthermore, product or components from a new supplier may not be identical to those provided by the original supplier. Such differences could have material effects on our overall business plan and timing, could fall outside of regulatory requirements, affect product formulations or the safety and effectiveness of our products that are being developed.

We have limited manufacturing experience and therefore depend on third parties to formulate and manufacture our products. We may not be able to secure or maintain the manufacture of sufficient quantities or at an acceptable cost necessary to successfully commercialize or continue to sell our products.

Our management s expertise has primarily been in the areas of research and development, formulation development and clinical trial phases of pharmaceutical product development. Our management s experience in the manufacturing of pharmaceutical products is more limited and we have limited equipment and no facilities of our own from which these activities could be performed. Therefore, we are fully dependent on third parties for our formulation development, manufacturing and the packaging of our products. This is particularly true with respect to ARx and Sharp, the primary manufacturers of our approved and commercialized product, BUNAVAIL®. We also rely on Aveva, the manufacturer of ONSOLIS® in the U.S., and LTS, the manufacturer for BREAKYL in the E.U. This reliance exposes us to the risk of not being able to directly oversee the production and quality of the manufacturing process and provide ample commercial supplies to formulate sufficient product to conduct clinical trials and maintain adequate supplies to meet market demand for our products.

Furthermore, these third party contractors, whether foreign or domestic, may experience regulatory compliance difficulty, mechanical shut downs, employee strikes, or any other unforeseeable acts that may delay or limit production, which could leave our commercial partners with inadequate supplies of product to sell, especially when regulatory requirements or customer demand necessitate the need for additional product supplies. Our inability to adequately establish, supervise and conduct (either ourselves or through third parties) all aspects of the formulation and manufacturing processes, and the inability of third party manufacturers like ARx, Sharp, Aveva and LTS to consistently supply quality product when required would have a material adverse effect on our ability to commercialize and sell our products.

These risks associated with reliance on key third party manufacturers was demonstrated in March 2012, when Meda temporarily suspended distribution of ONSOLIS® following discussions with the FDA regarding certain appearance issues with the product. Specifically, the FDA raised concerns about two appearance issues with ONSOLIS® following an inspection of Aveva s manufacturing facility. On March 12, 2012, we announced the postponement of the U.S. and Canadian relaunch of ONSOLIS® until the product formulation can be modified to address these issues. Therefore, ONSOLIS® is not currently being marketed in the US and Canada and the relaunch

and additional manufacturing of ONSOLIS® for those jurisdictions has been postponed until such product issues have been resolved. Any future manufacturing interruptions or related supply issues could have an adverse effect on our company, including loss of sales and royalty revenue and claims by or against us or our partners for breach of contract.

There are risks associated with our reliance on third parties for marketing, sales, managed care and distribution infrastructure and channels.

We expect that we will be required to enter into agreements with commercial partners (such as our agreement with Endo) to engage in sales, marketing and distribution efforts around our products and product candidates. This is the case with our current self-commercialization activities with BUNAVAIL®, for which we have contracted with Quintiles to provide our sales force. We may be unable to establish or maintain third-party relationships on a commercially reasonable basis, if at all. In addition, these third parties may have similar or more established relationships with our competitors. If we do not enter into relationships with third parties for the sales and marketing of our proposed formulations or products, we will need to develop our own sales and marketing capabilities.

Table of Contents

We may be unable to engage qualified distributors. Even if engaged, these distributors may:

- fail to satisfy financial or contractual obligations to us;
- fail to adequately market our formulations or products;
- cease operations with little or no notice to us; or
- offer, design, manufacture or promote competing formulations or products.

If we fail to develop sales, managed care, marketing and distribution channels, we would experience delays in generating sales and incur increased costs, which would harm our financial results.

The class-wide Risk Evaluation and Mitigation Strategy (REMS) for all transmucosal fentanyl products, and similar programs for other narcotic products, may continue to slow sales and marketing efforts for ONSOLIS® and our future sales and marketing efforts for future products that contain narcotics, which could impact our royalty and sales revenue from such products.

Our approved product ONSOLIS® is formulated with the potent narcotic fentanyl. On December 29, 2011, FDA approved a REMS program covering all transmucosal fentanyl products. The program, which is referred to as the Transmucosal Immediate Release Fentanyl (TIRF) REMS Access Program, was designed to ensure informed risk-benefit decisions before initiating treatment with a transmucosal fentanyl product, and while patients are on treatment, to ensure appropriate use. The approved program covers all approved transmucosal fentanyl products under a single program and was implemented in March 2012. There is a risk that healthcare providers may respond negatively to this class-wide REMS program in a manner similar to the original ONSOLIS® REMS program that we were required to implement prior to the adoption of the class-wide REMS. Should this occur, our ability (or the ability of potential future commercial partners) to generate revenue from sales of ONSOLIS® in the U.S. and Canada, once the appearance and related formulation issues have been resolved and the product is relaunched in the U.S. and Canada, could be materially compromised, which would result in low payments to us. Additionally, the FDA has implemented a class-wide REMS covering the extended release and long acting opioid class. The class-wide REMS program consists of a REMS-compliant educational program offered by an accredited provider of continuing medical education, patient counseling materials and a medication guide. BELBUCA is anticipated to fall within the existing class-wide REMS program. The cost and implementation of the extended release and long-acting opioid REMS is shared among multiple companies in the category.

There also continues to be a REMS in place for buprenorphine for the treatment of opioid dependence referred to as the BTOD (Buprenorphine-containing Transmucosal products for Opioid Dependence) REMS. BUNAVAIL® falls within the existing REMS, which is far less cumbersome and includes a medication guide and healthcare professional and patient education. Given the existence of a REMS in both the extended release and long-acting opioid and opioid dependence markets, we anticipate our products will fit within the existing REMS and will avoid the issues encountered with ONSOLIS®, where a REMS program was yet to be developed.

BUNAVAIL® is the first product that we have elected to commercialize. If we are unable to adequately develop, implement, or manage our sales, marketing and distribution capabilities, either on our own or through third parties

who perform these functions, our commercialization efforts for BUNAVAIL® or any future product we may commercialize would not produce the desired results, which would hurt our revenues and results of operations.

Prior to our decision to commercialize BUNAVAIL®, we have relied on third parties to manage sales and marketing efforts for us, including Meda for ONSOLIS® and, if BELBUCA is approved, Endo. We therefore have little experience as a company in commercializing a product, and our sales, marketing and distribution capabilities are new. As such, we may not achieve success in marketing and promoting BUNAVAIL®, or any other products we develop or acquire in the future or products we may commercialize through the exercise of co-promotion rights. Specifically, in order to optimize the commercial potential of BUNAVAIL®, we must execute upon our commercialization plan effectively and efficiently. In addition, we must continually assess and modify our commercialization plan in order to adapt to the promotional response. Further, we must continue to focus and refine our marketing campaign to ensure a clear and understandable physician-patient dialogue around BUNAVAIL® as an appropriate therapy. In addition, we must provide our sales force with the highest quality training, support, guidance and oversight in order for them to effectively promote BUNAVAIL®. If we fail to perform these commercial functions in the highest quality manner, BUNAVAIL® will not achieve its maximum commercial potential or any level of success at all. With respect to BUNAVAIL®, we rely on our agreement with Quintiles, who is responsible for providing our sales force on an outsourced basis. Should our relationship with Quintiles deteriorate or if our agreement with Quintiles is terminated, our sales efforts with BUNAVAIL® would likely suffer materially and we may not be able to keep or reconstitute our sales force. In addition, sales and marketing efforts could be negatively impacted by the delay or failure to obtain additional supportive clinical trial data for our products, as is the requirement for BUNAVAIL®. The deterioration or loss of our sales force would materially and adversely impact our ability to generate sales revenue, which would hurt our results of

Table of Contents

operations. Finally, we are competing and expect to compete with other companies that currently have extensive and well-funded marketing and sales operations, and our marketing and sales efforts may be unable to compete against these other companies, which would also hurt our results of operations.

Our business and operations would suffer in the event of system failures.

Despite the implementation of security measures, our internal computer systems and those of our current and any future partners, contractors, and consultants are vulnerable to damage from cyber-attacks, computer viruses, unauthorized access, natural disasters, terrorism, war, and telecommunication and electrical failures. System failures, accidents, or security breaches could cause interruptions in our operations, and could result in a material disruption of our commercialization activities, development programs and our business operations, in addition to possibly requiring substantial expenditures of resources to remedy. The loss of clinical trial data from completed or future clinical trials could result in delays in our regulatory approval efforts and significantly increase our costs to recover or reproduce the data. To the extent that any disruption or security breach were to result in a loss of, or damage to, our data or applications, or inappropriate disclosure of confidential or proprietary information, we could incur liability and the commercialization of any potential product candidate could be delayed.

Risks Related to Our Products in Development and Regulation

We depend in large part on our BEMA® drug delivery technology, and the loss of access to this technology would terminate or delay the further development of our products, injure our reputation or force us to pay higher fees.

We depend, in large part, on our BEMA® drug delivery technology. The loss of this key technology would seriously impair our business and future viability, and could result in delays in developing, introducing or maintaining our products and formulations until equivalent technology, if available, is identified, licensed and integrated. In addition, any defects in the BEMA® technology or other technologies we gain access to in the future could prevent the implementation or impair the functionality of our products or formulations, delay new product or formulation introductions or injure our reputation. If we are required to acquire or enter into license agreements with third parties for replacement technologies, we could be subject to higher fees, milestone or royalty payments, assuming we could access such technologies at all.

Our failure to obtain costly government approvals, including required FDA approvals, or to comply with ongoing governmental regulations relating to our technologies and proposed products and formulations could delay or limit introduction of our proposed formulations and products and result in failure to achieve revenues or maintain our ongoing business.

Our research and development activities and the manufacture and marketing of our products and product candidates are subject to extensive regulation for safety, efficacy and quality by numerous government authorities in the United States and abroad. Before receiving FDA or foreign regulatory clearance to market our proposed formulations and products, we will have to demonstrate that our formulations and products are safe and effective in the patient population and for the diseases that are to be treated. Clinical trials, manufacturing and marketing of drugs are subject to the rigorous testing and approval process of the FDA and equivalent foreign regulatory authorities. The Federal Food, Drug and Cosmetic Act and other federal, state and foreign statutes and regulations govern and influence the testing, manufacture, labeling, advertising, distribution and promotion of drugs and medical devices. As a result, regulatory approvals can take a number of years or longer to accomplish and require the expenditure of substantial financial, managerial and other resources.

Moreover, although we received FDA approval for ONSOLIS® and BUNAVAIL®, ONSOLIS® is not currently being marketed in the U.S. and Canada pending resolution of certain appearance and related formulation issues, and we may not receive regulatory approval for any required changes to the ONSOLIS® formulation or of our other product candidates. We may be unable to obtain all required regulatory approvals, and our failure to do so would materially and adversely affect our business, results of operations and viability.

Our failure to complete or meet key milestones relating to the development of our technologies and proposed products and formulations would significantly impair the viability of our company.

In order to be commercially viable, we must research, develop, obtain regulatory approval for, manufacture, introduce, market and distribute formulations or products incorporating our technologies. For each drug that we formulate with our drug delivery technologies, we must meet a number of critical developmental milestones, including:

demonstration of the benefit from delivery of each specific drug through our drug delivery technologies;

demonstration, through non-clinical and clinical trials, that our drug delivery technologies are safe and effective; and

establishment of a viable Good Manufacturing Process capable of potential scale-up.

Table of Contents

The estimated required capital and time-frames necessary to achieve these developmental milestones is subject to inherent risks, many of which may be beyond our control. As such, we may not be able to achieve these or similar milestones for any of our proposed product candidates or other product candidates in the future. Our failure to meet these or other critical milestones would adversely affect the viability of our company.

Conducting and completing the clinical trials necessary for FDA approval is costly and subject to intense regulatory scrutiny as well as the risk of failing to meet the primary endpoint of such trials. We will not be able to commercialize and sell our proposed products and formulations without completing such trials.

Clinical testing is expensive and can take many years to complete, and its outcome is inherently uncertain. In order to conduct clinical trials that are necessary to obtain approval by the FDA to market a drug product, the FDA requires the submission of an investigational new drug application, or IND. The FDA has 30 days to review the IND and, unless the FDA raises an issue or concern about the clinical trial plan during that time period, the IND becomes effective at the end of that 30 days and sponsors may proceed with their clinical trial plans. The FDA can suspend or terminate clinical trials at any time due to a number of factors, including for safety or efficacy reasons, because we or our clinical investigators did not comply with the FDA s requirements for conducting clinical trials, changes in governmental regulations or administrative actions or lack of adequate funding to continue the clinical trial. If the FDA does not permit us to proceed with our planned clinical trials or the trials are suspended or permanently terminated by us, the FDA or any institutional review boards overseeing the trials, the commercial prospects of our product candidates will be harmed, and our ability to generate product revenues from any of these product candidates will be delayed. In addition, many of the factors that cause, or lead to, a delay in the commencement or completion of clinical trials may also ultimately lead to the denial of regulatory approval of our product candidates.

In addition, it is our stated intention to seek to avail ourselves of the FDA s 505(b)(2) approval procedure where it is appropriate to do so. Section 505(b)(2) of the Federal Food, Drug, and Cosmetic Act permits an applicant to file a NDA where at least some of the information required for approval comes from studies not conducted by or for the applicant and for which the applicant has not obtained a right of reference. The applicant may rely upon published literature and the FDA s findings of safety and effectiveness based on certain preclinical testing or clinical studies conducted for an approved product. The FDA may also require companies to perform additional studies or measurements to support the change from the approved product. If this approval pathway is not available to us with respect to a particular formulation or product, or at all, the time and cost associated with developing and commercializing such formulations or products may be prohibitive and our business strategy would be materially and adversely affected. For example, in September 2012, the FDA received a Citizen Petition requesting that it refuse to file any Section 505(b)(2) NDA or abbreviated new drug application, or ANDA, for buprenorphine/naloxone drugs intended to be applied to the oral mucosal membranes unless such application refers to the sublingual film formulation of Suboxone®, rather than the tablet formulation, as the reference listed drug, or RLD. Our proposed Section 505(b)(2) marketing application for BUNAVAIL® is expected to reference the tablet formulation of Suboxone® rather than the film formulation as the reference listed drug, and the data we have generated has been based off of the tablet formulation of Suboxone®. While the FDA, on February 22, 2013, rejected the Citizen Petition referred to above, we may be faced with similar issues in the future which might require us to conduct additional studies of our product candidates or otherwise face delays and additional costs.

Moreover, we may be required to conduct additional costly and time-consuming clinical studies beyond those that we originally anticipate in the event that our clinical trials fail to meet their primary endpoints or for other reasons, which would render them inadequate to support approval by the FDA. For example, in September 2011, we announced that our Phase 3 clinical trial for BELBUCA did not meet its primary endpoint and therefore we were required to conduct new trials. In our licensing and development agreement with Endo, we are responsible for the conduct of planned clinical studies leading up to the submission of an NDA for BELBUCA . Conducting a new clinical trial in accordance

with the FDA requirements has required significant additional capital, and we will not be able to commercialize and sell our BELBUCA product until we are able to meet our primary endpoints for both trials and obtain subsequent FDA approval.

Data obtained from clinical trials are susceptible to varying interpretations, which could delay, limit or prevent regulatory approvals.

Data already obtained, or data we may obtain in the future, from non-clinical studies and clinical trials do not necessarily predict the results that will be obtained from later non-clinical studies and clinical trials. Moreover, non-clinical and clinical data are susceptible to multiple and varying interpretations, which could delay, limit or prevent regulatory approval. A number of companies in the pharmaceutical industry, including those involved in competing drug delivery technologies, have suffered significant setbacks in advanced clinical trials, even after promising results in earlier trials. The failure to adequately demonstrate the safety and effectiveness of a proposed formulation or product under development could delay or prevent regulatory clearance of the product candidate,

Table of Contents

resulting in delays to commercialization, and could materially harm our business. In addition, our clinical trials may not demonstrate sufficient levels of safety and efficacy necessary to obtain the requisite regulatory approvals for our drugs, and thus our proposed drugs may not be approved for marketing.

Finally, if any of our clinical trials do not meet their primary endpoints, or for a variety of other reasons, we may be required to conduct additional clinical trials in order to progress development of the subject product. These additional trials would be costly and time-consuming, and would divert resources from other projects. The foregoing risks were evidenced by the failure of our Phase 3 trial for BELBUCA for the treatment of moderate to severe chronic pain to meet its primary endpoint, which we announced September 2011.

We compete with larger and better capitalized companies, and competitors in the drug development or specialty pharmaceutical industries may develop competing technologies or products which outperform or supplant our technologies or products.

Drug companies and/or other technology companies have developed (and are currently marketing in competition with us), have sought to develop and may in the future seek to develop and market mucosal adhesive, encapsulation or other drug delivery technologies and related pharmaceutical products which do and may compete with our technologies and products. Competitors have developed and may in the future develop similar or different technologies or products which may become more accepted by the marketplace or which may supplant our technology entirely. In addition, many of our current competitors are, and future competitors may be, significantly larger and better financed than we are, thus giving them a significant advantage over us.

We and our partners may be unable to respond to competitive forces presently in the marketplace (including competition from larger companies), which would severely impact our business. Moreover, should competing or dominating technologies or products come into existence and the owners thereof patent the applicable technological advances, we could also be required to license such technologies in order to continue to manufacture, market and sell our products. We may be unable to secure such licenses on commercially acceptable terms, or at all, and our resulting inability to manufacture, market and sell the affected products could have a material adverse effect on us.

Our approved product and other product candidates contain narcotic ingredients which are tightly regulated by federal authorities. The development, manufacturing and sale of such products are subject to strict regulation, including the necessity of risk management programs, which may prove difficult or expensive to comply with.

Our FDA approved products, ONSOLIS® and BUNAVAIL® and our lead product candidate, BELBUCA , contain tightly controlled and highly regulated narcotic ingredients. Misuse or abuse of such drugs can lead to physical or other harm. The FDA or the U.S. Drug Enforcement Administration, or DEA, currently impose and may impose additional regulations concerning the development, manufacture, transportation and sale of prescription narcotics. Such regulations include labeling requirements, the development and implementation of risk management programs, restrictions on prescription and sale of these products and mandatory reformulation of our products in order to make abuse more difficult. This is particularly true with respect to the REMS that the FDA required for ONSOLIS®. In addition, state health departments and boards of pharmacy have authority to regulate distribution and may modify their regulations with respect to prescription narcotics in an attempt to curb abuse. Any such current or new regulations may be difficult and expensive for us and our manufacturing and commercial partners to comply with, may delay the introduction of our products, may adversely affect our net sales, if any, and may have a material adverse effect on our results of operations.

The DEA limits the availability of the active ingredients used in ONSOLIS®, BUNAVAIL® and certain of our product candidates and, as a result, our procurement quota may not be sufficient to meet commercial demand or

complete clinical trials.

The DEA regulates chemical compounds as Schedule I, II, III, IV or V substances, with Schedule I substances considered to present the highest risk of substance abuse and Schedule V substances the lowest risk. The active ingredients in our approved product ONSOLIS® (fentanyl) and BUNAVAIL® (buprenorphine) and in our lead product candidate BELBUCA (BEMA® Buprenorphine) are listed by the DEA as Schedule II (ONSOLIS®) and III (BUNAVAIL® and BELBUCA) substances, respectively, under the Controlled Substances Act of 1970. Consequently, their manufacture, shipment, storage, sale and use are subject to a high degree of regulation. For example, all Schedule II drug prescriptions must be signed by a physician, physically presented to a pharmacist and may not be refilled.

The DEA limits the availability of the active ingredients used in ONSOLIS®, BUNAVAIL® and potentially other of our product candidates and, as a result, our procurement quota of these active ingredients may not be sufficient to complete clinical trials or meet commercial demand. We must annually apply to the DEA for a procurement quota in order to obtain these substances. The DEA may not establish a procurement quota following FDA approval of an NDA for a controlled substance until after DEA reviews and provides for public comment on the labeling, promotion, risk management plan and other documents associated with such product. A

Table of Contents

DEA review of such materials may result in potentially significant delays in obtaining procurement quota for controlled substances, a reduction in the quota issued to us or an elimination of our quota entirely. Any delay or refusal by the DEA in establishing our procurement quota for controlled substances could delay or stop our clinical trials, product launches or sales of products, which could have a material adverse effect on our business and results of operations.

Risks Related to Our Industry

The market for our products and product candidates is rapidly changing and competitive, and new drug delivery mechanisms, drug delivery technologies, new drugs and new treatments which may be developed by others could impair our ability to maintain and grow our business and remain competitive.

The pharmaceutical and biotechnology industries are subject to rapid and substantial technological change. Developments by others may render our technologies, our approved products and our product candidates noncompetitive or obsolete, or we may be unable to keep pace with technological developments or other market factors. Technological competition from pharmaceutical and biotechnology companies, universities, governmental entities and others now existing or diversifying into the field is intense and is expected to increase. Many of these entities (including our competitors with respect to our two approved products, ONSOLIS® and BUNAVAIL®) have significantly greater research and development capabilities, human resources and budgets than we do, as well as substantially more marketing, manufacturing, financial and managerial resources. These entities represent significant competition for us. Acquisitions of, or investments in, competing pharmaceutical or biotechnology companies by large corporations could increase such competitors financial, marketing, manufacturing and other resources.

With respect to our drug delivery technologies, we may experience technical or intellectual property related challenges inherent in such technologies. Competitors have developed or are in the process of developing technologies that are, or in the future may be, the basis for competition. Some of these technologies may have an entirely different approach or means of accomplishing similar therapeutic effects compared to our technologies. Our competitors may develop drug delivery technologies and drugs that are safer, more effective or less costly than our proposed formulations or products and, therefore, present a serious competitive threat to us.

The potential widespread acceptance of therapies that are alternatives to ours may limit market acceptance of our formulations or products, even if commercialized. Many of our targeted diseases and conditions can also be treated by other medication or drug delivery technologies. These treatments may be widely accepted in medical communities and have a longer history of use. The established use of these competitive drugs may limit the potential for our technologies, formulations and products to receive widespread acceptance if commercialized.

If users of our products and product candidates are unable to obtain adequate reimbursement from third-party payers, or if new restrictive legislation is adopted, market acceptance of our proposed formulations or products may be limited and we may not achieve material revenues.

The continuing efforts of government and insurance companies, health maintenance organizations and other payers of healthcare costs to contain or reduce costs of health care may affect our future revenues and profitability, and the future revenues and profitability of our potential customers, suppliers and collaborative partners and the availability of capital. For example, in certain foreign markets, pricing or profitability of prescription pharmaceuticals is subject to government control. In the United States, given recent federal and state government initiatives directed at lowering the total cost of health care, the U.S. Congress and state legislatures will likely continue to focus on health care reform, the cost of prescription pharmaceuticals and on the reform of the Medicare and Medicaid systems. While we cannot predict whether any such legislative or regulatory proposals will be adopted, the announcement or adoption of such

proposals and related laws, rules and regulations could materially harm our business, financial conditions, results of operations or stock price. Moreover, the passage of the Patient Protection and Affordable Care Act in 2010, and efforts to amend or repeal such law, has created significant uncertainty relating to the scope of government regulation of healthcare and related legal and regulatory requirements, which could have an adverse impact on sales of our products.

The ability of our company or any partners with which we may enter into a new licensing arrangement to sell ONSOLIS® and our ability to commercialize BUNAVAIL® will depend in part on the extent to which appropriate reimbursement levels for the cost of our proposed formulations and products and related treatments are obtained by governmental authorities, private health insurers and other organizations, such as HMOs. Consumers and third-party payers are increasingly challenging the prices charged for drugs and medical services. Also, the trend toward managed health care in the United States and the concurrent growth of organizations such as HMOs, which could control or significantly influence the purchase of health care services and drugs, as well as legislative proposals to reform health care or reduce government insurance programs, may all result in lower prices for or rejection of our drugs.

Table of Contents

We could be exposed to significant drug product liability claims which could be time consuming and costly to defend, divert management attention and adversely impact our ability to obtain and maintain insurance coverage.

The testing, manufacture, marketing and sale of our proposed drug formulations involve an inherent risk that product liability claims will be asserted against us. All of our clinical trials have been, and all of our proposed clinical trials are anticipated to be conducted by collaborators and third party contractors. We currently have a general liability/product liability policy which includes coverage for our clinical trials and our commercially marketed products. Annual aggregate limits include $2 million for general liability, with $1 million for each occurrence; product liability is $15 million for aggregate and $15 million per occurrence with excess liability in the amount of an additional $5 million; umbrella liability is $5 million aggregate and $5 million per occurrence. It is possible that this coverage will be insufficient to protect us from future claims. Under our agreements, Meda is required to carry comprehensive general product liability and tort liability insurance, each in amounts not less than $2 million per incident and US $10 million annual aggregate and to name us as an additional insured thereon.

Should we decide to seek additional insurance against such risks before our product sales commence, there is a risk that such insurance will be unavailable to us, or if it can be obtained at such time, that it will be available at an unaffordable cost. Even if we obtain insurance, it may prove inadequate to cover claims and/or litigation costs, especially in the case of wrongful death claims. Product liability claims or other claims related to our products, regardless of their outcome, could require us to spend significant time and money in litigation or to pay significant settlement amounts or judgments. Any successful product liability or other claim may prevent us from obtaining adequate liability insurance in the future on commercially desirable or reasonable terms. An inability to obtain sufficient insurance coverage at an acceptable cost or otherwise to protect against potential product liability claims could prevent or inhibit the commercialization of our products and product candidates. A product liability claim could also significantly harm our reputation and delay market acceptance of our proposed formulations and products. In addition, although third party partners are required to provide insurance in connection with specific products such partners may face similar insurance related risks.

Our business involves environmental risks related to handling regulated substances which could severely affect our ability to conduct research and development of our drug delivery technology and product candidates.

In connection with our or our partners research and clinical development activities, as well as the manufacture of materials and products, we and our partners are subject to federal, state and local laws, rules, regulations and policies governing the use, generation, manufacture, storage, air emission, effluent discharge, handling and disposal of certain materials, biological specimens and wastes. We and our partners may be required to incur significant costs to comply with environmental and health and safety regulations in the future. Our research and clinical development, as well as the activities of our manufacturing and commercial partners, both now and in the future, may involve the controlled use of hazardous materials, including but not limited to certain hazardous chemicals and narcotics. We cannot completely eliminate the risk of accidental contamination or injury from these materials. In the event of such an occurrence, we could be held liable for any damages that result and any such liability could exceed our resources.

Government and other efforts to reform the healthcare industry could have adverse effects on our company, including the inability of users of our current and future approved products to obtain adequate reimbursement from third-party payers, which could lead to diminished market acceptance of, and revenues from, such products.

On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act (or the PPACA). The Healthcare and Education Reconciliation Act of 2010 (or the Reconciliation Act), which contains a number of amendments to the PPACA, was signed into law on March 30, 2010. Two primary goals of the PPACA, combined with the Reconciliation Act (which we collectively refer to as the Health Reform Legislation), are to provide for

increased access to coverage for healthcare and to reduce healthcare-related expenses. On June 28, 2012, the United States Supreme Court upheld the constitutionality of the requirement in PPACA that individuals maintain health insurance or pay a penalty.

The Healthcare Reform Legislation contains a number of provisions that are expected to impact our business and operations or those of our commercial partners, including provisions governing enrollment in federal healthcare programs, reimbursement and discount programs and fraud and abuse prevention and control. The impact of these programs on our business is presently uncertain and may have unexpected consequences for our company. For example, expansion of health insurance coverage under the Health Reform Legislation may result in a reduction in uninsured patients and increase in the number of patients with access to healthcare that have either private or public program coverage, and subsequently prescription drug coverage, including coverage for those products currently approved or in development by us or our partners. However, this outcome, along with any other potential benefits of the Health Reform Legislation which could prove a benefit for us or our commercial partners, is uncertain and may not occur.

In addition to the Health Reform Legislation, we expect that there will continue to be proposals by legislators or new laws, rules and regulations at both the federal and state levels, as well as actions by healthcare and insurance regulators, insurance companies, health maintenance organizations and other payers of healthcare costs aimed at keeping healthcare costs down while expanding individual healthcare benefits. Certain of these changes (including, without limitation, those enacted in connection with the federal or state implementation of the Health Reform Legislation) could impose limitations on the prices we or our commercial partners will be able to charge for any of our approved products or the amounts of reimbursement available for these products from governmental

Table of Contents

agencies or third-party payors, or may increase the tax obligations on life sciences companies such as ours. Any or all of these changes (which are presently unclear and subject to potential modification on an ongoing basis) could impact the ability of users of our approved products to obtain insurance reimbursement for the use of such products or the ability of healthcare professionals to prescribe such products, any of which could have a material adverse effect on our revenues (royalty or otherwise), potential profitability and results of operations.

Furthermore, the ability of our company or of future partners of our company with whom we may enter into licensing arrangements to sell ONSOLIS® (once it is reformulated and placed back on the market in the U.S. and Canada) and the Company s ability to commercialize BUNAVAIL® and our product candidates with partners such as Endo or otherwise will depend in part on the extent to which appropriate reimbursement levels for the cost of our proposed formulations and products and related treatments are obtained by governmental authorities, private health insurers, managed care, and other organizations and may all result in lower prices for or rejection of our products, which could further have a material adverse effect on our revenues (royalty or otherwise) and results of operations.

We may also be subject to healthcare laws, regulation and enforcement; our failure to comply with those laws could have a material adverse effect on our results of operations and financial conditions.

Although we currently do not directly market or promote any of our products, we may also be subject to several healthcare regulations and enforcement by the federal government and the states and foreign governments in which we conduct our business. The laws that may affect our ability to operate include:

- the federal Health Insurance Portability and Accountability Act of 1996 (or HIPAA), as amended by the Health Information Technology for Economic and Clinical Health Act, which governs the conduct of certain electronic healthcare transactions and protects the security and privacy of protected health information;

- the federal healthcare programs Anti-Kickback Law, which prohibits, among other things, persons from knowingly and willfully soliciting, receiving, offering or paying remuneration, directly or indirectly, in exchange for or to induce either the referral of an individual for, or the purchase, order or recommendation of, any good or service for which payment may be made under federal healthcare programs such as the Medicare and Medicaid programs;

- federal false claims laws which prohibit, among other things, individuals or entities from knowingly presenting, or causing to be presented, claims for payment from Medicare, Medicaid, or other third-party payors that are false or fraudulent;

- federal criminal laws that prohibit executing a scheme to defraud any healthcare benefit program or making false statements relating to healthcare matters; and

- state law equivalents of each of the above federal laws, such as anti-kickback and false claims laws which may apply to items or services reimbursed by any third-party payor, including commercial insurers.

If our operations are found to be in violation of any of the laws described above or any other governmental regulations that apply to us, we may be subject to penalties, including civil and criminal penalties, damages, fines, the curtailment

or restructuring of our operations, the exclusion from participation in federal and state healthcare programs and imprisonment, any of which could adversely affect our ability to operate our business and our financial results.

Risks Related to Our Common Stock and Series A Non-Voting Convertible Preferred Stock

Our business is subject to increasingly complex corporate governance, public disclosure, and accounting requirements and regulations that could adversely affect our business and financial results and condition.

We are subject to changing rules and regulations of various federal and state governmental authorities as well as the stock exchange on which our common stock is listed. These entities, including the Public Company Accounting Oversight Board, the Securities and Exchange Commission (or the SEC) and the Nasdaq Capital Market, have issued a significant number of new and increasingly complex requirements and regulations over the course of the last several years and continue to develop additional requirements and regulations in response to laws enacted by Congress, including the Sarbanes-Oxley Act of 2002 and, most recently, the Dodd-Frank Wall Street Reform and Protection Act, or the Dodd-Frank Act.

There are significant corporate governance and executive compensation-related provisions in the Dodd-Frank Act that expressly authorized or required the SEC to adopt additional rules in these areas, such as shareholder approval of executive compensation (say on pay) and proxy access. Our efforts to comply with these requirements are likely to result in an increase in expenses which is difficult to quantify at this time.

Table of Contents

In addition, we are subject to often complex accounting rules and interpretations promulgated by the Financial Accounting Standards Board (including its Emerging Issues Task Force). In 2012, we became engaged in an SEC review process over our accounting (under applicable revenue recognition literature) for payments we received under our license and commercialization with Endo. On February 28, 2013, we announced the conclusion of that review, which led to our adoption of an alternative revenue recognition interpretation and a resulting restatement of our unaudited financial statements for the first three fiscal quarters of 2012. We may be faced with similar issues in the future, and adjustments to or restatements of our financial statements or accounting policies could have a material adverse effect on our public stock price and our reputation.

Our stock price is subject to market factors, and your investment in our securities could decline in value.

Since our initial public offering in June 2002, there has only been a relatively limited public market for our securities and there is a risk that an active trading market in our securities may not be adequately maintained. In addition, the overall market for securities in recent years has experienced extreme price and volume fluctuations that have particularly affected the market prices of many smaller companies. In particular, the market prices of securities of biotechnology and pharmaceutical companies have been extremely volatile, and have experienced fluctuations that often have been unrelated or disproportionate to operating performance of these companies. These broad market fluctuations could result in extreme fluctuations in the price of our securities, which could cause a decline in the value of your securities. These fluctuations, as well as general economic and market conditions, may have a material or adverse effect on the market price of our common stock.

If we cannot meet the NASDAQ Capital Market s continuing listing requirements and NASDAQ rules, NASDAQ may delist our securities, which could negatively affect our company, the price of our securities and your ability to sell our securities.

As of the date of this Report, our shares are listed on the NASDAQ Capital Market. In the future, however, we may not be able to meet the continued listing requirements of the NASDAQ Capital Market and NASDAQ rules, which require, among other things, maintaining a minimum bid price per share of $1.00, minimum stockholders equity of $2.5 million or a minimum market capitalization of $35 million and a majority of independent directors on our board of directors. We have been subject to delisting proceedings and comments by NASDAQ in the past, and during 2011 our stock price declined to levels that put us at risk of not being able to maintain the required minimum bid price or market capitalization levels or both. If we are unable to satisfy the NASDAQ criteria for continued listing, especially at our current stock price levels, our securities could again be subject to delisting. Trading, if any, of our securities would thereafter be conducted in the over-the-counter market, in the so-called pink sheets or on the OTC Bulletin Board. As a consequence of any such delisting, our stockholders would likely find it more difficult to dispose of, or to obtain accurate quotations as to the prices of our securities.

Our Series A Non-Voting Convertible Preferred Stock ranks senior to our common stock in the event of a bankruptcy, liquidation or winding up of our assets.

As of the date of this Report, we currently have issued and outstanding 2,139,000 shares of Series A Non-Voting Convertible Preferred Stock, which we issued in connection with our $40 million financing which closed on December 2012. In the event of our bankruptcy, liquidation or winding up, our assets will be available to pay obligations on our Series A Non-Voting Convertible Preferred Stock in preference to the holders of our common stock.

Executive officers, directors and entities affiliated with them could, due to their collective ownership interests in our company, have a material level of control over us, which could delay or prevent a change in our corporate

control favored by our other stockholders.

As of the date of this Report, our directors, executive officers and affiliated principal stockholders, together with their affiliates, beneficially own, in the aggregate, approximately 10.98% of our outstanding common stock. These figures do not reflect any future potential exercise of outstanding common stock purchase warrants into shares of common stock. The interests of our current officers, directors and affiliated stockholders may differ from the interests of other stockholders. As a result, these current officers, directors and affiliated stockholders could have the ability to exercise substantial influence over all corporate actions requiring stockholder approval, irrespective of how our other stockholders may vote, including the following actions:

approval of certain mergers and other significant corporate transactions, including a sale of substantially all of our assets and material financing transactions;

election of directors;

Table of Contents

adoption of or amendments to stock option plans;

amendment of charter documents; or

issuance of blank check preferred stock.

Additional authorized shares of our common stock and preferred stock available for issuance may adversely affect the market for our common stock.

As of March 12, 2015, there are 52,320,866 shares of common stock issued and 52,305,375 shares of common stock outstanding and there were 2,139,000 shares of Series A Non-Voting Convertible Preferred Stock issued and outstanding. On July 21, 2011, our stockholders approved an amendment to our certificate of incorporation to increase the number of authorized shares of common stock, par value $.001, of our common stock from 45,000,000 to 75,000,000 shares. This increase in our authorized shares of common stock provides us with the flexibility to issue more shares in the future, which might cause dilution to our stockholders. In addition, the total number of shares of our common stock issued and outstanding does not include shares reserved in anticipation of the exercise of outstanding options or warrants. To the extent such options (including options under our stock incentive plan) or warrants are exercised, the holders of our common stock may experience further dilution.

Moreover, in the event that any future financing should be in the form of, be convertible into or exchangeable for, equity securities, and upon the exercise of options and warrants, investors would experience additional dilution. Finally, in addition to the above referenced shares of common stock which may be issued without stockholder approval, we have 5 million shares of authorized preferred stock, of which 2,139,000 shares have been designated as Series A Non-Voting Convertible Preferred Stock. The remaining 2,290,700 shares of preferred stock remain undesignated shares of preferred stock, the terms of which may be fixed by our board of directors. We have issued preferred stock in the past, and our board of directors has the authority, without stockholder approval, to create and issue one or more additional series of such preferred stock and to determine the voting, dividend and other rights of holders of such preferred stock. The issuance of any of such series of preferred stock may have an adverse effect on the holders of common stock.

Shares eligible for future sale may adversely affect the market for our common stock.

We have a material number of shares of common stock underlying securities of our company, the future sale of which could depress the price of our publicly-traded stock. As of March 12, 2015: (i) 3,254,268 shares of common stock are issuable upon exercise of outstanding stock options at a weighted average exercise price of $5.47 per share, (ii) 284 shares of common stock issuable upon exercise of our outstanding warrants at an exercise price of $3.12 per share and (iii) 4,260,370 restricted stock units eligible to be converted shares of our common stock (iv) 2,139,000 shares of Series A preferred eligible to be converted into shares of our common stock. If and when these securities are exercised into shares of our common stock, our shares outstanding will increase. Such increase in our outstanding securities, and any sales of such shares, could have a material adverse effect on the market for our common stock and the market price of our common stock.

In addition, from time to time, certain of our stockholders may be eligible to sell all or some of their shares of common stock by means of ordinary brokerage transactions in the open market pursuant to Rule 144, promulgated under the Securities Act of 1933, as amended, which we refer to herein as the Securities Act, subject to certain limitations. In general, pursuant to Rule 144, after satisfying a six month holding period: (i) affiliated stockholder (or stockholders whose shares are aggregated) may, under certain circumstances, sell within any three month period a

number of securities which does not exceed the greater of 1% of the then outstanding shares of common stock or the average weekly trading volume of the class during the four calendar weeks prior to such sale and (ii) non-affiliated stockholders may sell without such limitations, provided we are current in our public reporting obligations. Rule 144 also permits the sale of securities by non-affiliates that have satisfied a one year holding period without any limitation or restriction. Any substantial sale of our common stock pursuant to Rule 144 or pursuant to any resale report may have a material adverse effect on the market price of our securities.

Furthermore, sales of our common stock by our directors, officers, or employees may occur as a result of sales effected pursuant to predetermined trading plans adopted under the safe-harbor afforded by SEC Rule 10b5-1.

Table of Contents

Our certificate of incorporation and bylaws contain provisions that may discourage, delay or prevent a change in our management team that stockholders may consider favorable.

Our certificate of incorporation, as amended, our amended and restated bylaws (which were adopted in 2010) and Delaware law contain provisions that may have the effect of preserving our current management, such as:

- providing for a staggered board of directors, which impairs the ability of our stockholders to remove our directors at annual or special meetings of stockholders;
- authorizing the issuance of blank check preferred stock without any need for action by stockholders;
- limiting the ability of stockholders to call special meetings of stockholders;
- permitting stockholder action by written consent;
- establishing advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted on by stockholders at stockholder meetings;
- requiring a super-majority vote of our stockholders to remove directors of our company; and
- providing that our stockholders may only remove our directors for cause (as defined in our bylaws).

These provisions affect your rights as a stockholder since they permit our board of directors to make it more difficult for common stockholders to replace members of the board or undertake other significant corporate actions. Because our board of directors is responsible for appointing the members of our management team, these provisions could in turn affect any attempt to replace our current management team.

The financial and operational projections that we may make from time to time are subject to inherent risks.

The projections that our management may provide from time to time (including, but not limited to, those relating to potential peak sales amounts, product approval, production and supply dates, commercial launch dates, and other financial or operational matters) reflect numerous assumptions made by management, including assumptions with respect to our specific as well as general business, economic, market and financial conditions and other matters, all of which are difficult to predict and many of which are beyond our control. Accordingly, there is a risk that the assumptions made in preparing the projections, or the projections themselves, will prove inaccurate. There will be differences between actual and projected results, and actual results may be materially different from those contained in the projections. The inclusion of the projections in (or incorporated by reference in) this Report should not be regarded as an indication that we or our management or representatives considered or consider the projections to be a reliable prediction of future events, and the projections should not be relied upon as such.

We do not intend to pay dividends on our common stock.

We have never declared or paid any cash dividend on our capital stock. We currently intend to retain any future earnings and do not expect to pay any dividends for the foreseeable future. Therefore, you should not invest in our common stock in the expectation that you will receive dividends.

Our additional financing requirements could result in dilution to existing stockholders.

The additional financings which we have undertaken and which we may in the future require, have and may be obtained through one or more transactions which have diluted or will dilute (either economically or in percentage terms) the ownership interests of our stockholders. Further, we may not be able to secure such additional financing on terms acceptable to us, if at all. We have the authority to issue additional shares of common stock and preferred stock, as well as additional classes or series of ownership interests or debt obligations which may be convertible into any one or more classes or series of ownership interests. We are authorized to issue 75 million shares of common stock and 2,290,700 shares of preferred stock. Such securities may be issued without the approval or other consent of our stockholders.

Item 1B. Unresolved Staff Comments.

None.

Table of Contents

Item 2. Description of Property.

Our executive offices are located in Raleigh, North Carolina. We moved our corporate office to a larger facility in February 2015. The lease, which commenced November 14, 2014 for 89 months, is approximately 12,000 square foot space and has remaining base rent of $2.4 million payable through July, 2022. Rent is payable in monthly installments, and is subject to yearly price increases and increases for our share of common area maintenance costs. The landlord for this space is HRLP Raleigh, L.P. We believe this space is adequate as our principal executive office location.

Item 3. Legal Proceedings.

Readers are advised that the following disclosure regarding our ongoing litigations with MonoSol and Reckitt Benckiser is intended to provide some background and an update on the matter as required by the rules of the SEC. Additional details regarding the past procedural history of the matter can be found in our previously filed periodic filings with the SEC.

Litigation Related To ONSOLIS®

On November 2, 2010, MonoSol filed an action against us and our commercial partners for ONSOLIS® in the Federal District Court of New Jersey (the DNJ) for alleged patent infringement and false marking. We were formally served in this matter on January 19, 2011. MonoSol claims that our manufacturing process for ONSOLIS®, which has never been disclosed publicly and which we and our partners maintain as a trade secret, infringes its patent (United States Patent No. 7,824,588) (the 588 Patent). Of note, the BEMA® technology itself is not at issue in the case, nor is BELBUCA or BUNAVAIL®, but rather only the manner in which ONSOLIS®, which incorporates the BEMA® technology, is manufactured. Pursuant to its complaint, MonoSol is seeking an unspecified amount of damages, attorney s fees and an injunction preventing future infringement of MonoSol s patents.

We strongly refute as without merit MonoSol s assertion of patent infringement, which relates to our confidential, proprietary manufacturing process for ONSOLIS®. On February 23, 2011, we filed our initial answer in this case. In our answer, we stated our position that our products, methods and/or components do not infringe MonoSol s 588 Patent because they do not meet the limitations of any valid claim of such patent. Moreover, in our answer, we stated our position that MonoSol s 588 Patent is actually invalid and unenforceable for failure to comply with one or more of the requirements of applicable U.S. patent law.

On September 12, 2011, we filed a request for inter partes reexamination in the USPTO of MonoSol s 588 Patent demonstrating that all claims of such patent were anticipated by or obvious in the light of prior art references, including several prior art references not previously considered by the USPTO, and thus invalid. On September 16, 2011, we filed in court a motion for stay pending the outcome of the reexamination proceedings, which subsequently was granted due to the results of the USPTO proceedings as described below.

On November 28, 2011, we announced that we were informed by the USPTO that it had rejected all 191 claims of MonoSol s 588 Patent. On January 20, 2012, we filed requests for reexamination before the USPTO of MonoSol s US patent No 7,357,891 (the 891 Patent), and No 7,425,292 (the 292 Patent), the two additional patents asserted by MonoSol, demonstrating that all claims of those two patents were anticipated by or obvious in the light of prior art references, including prior art references not previously considered by the USPTO, and thus invalid.

In February and March 2012, respectively, the USPTO granted the requests for reexamination we filed with respect to MonoSol s 292 and 891 Patents. In its initial office action in each, the USPTO rejected every claim in each patent.

Based on the action of the USPTO on these three patent reexaminations, the court in our case with MonoSol conducted a status conference on March 7, 2012, at which it granted our motion to stay the case pending final outcome of the reexamination proceedings in the USPTO.

As expected, in the 891 Patent and 292 Patent Ex Parte Reexamination proceedings, MonoSol amended the claims several times and made multiple declarations and arguments in an attempt to overcome the rejections made by the USPTO. These amendments, declarations and other statements regarding the claim language significantly narrowed the scope of their claims in these two patents. In the case of the 891 Patent, not one of the original claims survived reexamination and five separate amendments were filed confirming our position that the patent was invalid. Additionally, we believe that arguments and admissions made by MonoSol prevent it from seeking a broader construction during any subsequent litigation by employing arguments or taking positions that contradict those made during prosecution.

A Reexamination Certificate for MonoSol s 891 Patent in its amended form was issued August 21, 2012 (Reexamined Patent No. 7,357,891C1 or the 891C1 Patent). A Reexamination Certificate for MonoSol s 292 Patent in its amended form was issued on July 3, 2012 (Reexamined Patent No. 7,425,292C1 or the 292C1 Patent). These actions by the USPTO confirm the invalidity of the original patents and through the narrowing of the claims in the reissued patents strengthens our original assertion that our products and technologies do not infringe on MonoSol s original patents.

Table of Contents

Inter partes reviews, a new USPTO process to review the patentability of one or more claims of patents, was enacted in September, 2012. As such, on June 12, 2013, despite our previously noted success in the prior ex parte reexaminations for the 292 and 891 Patents, we availed ourselves of this new process and filed requests for inter partes reviews on the narrowed yet reexamined patents, the 292C1 and 891C1 Patents, to challenge their validity and continue to strengthen our position. This inter partes review process allows us to actively participate in the reviews and address any of MonoSol s arguments and representations made during the review process, which heightens our ability to invalidate these patents. On November 13, 2013, the USPTO decided not to institute the two inter partes reviews for the 891C1 and 292C1 Patents. The USPTO s decision was purely on statutory grounds and based on a technicality (in that the IPRs were not filed within what the UPSTO determined to be the statutory period) rather than substantive grounds. Thus, even though the inter partes reviews were not instituted, the USPTO decision preserves our right to raise the same arguments at a later time (e.g., during litigation). Regardless, our assertion that our products and technologies do not infringe the original 292 and 891 Patents and, now, the reexamined 891C1 and 292C1 Patents remains the same.

Importantly, in the case of MonoSol s 588 Patent, at the conclusion of the reexamination proceedings (and its appeals process), on April 17, 2014, the PTAB issued a Decision on Appeal affirming the Examiner s rejection (and confirming the invalidity) of all the claims of the 588 Patent. MonoSol did not request a rehearing by the May 17, 2014 due date for making such a request and did not further appeal the Decision to the Federal Court of Appeals by the June 17, 2014 due date for making such an appeal. Subsequently, on August 5, 2014, the USPTO issued a Certificate of Reexamination cancelling the 588 Patent claims.

Based on our original assertion that our proprietary manufacturing process for ONSOLIS® does not infringe on patents held by MonoSol, and the denial and subsequent narrowing of the claims on the two reissued patents MonoSol has asserted against us while the third has had all claims rejected by the USPTO, we remain very confident in our original stated position regarding this matter. Thus far, we have proven that the original 292 and 891 patents in light of their reissuance with fewer and narrower claims were indeed invalid and the third and final patent, the 588 patent, was invalid as well with all its claims cancelled. Given the outcomes of the 292, 891 and 588 reexamination proceedings, at a January 22, 2015 status meeting, the Court decided to lift the stay and grant our request for the case to proceed on an expedited basis with a Motion for Summary Judgment to dismiss the action. In doing so, the Judge denied MonoSol s request for full litigation proceedings (including, for example, discovery, depositions, *etc.*). We are required to file our motion for summary judgment by March 13, 2015 and based upon the expedited schedule, the Court could issue a decision on our summary judgment motion by the beginning of April, 2015 on the pleadings alone or if an oral hearing is scheduled, soon thereafter. Based upon the outcome from reexaminations and the Court s grant of our request for the proceedings to move directly to a motion for summary judgment, we believe we will prevail and the case will be dismissed. However, if this does not occur and the case proceeds to trial, we will continue to defend this case vigorously and seek a dismissal at trial. Ultimately, whether now with the motion for summary judgment proceedings or later with trial proceedings, we anticipate that MonoSol s claims against us will be rejected.

Litigation Related To BUNAVAIL®

On October 29, 2013, Reckitt Benckiser, Inc., RB Pharmaceuticals Limited, and MonoSol (collectively, the RB Plaintiffs) filed an action against us relating to our BUNAVAIL® product in the United States District Court for the Eastern District of North Carolina for alleged patent infringement. BUNAVAIL® is a drug approved for the maintenance treatment of opioid dependence. The RB Plaintiffs claim that the formulation for BUNAVAIL®, which has never been disclosed publicly, infringes its patent (United States Patent No. 8,475,832) (the 832 Patent).

On May 21, 2014, the Court granted our motion to dismiss. In doing so, the Court dismissed the case in its entirety. The RB Plaintiffs did not appeal the Court Decision by the June 21, 2014 due date and therefore, the dismissal will

stand and the RB Plaintiffs lose the ability to challenge the Court Decision in the future. The possibility exists, however, that the RB Plaintiffs could file another suit alleging infringement of the 832 Patent. If this occurs, based on our original position that our BUNAVAIL® product does not infringe the 832 Patent, we would defend the case vigorously (as we have done so previously), and we anticipate that such claims against us ultimately would be rejected.

On September 20, 2014, based upon our position and belief that our BUNAVAIL® product does not infringe any patents owned by the RB Plaintiffs, we proactively filed a declaratory judgment action in the United States District Court for the Eastern District of North Carolina, requesting the Court to make a determination that our BUNAVAIL® product does not infringe the RB Plaintiffs 832 Patent, US Patent No. 7,897,080 (080 Patent) and US Patent No. 8,652,378 (378 Patent). With the declaratory judgment, there is an automatic stay in proceedings. The RB Plaintiffs may request that the stay be lifted, but they have the burden of showing that the stay should be lifted. For the 832 Patent, the January 15, 2014 IPR was instituted and all challenged claims were rejected for both anticipation and obviousness. For the 080 Patent, all claims remain rejected in an inter partes reexamination and the reexamination is

Table of Contents

currently in the appeals process, with the oral hearing scheduled for November 5, 2014, and we are currently awaiting a decision from the PTAB. For the 378 Patent, an IPR was filed on June 1, 2014, but an IPR was not instituted. However, in issuing its November 5, 2014 decision not to institute the IPR, the PTAB construed the claims of the 378 Patent narrowly. As in prior litigation proceedings, we believe these IPR and the reexamination filings will provide support for maintaining the stay until the IPR and reexamination proceedings conclude. Indeed, given the PTAB s narrow construction of the claims of the 378 Patent, we filed a motion to withdraw the 378 Patent from the case on December 12, 2014. In addition, we also filed a joint motion to continue the stay (with RB Plaintiffs) in the proceedings on the same day. Both the motion to withdraw the 378 Patent from the proceedings and motion to continue the stay were granted.

On September 22, 2014, the RB Plaintiffs filed an action against us (and our commercial partner) relating to our BUNAVAIL® product in the United States District Court for the District of New Jersey for alleged patent infringement. The RB Plaintiffs claim that BUNAVAIL®, whose formulation and manufacturing processes have never been disclosed publicly, infringes its patent (U.S. Patent No. 8,765,167) (167 Patent). As with prior actions by the RB Plaintiffs, we believe this is another anticompetitive attempt by the RB Plaintiffs to distract our efforts from commercializing BUNAVAIL®. We strongly refute as without merit the RB Plaintiffs assertion of patent infringement and will vigorously defend the lawsuit. In this regard, on October 28, 2014, we filed multiple IPR requests on the 167 Patent demonstrating that certain claims of such patent were anticipated by or obvious in the light of prior art references, including prior art references not previously considered by the USPTO, and thus, invalid. On December 12, 2014, we filed a motion to transfer the case from New Jersey to North Carolina and a motion to dismiss the case against our commercial partner. An oral hearing on these motions was set for March 2, 2015, however, the Court has decided to move forward without an oral hearing and we are awaiting their decision. The Court can still ultimately decide to hold an oral hearing later.

Item 4. Mine Safety Disclosures.

Not applicable.

Table of Contents

PART II

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

Our common stock is listed for quotation on the NASDAQ Capital Market under the symbol BDSI . The range of reported high and reported low sales prices per share for our common stock for each fiscal quarter during 2014 and 2013, as reported by the NASDAQ Capital Market, is set forth below.

Quarterly Common Stock Price Ranges

Fiscal Year 2014, Quarter Ended:	**High**	**Low**
March 31, 2014	$ 10.20	$ 5.65
June 30, 2014	$ 12.81	$ 6.71
September 30, 2014	$ 18.48	$ 11.76
December 31, 2014	$ 18.33	$ 11.48

Fiscal Year 2013, Quarter Ended:	**High**	**Low**
March 31, 2013	$ 4.94	$ 3.52
June 30, 2013	$ 5.74	$ 3.86
September 30, 2013	$ 5.55	$ 4.05
December 31, 2013	$ 6.09	$ 4.16

As of March 12, 2015, we had approximately 115 holders of record of our common stock. No cash dividends have been paid on the common stock to date. We currently intend to retain earnings for further business development and do not expect to pay cash dividends in the foreseeable future.

Table of Contents

Securities Authorized for Issuance Under Equity Compensation Plans

The following table indicates shares of common stock authorized for issuance under our 2011 Equity Incentive Plan as of December 31, 2014:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights [1]	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance
Equity compensation plans approved by security holders	6,045,460	$ 4.32	2,867,530
Equity compensation plans not approved by security holders			
Total	6,045,460	$ 4.32	2,867,530

[1] Includes 2,073,039 shares of common stock underlying options previously granted under our Amended and Restated 2001 Incentive Plan, which are still exercisable despite the fact that such plan expired July 2011.

Performance Graph

The following graph shows a comparison of the five year total cumulative returns of an investment of $100 in cash on December 31, 2009 in (i) our common stock (ii) the Nasdaq Composite Index (iii) the Nasdaq Biotechnology Index and (iv) the NYSE Pharmaceutical Index. All values assume reinvestment of the full amount of all dividends (to date, we have not declared any dividends).

This stock performance graph shall not be deemed filed with the SEC or subject to Section 18 of the Securities Exchange Act, nor shall it be deemed incorporated by reference in any of our filings under the Securities Act of 1933, as amended (the Securities Act).

Comparison of cumulative total return on investment since December 31, 2009:

	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013	12/31/2014
BioDelivery Sciences Int l, Inc.	$ 100.00	$ 90.33	$ 20.61	$ 109.67	$ 149.87	$ 305.85
Nasdaq Composite (U.S. Companies)	100.00	116.91	114.81	133.07	184.06	208.71
Nasdaq Biotechnology	100.00	115.01	128.59	169.61	280.89	376.68
NYSE Pharmaceutical	100.00	98.92	107.67	119.52	151.38	172.31

Table of Contents

Item 6. Selected Financial Data.

The statements of operations data and statements of cash flows data for the years ended December 31, 2014, 2013 and 2012 and the balance sheet data as of December 31, 2014 and 2013 have been derived from our audited consolidated financial statements included elsewhere in this annual report. The statements of operations data and statements of cash flows data for the years ended December 31, 2011 and 2010 and the balance sheet data as of December 31, 2012, 2011 and 2010 have been derived from our audited consolidated financial statements not included in this annual report. The following selected financial data should be read in conjunction with our Management s Discussion and Analysis of Financial Condition and Results of Operations and consolidated financial statements and related notes beginning on page F-1 and other financial information included in this Report.

	2014	2013	2012	2011	2010
Statements of Operations Data:					
Total revenue	$ 38,944	$ 11,356	$ 54,542	$ 3,263	$ 3,405
Operating (loss) income	(38,741)	(56,402)	7,062	(26,988)	(16,319)
Net (loss) income	(54,218)	(57,394)	1,652	(23,325)	(13,033)
Diluted net (loss) income per share	(1.12)	(1.51)	0.05	(0.82)	(0.56)
Balance Sheet Data:					
Cash, short-term and long-term investments	$ 70,472	$ 23,176	$ 63,189	$ 10,750	$ 18,209
Total assets	89,311	38,005	75,739	23,645	33,580
Long-term liabilities	4,873	12,545			
Accumulated deficit	(205,531)	(151,313)	(93,919)	(95,572)	(72,246)
Total stockholders equity (deficit)	54,395	(812)	49,777	4,120	9,786
Statements of Cash Flows Data:					
Net cash flows from operating activities	$ (28,833)	$ (60,103)	$ 12,187	$ (23,275)	$ (11,682)

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes appearing elsewhere in this Report. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. The actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those which are not within our control.

Overview

Strategy

We are a specialty pharmaceutical company that is developing and commercializing, either on our own or in partnerships with third parties, new applications of approved therapeutics to address important unmet medical needs using both proven and new drug delivery technologies. We have developed and are continuing to develop pharmaceutical products aimed principally in the areas of pain management and addiction.

Our strategy is to:

Focus our commercial and development efforts in the areas of pain management and addiction within the U.S. pharmaceutical marketplace;

Identify and acquire rights to products that we believe have potential for near-term regulatory approval through the 505(b)(2) approval process, or are already approved;

Market our products through specialty sales teams by primarily focusing on high-prescribing U.S. physicians in pain and addiction; and

We believe this strategy will allow us to increase our revenues, improve our margins and profitability and enhance stockholder value.

Background of Our Company

We were incorporated in the State of Indiana in 1997 and were reincorporated as a Delaware corporation and conducted our initial public offering in 2002. In August 2004, we acquired Arius Pharmaceuticals, the then licensee (and now owner) of our BEMA® drug delivery technology, and July 2006, we licensed commercialization rights in Europe for our lead product; BEMA® based ONSOLIS®, to Meda. In September 2007, we entered into a definitive License and Development Agreement with Meda for ONSOLIS® in the U.S., Canada and Mexico. In January 2012, we entered into a definitive License and Development Agreement with Endo for BELBUCA for chronic pain and in December 2014, we and Endo filed the NDA submission for FDA approval for BELBUCA , which was accepted February 2015. In March 2013, we entered into a definitive Exclusive License Agreement with

Table of Contents

Arcion pursuant to which Arcion agreed to grant to us an exclusive commercial world-wide license, with rights of sublicense, under certain patent and other intellectual property rights related to in-process research and development to develop, manufacture, market, and sell gel products containing clonidine (or a derivative thereof), alone or in combination with other active ingredients, for topical administration for the treatment of PDN and other indications. On July 31, 2013, we submitted the NDA for BUNAVAIL® to the FDA for review, and on June 6, 2014, we announced the FDA approval of BUNAVAIL®, which it launched November 3, 2014.

2014 and Beyond Highlights

On January 23, 2014, we announced positive top-line results from our pivotal Phase 3 efficacy study of BELBUCA in opioid- naive subjects. The locking of the database for the opioid naive study has triggered a $10 million milestone payment from Endo per our licensing agreement.

On February 7, 2014, we entered into a definitive Securities Purchase Agreement with certain institutional investors relating to a registered direct offering of 7,500,000 shares of our common stock, par value $.001 per share. The shares were sold at a price of $8.00 per share, yielding net offering proceeds of $58.2 million.

On June 25, 2014, the database for the pivotal Phase 3 efficacy study of BELBUCA in opioid-experienced patients was locked. The locking of the database triggered a $10 million milestone payment from Endo.

On October 27, 2014, we entered into a definitive Development and Exclusive License Option Agreement with Evonik to develop and commercialize an injectable, extended release, microparticle formulation of buprenorphine for the treatment of opioid dependence.

In September and October 2014, we sold 529,010 and 116,911 shares of common stock, respectively, under our established at-the market offering program for approximate net proceeds of $8.7 million and $1.9 million, respectively.

On December 8, 2014, we announced that we had completed the randomization of all patients in its ongoing initial pivotal Phase 3 clinical trial for Clonidine Topical Gel for the treatment of PDN. We anticipate that topline results of the study will be available by the end of March 2015.

On December 23, 2014, we announced along with Endo the submission of a NDA for BELBUCA (BEMA® Buprenorphine) to the FDA, which was accepted February 23, 2015. BELBUCA is under development for the management of pain severe enough to require daily, around-the-clock, long-term opioid treatment and for which alternative treatment options are inadequate.

On January 27, 2015, we announced that we had entered into an assignment and revenue sharing agreement with Meda to return to us the marketing authorizations for ONSOLIS® for the U.S. and the right to seek

marketing authorizations for ONSOLIS® in Canada and Mexico. Once the NDA has been returned, we will have the right to work directly with the FDA and submit a prior approval supplement that responds to FDA questions and requests and will hopefully lead to the re-introduction of the product. FDA s review of the application may take up to six months; therefore, we could receive a decision before the end of 2015.

Opportunities and Trends

Our franchise currently consists of five products or product candidates, three of which utilize our patented BEMA® drug delivery technology. ONSOLIS® is approved in the U.S., Canada, EU (where it is marketed as BREAKYL) and Taiwan (where it is marketed as PAINKYL), for the management of breakthrough pain in opioid tolerant, adult patients with cancer. The commercial rights to ONSOLIS® are licensed to Meda for all territories worldwide except for Taiwan (licensed to TTY and South Korea (licensed to Kunwha).

The Company s second product using the BEMA® technology is BUNAVAIL® (buprenorphine and naloxone) buccal film, which was approved by the FDA in June 2014 for the maintenance treatment of opioid dependence. The Company is commercializing BUNAVAIL® and launched the product during the fourth quarter 2014. As with all other buprenorphine containing products for opioid dependence, the approval of BUNAVAIL® carries a standard post-approval requirement by the FDA to conduct a study to determine the effect of BUNAVAIL® on QT prolongation (i.e., an abnormal lengthening of the heartbeat). The clinical study results must be reported to the FDA by the end of 2016.

The Company s third product using the BEMA® technology, BELBUCA , is for the management of pain severe enough to require daily, around-the-clock, long-term opioid treatment and for which alternative treatment options are inadequate. This product is licensed on a worldwide basis to Endo. We and Endo reported positive study results for two pivotal Phase 3 trials for this product in January and July 2014. In August 2014, we announced that, along with Endo, it engaged in a positive pre-NDA meeting with the FDA regarding its BELBUCA product. On December 23, 2014, we announced along with Endo the submission of a NDA for BELBUCA (BEMA® Buprenorphine) to the FDA, which was accepted February 23, 2015.

Table of Contents

Our fourth product is Clonidine Topical Gel, which is currently in Phase 3 development for the treatment of PND, which was licensed from Arcion in March 2013. In June 2014, we announced the completion of patient enrollment for our Phase 3 study of Clonidine Topical Gel. In August 2014, we announced our completion of a pre-specified interim analysis of the ongoing initial pivotal Phase 3 trial for Clonidine Topical Gel.

Our fifth product is Buprenorphine Depot Injection, which is in development as an injectable, extended release, microparticle formulation of buprenorphine for the treatment of opioid dependence, the rights to which we secured when we entered into a definitive development and exclusive license option agreement from Evonik in October 2014.

As we focus on the growth of our existing products and other product candidates, we also continue to position ourselves to execute upon the licensing and acquisition opportunities that will drive our next phase of growth. Our organization is fully committed to this effort, and we believe we will be successful in executing upon our corporate strategy in ways that will drive this future growth.

In order to do so, we will need to continue to maintain our strategic direction, manage and deploy our available cash efficiently and strengthen our alliance and partner relationships. We believe these actions, combined with the experience and expertise of our management team, position us well to drive the future growth of our revenue and income.

We expect to continue research and development of pharmaceutical products and related drug delivery technologies, some of which will be funded by our commercialization agreements. We will continue to seek additional license agreements, which may include upfront payments. We anticipate that funding for the next several years will come primarily from milestone payments and royalties from Meda and Endo, revenues from sales of BUNAVAIL®, potential sale of securities and collaborative research agreements, including those with pharmaceutical companies.

We have a very limited history of commercial operations, having focused the vast majority of our corporate effort on research and development activities. We have, since our founding, received revenue in the form of: (i) contract revenue from Endo related to an upfront, non-refundable payment for a license of our BELBUCA product in 2012 (a portion of which was recorded as deferred revenue that is being recognized as revenue under prevailing revenue recognition rules), (ii) payment from Endo for a certain patent-related milestones (iii) royalty revenue from Meda for sales of BREAKYL and ONSOLIS®, (iv) upfront non-refundable license and milestone payments from Meda in 2007, 2008, 2009 and 2012 (which were initially classified as deferred revenue and subsequently, a substantial amount was reclassified as recognized revenue under prevailing revenue recognition rules), (v) product sales revenue related to BUNAVAIL® sales and (vi) sponsored research revenue from both Endo and Meda. Only the BUNAVAIL® product sales and Breakyl royalty revenues are repeating or predictable. Until recurring revenue from product sales (BUNAVAIL® is the foremost opportunity) becomes a larger portion of our total revenue, we anticipate that our quarterly results of operations will fluctuate significantly for the foreseeable future.

Readers are cautioned that period-to-period comparisons of our operating results should not be relied upon as predictive of future performance. Our prospects must be considered in light of the risks, expenses and difficulties normally encountered by companies that are involved in the development and commercialization of their products and related technologies, particularly companies in new and rapidly changing markets such as pharmaceuticals, drug delivery and biotechnology. For the foreseeable future, we must, among other things, invest in non-clinical and clinical trials of, and seek regulatory approval for and commercialization of, our product candidates, the outcomes of which are subject to numerous risks, many of which are beyond our control. We must also maintain our relationships with our key commercial partners and address regulatory, legal and/or commercial issues and risks that relate to our business from time to time, many of which could impact, perhaps negatively, our planned operations. We may not be able to appropriately address these risks and difficulties.

Critical Accounting Policies and Estimates

Impairment Testing

In accordance with Generally Accepted Accounting Principles (referred to herein as GAAP), goodwill impairment testing is performed at the reporting unit level annually, or more frequently if indicated by events or conditions. We performed an evaluation and determined that there is only one reporting unit. In the course of the evaluation of the potential impairment of goodwill, either a qualitative or a quantitative assessment may be performed. If a qualitative evaluation determines that no impairment exists, then no further analysis is performed. If a qualitative evaluation is unable to determine whether impairment has occurred, a quantitative evaluation is performed. The quantitative impairment test first identifies potential impairments by comparing the fair value of the reporting unit with its carrying value. If the fair value exceeds the carrying amount, goodwill is not impaired. If the carrying value exceeds the fair value, the implied fair value of goodwill is calculated and an impairment is recorded if the implied fair value is less than the carrying amount. The determination of goodwill impairment is highly subjective. It considers many factors both internal and external and is subject to significant changes from period to period. No goodwill impairment charges have resulted from this analysis for 2014, 2013 or 2012.

Table of Contents

An impairment of a long-lived asset other than goodwill is recognized under GAAP if the carrying value of the asset (or the group of assets of which it is a part) exceeds (i) the future estimated undiscounted cash flow from the use of the asset (or group of assets) and (ii) the fair value of the asset (or asset group). In making this impairment assessment, we predominately use an undiscounted cash flow model derived from internal forecasts. Factors that could change the result of our impairment test include, but are not limited to, different assumptions used to forecast future net sales, expenses, capital expenditures, and working capital requirements used in our cash flow models. In the event that our management determines that the value of intangible assets have become impaired using this approach, we will record an accounting charge for the amount of the impairment. No impairment charges have been recorded for other amortizing intangibles in 2014, 2013 or 2012.

Fair market value accounting (derivative liability)

The most significant estimate that could have a material effect on net (loss) gain is the fair market value accounting for our derivative liability. Our derivative liability consists of free standing warrants that are recorded as liabilities due to the registration rights agreements and the requirement for continued effectiveness of the warrants. As a result, the warrants must be recorded as a liability at fair value. The changes in fair value are posted to the derivative (loss) gain in other (loss) income. We utilize the Black-Scholes method to estimate the fair value of our warrants. The three most significant factors in the Black-Scholes calculation are (i) our stock price, (ii) the volatility of our stock price and (iii) the remaining term of the warrants. During the year ending December 31, 2012, a $3.50 increase in the value of our stock was the primary cause of the $5.6 million derivative loss. During the year ending December 31, 2013, we had a lower average remaining term of the warrants, and the Black-Scholes volatility of our stock over this remaining term was relatively low compared to 2012. These two factors lowered the Black-Scholes value of the warrants, even though our stock price increased in 2013 of $1.58. The result was a $0.1 million derivative gain. During the year ending December 31, 2014, a $6.13 increase in the value of our stock was the primary cause of the $13.2 million derivative loss.

Stock-Based Compensation and other stock-based valuation issues (derivative accounting)

We account for stock-based awards to employees and non-employees using Financial Accounting Standards Board Accounting Standards Codification (FASB)(ASC) FASB ASC Topic 718 Accounting for Share-Based Payments, which provides for the use of the fair value based method to determine compensation for all arrangements where shares of stock or equity instruments are issued for compensation. Fair values of equity securities issued are determined by management based predominantly on the trading price of our common stock. The values of these awards are based upon their grant-date fair value. That cost is recognized over the period during which the employee is required to provide service in exchange for the award.

We use the Black-Scholes option pricing model to determine the fair value of stock option and warrant grants. In applying the Black-Scholes option pricing model during 2014, we assumed risk-free interest rates ranging from 1.58% to 1.70%, expected option terms of 5 years (for employee options), a volatility factor ranging from 73.00% to 78.05% and option exercise prices ranging from $5.58 to $16.36. During 2013, we assumed risk-free interest rates ranging from 0.70% to 1.60%, expected option terms of 5 years (for employee options), a volatility factor ranging from 77.59% to 81.65% and option exercise prices ranging from $4.33 to $5.39. During 2012, we assumed risk-free interest rates ranging from 0.62% to 1.02%, expected option terms of 5 years (for employee options), a volatility factor ranging from 81.96% to 83.69% and option exercise prices ranging from $1.78 to $4.72. During all years 2014, 2013 and 2012, we assumed no dividend yield.

We also use the Black-Scholes option pricing model as the primary basis for valuing our derivative liabilities at each reporting date (both embedded and free-standing derivatives). The underlying assumptions used in this determination

are primarily the same as are used in the determination of stock-based compensation discussed in the previous paragraph except contractual lives of the derivative instruments are utilized rather than expected option terms.

Revenue Recognition

Meda License, Development and Supply Agreements

In August 2006 and September 2007, we entered into certain agreements with Meda to develop and commercialize the ONSOLIS® product, a drug treatment for breakthrough cancer pain delivered utilizing the BEMA® technology. The aforementioned agreements relate to the United States, Mexico and Canada (we refer to such agreements as the Meda U.S. Agreements) and to certain countries in Europe (we refer to such agreements as the Meda EU Agreements and we refer to our agreements with Meda collectively as the Meda Agreements). They carry license terms that commence on the date of first commercial sale in each respective territory and end on the earlier of the entrance of a generic product to the market or upon expiration of the patents, which begin to expire in 2020.

Table of Contents

We recognize revenue associated with the Meda Agreements in accordance with GAAP related to multiple deliverables. Our deliverables under the Meda Agreements, including our related rights and obligations, contractual cash flows and performance periods, are more fully described in Note 6 to the accompanying financial statements.

We have determined that upon inception of both the U.S. and EU Meda arrangements all deliverables to each arrangement are to be considered one combined unit of accounting since the fair value of the undelivered license was not determinable and the research and development efforts provided do not have stand-alone value apart from the license. As such, all cash payments from Meda related to these deliverables prior to FDA approval in July 2009 were recorded as deferred revenue. All cash payments from Meda for upfront and milestone payments and research and development services provided are nonrefundable. Upon commencement of the license term (date of first commercial sale in each territory), the license and certain research and development services deliverables were deliverable to Meda. The first commercial sale in the U.S. occurred in October 2009. As a result, $59.7 million of the aggregate milestones and services revenue was recognized as revenue. The first commercial sale in a European country occurred in October 2012. As a result, $17.5 million was recognized as revenue, which included $5.0 million in milestones received during the year ended December 31, 2012. At December 31, 2014, there was remaining deferred revenue of $1.1 million which is related to the Meda research and development services. As time progresses, we will continue to estimate the time required for ongoing obligations, and adjust the remaining deferred revenue accordingly on a quarterly basis.

Upon delivery of the license to Meda, we have determined that each of the undelivered obligations have stand-alone value to Meda as these post-commercialization services encompass additional clinical trials on different patient groups but do not require further product development and these services and product supply obligations can be provided by third-party providers available to Meda. We have also obtained third-party evidence of fair value for the other research and development services and other service obligations, based on hourly rates billed by unrelated third-party providers for similar services contracted by us. We have obtained third-party evidence of fair value of the product supply deliverable based on the outsourced contract manufacturing cost charged to us from the third-party supplier of the product. The arrangements do not contain any general rights of return. Therefore, the remaining deliverables to the arrangements will be accounted for as three separate units of accounting to include (1) product supply, (2) research and development services for the ONSOLIS® product and (3) the combined requirements related to the remaining other service-related obligations due Meda to include participation in committees and certain other specified services. The estimated portion of the upfront payments of approximately $1.0 million (under the Meda U.S. Agreements) and $0.1 million (under the Meda EU Agreements) attributed to these other service-related obligations will be recognized as revenue as services are provided through expiration of the license terms, as defined above.

We have determined that we are acting as a principal under the Meda Agreements and, as such, we will record product supply revenue, research and development services revenue and other services revenue amounts on a gross basis in our consolidated financial statements.

Endo License, Development and Supply Agreements

In January 2012, we entered into the Endo Agreement with Endo pursuant to which we granted to Endo an exclusive commercial world-wide license to develop, manufacture, market and sell our BELBUCA product and to complete U.S. development of such product candidate for purposes of seeking FDA approval.

Pursuant to the Endo Agreement, Endo has obtained all rights necessary to complete the clinical and commercial development of BELBUCA and to sell the product worldwide. Although Endo has obtained all such necessary rights, we have agreed under the Endo Agreement to be responsible for the completion of certain clinical trials regarding BELBUCA (and providing clinical trial materials for such trials) necessary to submit a NDA to the FDA in order to

obtain approval of BELBUCA in the U.S., in each case pursuant to a development plan set forth in the Endo Agreement (as it may be amended pursuant to the Endo Agreement). We are responsible for development activities through the filing of the NDA in the U.S., while Endo is responsible for the development following the NDA submission as well as the manufacturing, distribution, marketing and sales of BELBUCA on a worldwide basis. In addition, Endo is responsible for all filings required in order to obtain regulatory approval of BELBUCA .

Pursuant to the Endo Agreement, we have received (or are expected to receive upon satisfaction of applicable conditions) the following payments (some portion(s) of which will be utilized by us to support our development obligations under the Endo Agreement with respect to BELBUCA):

$30 million non-refundable upfront license fee (earned in January 2012);

$15 million for enhancement of intellectual property rights (earned in May 2012);

$20 million for full database lock for two clinical trials ($10 million earned in January 2014 and $10 million earned in June 2014);

$10 million upon FDA acceptance of the filed NDA (earned February 2015);

Table of Contents

$50 million upon regulatory approval;

up to an aggregate of $55 million based on the achievement of four separate post-approval sales thresholds; and

sales-based royalties in a particular percentage range on U.S. sales of BELBUCA , and royalties in a lesser range on sales outside the United States, subject to certain restrictions and adjustments.

We have assessed our arrangement with Endo and our deliverables thereunder at inception to determine: (i) the separate units of accounting for revenue recognition purposes, (ii) which payments should be allocated to which of those units of accounting and (iii) the appropriate revenue recognition pattern or trigger for each of those payments. The assessment requires subjective analysis and requires management to make judgments, estimates and assumptions about whether deliverables within multiple-element arrangements are separable and, if so, to determine the amount of arrangement consideration to be allocated to each unit of accounting.

At the inception of the Endo arrangement, we determined that the Endo Agreement is a multi-deliverable arrangement with three deliverables: (1) the license rights related to BELBUCA , (2) services related to obtaining enhanced intellectual property rights through the issuance of a particular patent and (3) clinical development services. We concluded that the license delivered to Endo at the inception of the Endo Agreement has stand-alone value. It was also determined that there was a fourth deliverable, the provision of clinical trial material (or CTM). The amounts involved are, however, immaterial and delivered in essentially the same time frame as the clinical development services. Accordingly, we did not separately account for the CTM deliverable, but consider it part of the clinical development services deliverable.

The initial non-refundable $30 million license fee was allocated to each of the three deliverables based upon their relative selling prices using best estimates. The analysis of the best estimate of the selling price of the deliverables was based on the income approach, our negotiations with Endo and other factors, and was further based on management s estimates and assumptions which included consideration of how a market participant would use the license, estimated market opportunity and market share, our estimate of what contract research organizations would charge for clinical development services, the costs of clinical trial materials and other factors. Also considered were entity specific assumptions regarding the results of clinical trials, the likelihood of FDA approval of the subject product and the likelihood of commercialization based in part on our prior agreements with the BEMA® technology.

Based on this analysis, $15.6 million of the up-front license fee was allocated to the license (which was estimated to have a value significantly in excess of $30 million), and $14.4 million to clinical development services (which is inclusive of the cost of CTM). Although the intellectual property component was considered a separate deliverable, no distinct amount of the up-front payment was assigned to this deliverable because we determined the deliverable to be perfunctory. The amount allocated to the license was recognized as revenue in fiscal year 2012. The portion of the upfront license fee allocated to the clinical development services deliverable of $14.4 million is being recognized as those services are performed. We estimate that such clinical development services will extend into the first half of 2015. Based on the estimated proportion of those services performed, $2.5 million, $6.3 million and $5.2 million was recognized as contract revenue in fiscal years, 2014, 2013 and 2012, respectively, in the accompanying condensed consolidated statements of operations. As a result, $0.4 million remains deferred at December 31, 2014.

We concluded that each of the performance based milestones are substantive and, therefore, revenue has and will be recognized when milestones are earned.

The term of the Endo Agreement shall last, on a country-by-country basis, until the later of: (i) 10 years from the date of the first commercial sale of BELBUCA in a particular country or (ii) the date on which the last valid claim of our patents covering BELBUCA in a particular country has expired or been invalidated. The Endo Agreement shall be subject to termination by Endo, at any time, upon a specific timeframe of prior written notice to us and under certain other conditions by either party as specified in the Endo Agreement.

The remaining milestone payments are expected to be recognized as revenue as they are achieved, except that one milestone is contingently refundable for a period of time. Revenue related to such contingently refundable milestone is expected to be recognized as refund provisions, as defined in the agreement, expire. Sale threshold payments and sales-based royalties will be recognized as they accrue under the terms of the Endo Agreement.

We are reimbursed by Endo for certain contractor costs when these costs go beyond set thresholds as outlined in the Endo Agreement. Endo reimburses us for this spending at cost and we receive no mark-up or profit. The gross amount of these reimbursed research and development costs are reported as research and development reimbursement revenue in the accompanying consolidated statements of operations. We act as a principal, have discretion to choose suppliers, bear credit risk and may perform part of the services required in the transactions. Therefore, these reimbursements are treated as revenue to us. The actual expenses creating the reimbursements are reflected as research and development expense.

Table of Contents

Product Royalty Revenues

Product royalty revenue amounts are based on a percentage of net sales revenue of the ONSOLIS® product under our license agreement with Meda. Product royalty revenues are computed on a quarterly basis when revenues are fixed or determinable, collectability is reasonably assured and all other revenue recognition criteria are met. This is shown as product royalty revenues on the accompanying consolidated statements of operations. Meda has the right to reject products that do not comply with product, packaging, or regulatory specifications. Defective product must be identified by Meda within 10 days after inspection at Meda s distribution site. We bill Meda immediately upon receipt by Meda of product (FOB manufacturer). On a quarterly basis, a reconciliation is prepared that reflects the difference between actual net sales by Meda multiplied by the royalty percentage, and the actual royalty payments made during the quarter (which is based on a transfer price at the time we invoice Meda). The parties true-up the differences within 45 days of each quarter-end.

Product Sales

Product sales amounts relate to sales of BUNAVAIL® which was launched in November 2014. These sales are recognized as revenue when prescriptions are filled. This is shown as product sales on the accompanying consolidated statements of operations.

Research Revenues

Research revenue amounts are recognized as revenue under various contractor agreements with third parties. This is shown as research fees on the accompanying consolidated statements of operations.

Contract Revenue

In each of 2014 and 2013, we recognized as revenue $0.2 million in previously deferred revenue related to our agreement with Meda associated with ONSOLIS®. In 2012, we recognized as revenue $17.5 million in previously deferred revenue as a result of the E.U. launch of BREAKYL . In 2013, we received and recognized as revenue $0.3 million which related to our license agreement with TTY.

Research and Development Reimbursements

Reimbursable revenue amounts are related to certain research and development expenses that are reimbursable from Endo related to the Buprenorphine chronic pain program. Our contract with Endo states that Endo will begin reimbursing us for certain research and development expenses once these expenses exceed $45 million. During the years ended December 31, 2014 and 2013, we recognized $12.7 million and $2.8 million, respectively of reimbursable expenses related to our Endo agreement. This is shown as reimbursable revenue on the accompanying consolidated statements of operations.

Cost of Sales

The cost of sales includes direct costs attributable to the production of BREAKYL , PAINKYL and BUNAVAIL® Cost of sales also includes royalty expenses owed to third parties.

For BREAKYL and PAINKYL , we do not take ownership of the subject product as we do not have inventory, as such product is transferred to Meda, in the case of BREAKYL and TTY in the case of PAINKYL , immediately in accordance with the terms of our contractual arrangements with Meda and TTY. LTS manufactures both products for

us. Meda s and TTY s royalty payments to us include an amount related to cost of sales. Ownership and title to the product, including insurance risk, belong to LTS from raw material through completion and inventory of the subject product, and then to Meda and TTY upon shipment of such subject product. This is in accordance with our contracts with LTS and Meda and TTY, which identify the subject product as FOB manufacturer.

For BUNAVAIL®, cost of sales includes raw materials, production costs at our two contract manufacturing sites, quality testing directly related to the product, and depreciation on equipment that we have purchased to produce BUNAVAIL®. It also includes any batches not meeting specifications and raw material yield loss. At launch, $0.7 million of our BUNAVAIL® cost of sales expense has been deferred and will be recognized as expense when prescriptions are filled. Yield losses and batches not meeting specifications are expensed as incurred.

Research and Development Expenses

Overview

Our research and development expenses consist (and have historically consisted) primarily of expenses incurred in identifying, developing, testing, manufacturing and seeking regulatory approval of our product candidates, including:

- expenses associated with regulatory submissions, clinical trials and manufacturing, including additional expenses to prepare for commercial manufacture prior to FDA approval;

Table of Contents

fees paid to third-party contract research organizations, contract laboratories and independent contractors;

payments made to consultants who perform research and development on our behalf and assist us in the preparation of regulatory filings;

personnel related expenses, such as salaries, benefits, travel and other related expenses, including stock-based compensation for personnel directly involved in product development activities;

payments made to third-party investigators who perform research and development on our behalf and clinical sites where such research and development is conducted; and

other related expenses.

Clinical trial expenses for our product candidates are a significant component of our research and development expenses. Product candidates in later stage clinical development generally have higher research and development expenses than those in earlier stages of development, primarily due to the increased size and duration of the clinical trials. We coordinate clinical trials through a number of contracted investigational sites, and the associated expense is based on a number of factors, including actual subject enrollment and visits, direct pass-through costs and other clinical site fees.

Product development expenses are expensed as incurred and reflect costs directly attributable to product candidates in development during the applicable period. Additionally, product development expenses include the cost of qualifying new, current Good Manufacturing Practice (known as cGMP) third-party manufacturing for our product candidates, including expenses associated with any related technology transfer.

Results of Operations

For the Year Ended December 31, 2014 Compared to the Year Ended December 31, 2013

Product Sales. We recognized $0.1 million in product sales during the year ended 2014 from the launch of BUNAVAIL®. There were no product sales during the year ended 2013.

Product Royalty Revenues. We recognized $3.4 million and $1.8 million in product royalty revenue during the years ended 2014 and 2013, respectively, under our license agreement with Meda for BREAKYL in Europe. The increase in product royalty revenues in 2014 can be attributed to more orders from Meda for Spain, France, and the Netherlands as sales in those countries continues to increase over the initial launch year.

Research and Development Reimbursements. We recognized $12.7 million and $2.8 million of reimbursable revenue related to our agreement with Endo during the years ended 2014 and 2013, respectively. Our 2012 license agreement with Endo includes an obligation for Endo to reimburse us for certain trial expenses that exceed a maximum threshold. In the last quarter of 2013, these thresholds were exceeded. Therefore, near the end of 2013 Endo reimbursed us for two months of applicable research and development spending, whereas in 2014 there was a full year of these reimbursable expenses. Also, these trial expenses reached a second, higher threshold early in 2014. At this second stage, both companies equally shared the applicable trial expenses. Although Endo continues to reimburse us for the full amount of these trials, a future FDA approval milestone will be correspondingly reduced to account for

this.

Contract Revenues. We recognized $22.7 million and $6.8 million in contract revenue during the years ended 2014 and 2013, respectively, principally under our license agreement with Endo. Contract revenue in 2014 consisted of two $10 million milestone payments received from Endo as a result of finalizing our large clinical trials. The remaining $2.7 million of 2014 contract revenue is from recognition of a portion of the deferred revenue arising from the $30 million upfront payment received in 2012 from Endo. Of the $30 million initially received, $14.4 million was deferred and recognized over the life of our research and development spending on the Endo-related trials. In 2013, we recognized a larger portion of this Endo upfront payment, over $6.5 million. The revenue recognition in 2013 was higher because we had incurred higher research and development spending, as all three of our large trials were in place.

Cost of Sales. We incurred $4.9 million and $2.1 million in cost of sales during the years ended 2014 and 2013, respectively. In 2013, we had a standard, minimum $1.5 million contractual royalty due to CDC related to our ONSOLIS® and BREAKYL product. The remaining $0.6 million in 2013 represents cost of sales for our BREAKYL Europe sales. In 2014, we incurred the same $1.5 million royalty to CDC and $1.3 million for our increased BREAKYL sales in Europe. In addition for 2014, we incurred $2.1 million in cost of sales for BUNAVAIL® which included expenses related to our inability to put into commerce certain initial batches from our supplier due to certain validation and batch size scale up challenges and thus, had to be expensed immediately.

Table of Contents

Expenditures for Research and Development Programs

BUNAVAIL®

We incurred research and development expenses for BUNAVAIL® of approximately $2.9 million for the year ended December 31, 2014 and approximately $7.1 million for the year ended December 31, 2013. We have incurred approximately $27.3 million in the aggregate since inception of our development of this product. BUNAVAIL® was approved by the FDA in 2014. Therefore, BUNAVAIL® research and development expenses in 2014 primarily consist of manufacturing process development and stability work prior to approval.

BELBUCA (BEMA® Buprenorphine)

We incurred research and development expenses for BELBUCA of approximately $22.0 million for the year ended December 31, 2014 and approximately $41.8 million for the year ended December 31, 2013. Aggregate expenses approximate $111.4 million since inception of our development of this product candidate. Our expense obligations for this product candidate were detailed in our license and development agreement with Endo. Since our license agreement with Endo in 2012, a portion of these expenses were reimbursed by Endo. Our expenses for this product over such periods consisted primarily of three large clinical trials addressing the efficacy and safety of the product, along with formulation and manufacturing development.

Clonidine Topical Gel

We incurred research and development expenses for Clonidine Topical Gel of approximately $9.0 million for the year ended December 31, 2014 and approximately $3.3 million for the year ended December 31, 2013, and have incurred approximately $12.3 million in the aggregate since inception of our development of this product candidate. Our expenses for this product candidate over such periods consisted mainly of a Phase 2 trial testing the efficacy of the product and in 2013, expensing of $2.5 million of in-process research and development associated with licensing of the product from Arcion.

Buprenorphine Depot Injection

We incurred research and development expenses for Buprenorphine Depot Injection of approximately $0.4 million for the year ended December 31, 2014 in the aggregate since inception of our development of this product candidate. No such expenses were incurred in 2013. Our 2014 expenses for this product candidate consisted mainly of one payment to Evonik for Buprenorphine data in accordance with our agreement.

Selling, General and Administrative Expenses. During the years ended December 31, 2014 and 2013, selling, general and administrative expenses totaled $38.5 million and $12.3 million, respectively. Selling, general and administrative costs include BUNAVAIL® sales, marketing, and commercial expenses. These costs also include legal and professional fees, wages, and stock-based compensation expense. The increase in general and administrative expenses can be attributed to the preparation for and launch of BUNAVAIL® during 2014, which represents $17.3 million of the increase. These BUNAVAIL® related costs include the hiring of a sales force, marketing, market support studies, and wages. The remaining increase in selling, general and administrative costs is due to stock compensation expense related to restricted stock grants along with patent defense and litigation expenses.

Interest Expense, Net. During the year ended December 31, 2014 we had net interest expense of $2.1 million, consisting of $1.4 million of scheduled interest payments and $0.7 million of related amortization of discount and loan costs associated with the July 2013 secured loan facility from MidCap. These 2014 costs were partially offset by

interest income of $0.07 million. During the year ended December 31, 2013 we had net interest expense of $0.9 million, consisting of $0.9 million of scheduled interest payments and $0.3 million of related amortization of discount and loan costs associated with the July 2013 secured loan facility from MidCap. These 2013 costs were partially offset by interest income of $0.3 million.

Derivative (Loss) Gain. Derivative (loss) gain in 2014 and 2013 is related to the adjustment of derivative liabilities to fair value as of December 31, 2014 and 2013, respectively. Our derivatives are free-standing warrants. The warrants are measured using Black-Scholes calculations. A major component of the calculation is our stock price. As our stock price increases, the warrants are valued higher, which results in an increase in the derivative liability and a corresponding derivative loss. During the year ending December 31, 2014, our stock price increased dramatically, from $5.89 to $12.02, which resulted in a $13.2 million derivative loss.

Income Tax Expense and Tax Net Operating Loss Carryforwards. We had federal and state net operating loss carryforwards (or NOL) of approximately $159 million and $143 million, respectively at December 31, 2014 as compared to federal and state NOLs of $109 million and $100 million, respectively as of December 31, 2013. These loss carryforwards expire principally beginning in 2020 through 2034 for federal and 2029 for state purposes. In accordance with GAAP, it is required that a deferred tax asset be reduced by a valuation allowance if, based on the weight of available evidence it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount which is more likely than not to be realized. As a result, we recorded a valuation allowance with respect to all

Table of Contents

of our deferred tax assets. Under Section 382 and 383 of the Internal Revenue Code, if an ownership change occurs with respect to a loss corporation (as defined in the Internal Revenue Code), there are annual limitations on the amount of the net operating loss and other deductions which are available to us.

For the Year Ended December 31, 2013 Compared to the Year Ended December 31, 2012

Product Royalty Revenues. We recognized $1.8 million and $1.1 million in product royalty revenue during the years ended 2013 and 2012, respectively, under our license agreement with Meda. The increase in product royalty revenues can be attributed to the commercial launch of BREAKYL in the EU in October 2012.

Research Revenues. We recognized $0.01 million of revenue related to a research and development agreement with Meda during the year ended 2012. There were no such research revenue during the year ended 2013.

Research and Development Reimbursements. We recognized $2.8 million of reimbursable revenue related to our agreement with Endo during the year ended 2013. There was no such reimbursable revenue during the year ended 2012.

Contract Revenues. We recognized $6.8 million and $53.4 million in contract revenue during the years ended 2013 and 2012, respectively. In 2013 contract revenues resulted from the recognition of $6.5 million in deferred revenue from the Endo transaction and $0.3 million related to the license agreement with TTY. For 2012, corresponding amounts related to recognition of $15.6 million of the $30 million upfront payment for the Endo license ($14.4 was recorded as deferred revenue), receipt of a $15.0 million milestone from Endo relating to issuance of a certain patent and recognition of $17.5 million in deferred revenue from Meda relating to the first sale of ONSOLSIS in the E.U.

Cost of Sales. We incurred $2.1 million and $1.9 million in cost of sales during the years ended 2013 and 2012, respectively, related to direct costs attributable to the production of ONSOLIS®. This includes both manufacturing costs and royalties owed to CDC and Athyrium. We are required to pay royalties of $0.375 million per quarter to CDC and Athyrium under a Clinical Development and License Agreement entered into in 2005, and most recently amended in May 2011.

Expenditures for Research and Development Programs

BUNAVAIL®

We incurred research and development expenses for BUNAVAIL®, of approximately $7.1 million for the year ended December 31, 2013 and approximately $12.5 for the year ended December 31, 2012, and have incurred approximately $24.4 million in the aggregate since inception of our development of this product. Our expenses for this product over such periods consisted mainly of Phase 1 and Phase 2 trials, along with FDA regulatory fees, and manufacturing development costs.

BELBUCA (BEMA® Buprenorphine)

We incurred research and development expenses for BELBUCA of approximately $41.8 million for the year ended December 31, 2013 and approximately $21.9 million for the year ended December 31, 2012, and have incurred approximately $89.4 million in the aggregate since inception of our development of this product. Our expense obligations for this product candidate were detailed in our license and development agreement with Endo. Our expenses for this product over such periods consisted primarily of three large clinical trials testing the efficacy and safety of the product, along with formulation and manufacturing development.

Clonidine Topical Gel

We incurred research and development expenses for Clonidine Topical Gel of approximately $3.3 million for the year ended December 31, 2013 and none for the year ended December 31, 2012. Our expenses for this product candidate consisted mainly of a Phase 2 trial testing the efficacy of the product.

Sales, General and Administrative Expenses. During the years ended December 31, 2013 and 2012, sales, general and administrative expenses totaled $12.3 million and $10.1 million, respectively. General and administrative costs include legal and professional fees, office supplies, travel costs, compensation costs, consulting fees and business development costs. The increase in general and administrative expenses can be attributed to an increase in professional service fees including legal expenses and additional incentive compensation.

Interest Expense, Net. During the year ended December 31, 2013 we had net interest expense of $0.9 million, consisting of $0.9 million of scheduled interest payments and $0.3 million of related amortization of discount and loan costs associated with the July 2013 secured loan facility from MidCap. These 2013 costs were partially offset by interest income of $0.3 million. During the year ended December 31, 2012, we had interest income of $0.3 million.

Table of Contents

Derivative Gain (Loss). Derivative gain (loss) in 2013 and 2012 is related to the adjustment of derivative liabilities to fair value as of December 31, 2013 and 2012, respectively. Our derivatives are free-standing warrants. The warrants are measured using Black-Scholes calculations. A major component of the calculation is our stock price. During the year ending December 31, 2013, we had a lower average remaining term of the warrants, and the Black-Scholes volatility of our stock over this remaining term was relatively low compared to 2012. These two factors lowered the Black-Scholes value of the warrants, even though our stock price increased in 2013 by $1.58. The result was a $0.1 million derivative gain. During 2012, our stock price increased by $3.49 per share. This increased our warrant liability, and correspondingly caused the $5.6 million derivative loss.

Income Tax Expense and Tax Net Operating Loss Carryforwards. We had federal and state NOLs of approximately $109 million and $100 million, respectively at December 31, 2013 as compared to federal and state NOLs of $45 million and $38.8 million, respectively as of December 31, 2012. These loss carryforwards expire principally beginning in 2020 through 2033 for federal and 2028 for state purposes. In accordance with GAAP, it is required that a deferred tax asset be reduced by a valuation allowance if, based on the weight of available evidence it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount which is more likely than not to be realized. As a result, we recorded a valuation allowance with respect to all of our deferred tax assets. Under Section 382 and 383 of the Internal Revenue Code, if an ownership change occurs with respect to a loss corporation (as defined in the Internal Revenue Code), there are annual limitations on the amount of the net operating loss and other deductions which are available to us.

Major Research and Development Projects

In 2014, our research and development resources were focused on:

- Completion of the Phase 3 clinical development program and registration stability studies with BELBUCA
- Initiating the first Phase 3, placebo controlled study with Clonidine Topical Gel for Painful Diabetic Neuropathy
- Obtaining approval of the BUNAVAIL® NDA
- Establishing a Medical Affairs effort to support BUNAVAIL®
- Providing commercial supplies for the launch of BUNAVAIL®
- Supporting the NDA preparation efforts for BELBUCA
- Entering into a development agreement for the Buprenorphine Depot Injection product

Research and development expenses in 2014 were primarily dedicated to Phase 3 studies for BELBUCA for the treatment of chronic pain, the initial Phase 3 clinical study for Clonidine Topical Gel, and manufacturing of commercial supplies of BUNAVAIL® as well as registration batches for Clonidine Topical Gel.

The projected dates for IND and NDA submissions, and FDA approval of NDAs, our estimates of development costs and our projected sales associated with each of our product candidates discussed below and elsewhere in this Report are merely estimates and subject to multiple factors, many of which are, or may be beyond our control, including those detailed in the Risk Factors section of this Report. These factors and risks could cause delays, cost overruns or otherwise cause us to not achieve these estimates. Readers are also advised that our projected sales figures do not take into account the royalties and other payments we will need to make to our licensors and strategic partners. Our estimates are based upon our market research and management s reasonable judgments, but readers are advised that such estimates may prove to be inaccurate.

The following is a summary of our current major research and development initiatives and the risks related to such initiatives:

BELBUCA (BEMA® Buprenorphine). BELBUCA is our second analgesic product using the BEMA® technology. The Phase 3 studies to evaluate the efficacy and safety of BELBUCA in the treatment of opioid naïve and experienced patients with chronic pain were completed in 2014 and supported by the positive results from two placebo controlled studies. The NDA was submitted on December 23, 2014 and was accepted February 23, 2015. We will be supporting Endo in responding to FDA questions, scale-up of manufacturing and publishing the results of the clinical trials. Due to the ability of BELBUCA to participate in the key chronic pain market, we believe that BELBUCA has the potential to achieve greater than a 5% share of the $10 billion dollar U.S. market for opioid analgesics, which would translate to over $500 million in peak annual sales. We do not expect to generate any royalty revenue from sales of BELBUCA , if ever, until at least early 2016. A license and development agreement was finalized with Endo for the worldwide rights to BELBUCA for chronic pain in January 2012.

The risks to our company associated with the BELBUCA project include: (i) failure of FDA to approve the NDA; (ii) inability to manufacture adequate supplies for commercial use; (iii) unexpected product safety issues; and (v) failure of our commercial partner to effectively launch and sell the product. A technical or commercial failure of BELBUCA would have a material adverse effect on our future revenue potential and would negatively affect investor confidence in our company and our public stock price.

Table of Contents

BUNAVAIL®. The NDA for BUNAVAIL® was approved in June 2014 and BUNAVAIL® was launched in November 2014. Research and development work in 2015 will include a label expansion study evaluating the efficacy and safety of BUNAVAIL® in the induction (conversion to buprenorphine) of opioid dependent subjects, improvements in commercial manufacturing and packaging, finalizing agreement with FDA on the design of a Thorough QT study (i.e., an abnormal lengthening of the heartbeat) that was part of the post approval commitment and the initiation of Phase 4 market support studies.

The risks to our company associated with BUNAVAIL® include: (i) the inability to provide adequate clinical trial data to obtain expanded labeling for an induction claim (ii) inability to continue to supply product in adequate quantities to meet the commercial demand; and (iii) failure to reach agreement with FDA on the design of a Thorough QT study and complete the study in a time consistent with our post-approval commitment.

Clonidine Topical Gel. Prior to license of Clonidine Topical Gel to us, Arcion assessed its effectiveness in reducing pain in PDN in a double-blind, placebo-controlled, Phase 2 study where the primary study endpoint was the change in pain intensity over a 3 month treatment period in diabetic foot pain. A significant treatment difference was seen in the planned subset analysis of diabetic patients who had documented evidence of functioning pain receptors in the skin of the lower leg (p=0.01, n=63) thus, at a minimum, supporting the effectiveness of topical clonidine in diabetic patients with functioning pain receptors of the skin. In the overall population that included patients without functioning nerve receptors , there was a trend favoring Clonidine Topical Gel (p=0.07, n=182), though the overall results did not reach statistical significance.

A Phase 3 clinical study assessing the efficacy and safety of Clonidine Topical Gel in the enriched population identified in the Phase 2 study performed by Arcion was started in 2014. An interim analysis in the summer indicated that a sample size increase was needed to maintain 90% power to demonstrate a statistical difference between clonidine and placebo. Randomization of the final subject at the revised sample size was completed in December and results are expected the end of March 2015. In anticipation of a positive outcome, registration batches were placed on stability in December and a second placebo controlled study is planned to begin March 2015. Efforts are underway to submit a European application in the second half of 2015.

The risks to our company associated with the Clonidine Topical Gel clinical program include: (i) inability to develop and manufacture a stable formulation suitable for commercial use; (ii) failure of clinical trials; (iii) product safety issues; (iv) failure of or delay by the FDA to approve our NDA; (v) failure of a commercial partner or us to effectively launch and sell the product; and (vii) lack of funding to advance the program.

Buprenorphine Depot Injection. In 2014, we entered into an agreement with Evonik to develop and commercialize a long-acting buprenorphine depot injection capable of providing 30 days of continuous buprenorphine blood concentrations following a single monthly injection. Formulation development efforts have been initiated and animal testing will be performed in 2015 with the goal of identifying suitable formulations to support an IND submission before end of the year.

The risks to our company associated with the Buprenorphine Depot Injection program include: (i) inability to develop a formulation that provides suitable blood concentrations for the intended clinical use; (ii) inability to manufacture the formulation at adequate scale for clinical development and commercial purposes; (iii) failure of FDA to permit clinical development of the product under the IND; (iv) failure of the product to perform in the clinic; (v) slow patient enrollment in clinical trials; (vi) product safety issues; (vii) failure of or delay by the FDA to approve our NDA; (viii) failure of a commercial partner or us to effectively launch and sell the product; and (ix) lack of funding to advance the program.

Liquidity and Capital Resources

Since inception, we have financed our operations principally from the sale of equity securities, proceeds from short-term borrowings or convertible notes, funded research arrangements and revenue generated as a result of our worldwide license and development agreement with Meda regarding ONSOLIS® and revenue generated as a result of our January 2012 agreement with Endo regarding our BELBUCA product candidate. We intend to finance our research and development, commercialization and working capital needs from existing cash, royalty revenue, potential sales revenue from the commercialization of BUNAVAIL®, new sources of debt and equity financing, existing and new licensing and commercial partnership agreements and, potentially, through the exercise of outstanding common stock options and warrants to purchase common stock.

During 2012, significant sources of operating cash were the receipt of a $30 million, non-refundable license fee under the Endo Agreement. In addition, in May 2012, we received an additional $15 million milestone payment from Endo due to our achievement of a certain intellectual property-related milestone. In November 2012, we closed a registered direct offering of our common stock and newly designated Series A Non-Voting Convertible Preferred Stock, par value $.001 per share. The final amount of securities issued in the offering was an aggregate of (i) 6,791,887 shares of common stock and (ii) 2,709,300 shares of Series A Preferred Stock. The net proceeds to us, after deducting placement agent fees, the corporate finance fee and estimated offering expenses, was approximately $38.4 million.

Table of Contents

During 2013, we entered into a $20 million secured loan facility with MidCap, from which we received net proceeds in the aggregate amount of $19.8 million.

In November 2013, we filed a shelf registration statement which registered up to $75 million of our securities for potential future issuance, and such registration statement was declared effective on December 18, 2013. Concurrently with the filing of such registration statement, we established an at-the-market offering program utilizing the universal shelf registration for up to $15 million of common stock. During 2014, we sold an aggregate of 1,304,410 shares of common stock under such offering program for approximate net proceeds of $14.5 million.

In January, 2014, we announced positive top-line results from our pivotal Phase 3 efficacy study of BELBUCA in opioid- naive subjects. The locking of the database for the opioid naive study triggered a $10 million milestone payment from Endo per our licensing agreement that was received February, 2014.

In February, 2014, we entered into a definitive Securities Purchase Agreement with certain institutional investors relating to our registered direct offering of 7,500,000 shares of our common stock. The shares were sold at a price of $8.00 per share, yielding net offering proceeds of $58.2 million. The offering price per share was determined based on an approximately 3.1% discount to the closing price of the common stock on February 7, 2014.

We anticipate that the cash used in operations and our investment in our facilities will continue beyond our ONSOLIS® agreements with Meda; pending reformulation of ONSOLIS® and our agreement with Endo regarding BELBUCA for chronic pain. We plan to research, develop and potentially, manufacture and commercialize additional drug formulations with our BEMA® technology such as our BUNAVAIL® product as well as other non-BEMA® related products and technologies that we may acquire from other companies. As it relates to the latter, we are exploring other new product opportunities in pain and dependency as well as drug delivery technologies that may allow us to become less dependent on our BEMA® technology and the products we are currently developing that utilize BEMA®.

At December 31, 2014, we had cash and cash equivalents of approximately $70.5 million. We used $28.8 million of cash from operations during the twelve months ended December 31, 2014 and had stockholders equity of $54.4 million, versus deficit of ($0.8) million at December 31, 2013. We have sufficient cash to manage the business into early 2016, although this assumes that we do not accelerate the development of other opportunities available to us, engage in an extraordinary transaction or otherwise face unexpected events, costs or contingencies, any of which could affect our cash requirements

Additional capital may be required to support planned development of Clonidine Topical Gel, buprenorphine depot injection, our commercialization activities for BUNAVAIL®, the reformulation project for and anticipated commercial relaunch of ONSOLIS® and general working capital. Based on product development timelines and agreements with our development partners, the ability to scale up or reduce personnel and associated costs are factors considered throughout the product development life cycle. Available resources may be consumed more rapidly than currently anticipated, resulting in the need for additional funding.

Also, product development timelines and agreements with our development partners, the ability to scale up or reduce personnel and associated costs are factors considered throughout the product development life cycle. Available resources may be consumed more rapidly than currently anticipated, resulting in the need for additional funding.

Accordingly, we anticipate that we will be required to raise additional capital, which may be available to us through a variety of sources, including:

public equity markets;

private equity financings;

commercialization agreements and collaborative arrangements;

sale of product royalty;

grants and new license revenues;

bank loans;

equipment financing;

public or private debt; and

exercise of existing warrants and options.

Table of Contents

Readers are cautioned that additional funding, capital or loans (including, without limitation, milestone or other payments from commercialization agreements) may be unavailable on favorable terms, if at all. If adequate funds are not available, we may be required to significantly reduce or refocus our operations or to obtain funds through arrangements that may require us to relinquish rights to certain technologies and drug formulations or potential markets, either of which could have a material adverse effect on us, our financial condition and our results of operations in 2015 and beyond. To the extent that additional capital is raised through the sale of equity or convertible debt securities, the issuance of such securities would result in ownership dilution to existing stockholders.

Contractual Obligations and Commercial Commitments

Our non-cancellable contractual obligations as of December 31, 2014 are as follows:

	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating lease obligations	$ 2,440,281	$ 161,832	$ 649,809	$ 1,043,663	$ 584,974
Secured loan facility	12,666,667	8,000,000	4,666,667		
Purchase obligations*	441,316	170,832	270,484		
Interest on secured loan facility	957,816	816,273	141,543		
Minimum royalty expenses**	7,500,000	1,500,000	3,000,000	3,000,000	
Total contractual cash obligations***	$ 24,006,077	$ 10,648,937	$ 8,728,503	$ 4,043,663	$ 584,974

* Purchase obligations are primarily related to long term contracts for minimum services from commercial vendors.

** Minimum royalty expenses represent a contractual floor that we are obligated to pay CDC and Athyrium regardless of actual sales.

*** We signed a commercialization agreement with Endo in January 2012. Endo will have worldwide rights to market our BELBUCA product. In return for milestone payments and royalties, we are required to conduct and pay for certain clinical trials as outlined in a mutually agreed development plan. These costs will depend on the size and scope of the required trials. The Endo agreement does not specify minimums in terms of the cost of the trials.

Off Balance Sheet Arrangements

We are not a party to any off balance sheet arrangements.

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

Interest rate risk

Our cash and cash equivalents include all highly liquid investments with an original maturity of three months or less. Our cash equivalents include Government T-Bills. Because of the short-term maturities of our cash and cash equivalents, we do not believe that an increase in market rates would have a significant impact on the realized value of our investments. We place our cash and cash equivalents on deposit with financial institutions in the United States.

The Federal Deposit Insurance Corporation covers $0.25 million for substantially all depository accounts. We may from time to time have amounts on deposit in excess of the insured limits. As of December 31, 2014, we had approximately $70.5 million, which exceeded these insured limits.

Foreign currency exchange risk

We currently have limited, but may in the future have increased, clinical and commercial manufacturing agreements which are denominated in Euros or other foreign currencies. As a result, our financial results could be affected by factors such as a change in the foreign currency exchange rate between the U.S. dollar and the Euro or other applicable currencies, or by weak economic conditions in Europe or elsewhere in the world. We are not currently engaged in any foreign currency hedging activities.

Market indexed security risk

We have issued warrants to various holders underlying shares of our common stock. These warrant investments are re-measured to their fair value at each reporting period with changes in their fair value recorded as derivative gain (loss) in the accompanying consolidated statement of operations. We use the Black-Scholes model for valuation of the warrants.

Item 8. Financial Statements and Supplementary Data.

Our Consolidated Financial Statements and Notes thereto and the report of Cherry Bekaert LLP, our independent registered public accounting firm, are set forth on pages F-1 through F-35 of this Report.

Table of Contents

Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure.
None.

Item 9A. Controls and Procedures.
Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that, at December 31, 2014, such disclosure controls and procedures were effective.

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC.Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

Limitations on the Effectiveness of Controls

Our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of our disclosure control system are met. Because of inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected. Our Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of the end of the period covered by this Report that our disclosure controls and procedures were sufficiently effective to provide reasonable assurance that the objectives of our disclosure control system were met.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the year ended December 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management s Report on Internal Control Over Financial Reporting

As required by the SEC rules and regulations for the implementation of Section 404 of the Sarbanes-Oxley Act, our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of our consolidated financial statements for external reporting purposes in accordance with GAAP. Our 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 our company,

(2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors, and

(3) 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 consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect errors or misstatements in our consolidated financial statements. 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 or compliance with the policies or procedures may deteriorate. Management assessed the effectiveness of our internal control over financial reporting at December 31, 2014. In making these assessments, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (2013 Framework) (COSO) . Based on our assessments and those criteria, management determined that we maintained effective internal control over financial reporting at December 31, 2014.

Item 9B. Other Information.

None.

Table of Contents

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

Our directors and executive officers and their ages as of March 12, 2015 are as follows:

Name	Age	Position(s) Held
Frank E. O Donnell, Jr., M.D.	65	Executive Chairman and Director
Mark A. Sirgo, Pharm.D.	61	President, Chief Executive Officer and Director
Ernest R. De Paolantonio	61	Chief Financial Officer, Secretary and Treasurer
Andrew L. Finn, Pharm.D	65	Executive Vice President of Product Development
William B. Stone	71	Lead Director
John J. Shea	88	Director
Samuel P. Sears, Jr	71	Director
Thomas W. D Alonzo	71	Director
Charles J. Bramlage	54	Director
Barry I. Feinberg	60	Director

There are no arrangements between our directors and any other person pursuant to which our directors were nominated or elected for their positions. There are no family relationships between any of our directors or executive officers.

Frank E. O Donnell, Jr., M.D., age 65, has been our Chairman of the Board and a Director since March 29, 2002. He currently serves as Executive Chairman. Dr. O Donnell has previously served as our President and Chief Executive Officer. In January 2005, he relinquished the title of President and in August 2005 he relinquished the title of Chief Executive Officer. For more than the last six years, Dr. O Donnell has served as Manager of The Hopkins Capital Group, an affiliation of limited liability companies which engage in private equity and venture capital investing in disruptive technologies in healthcare. Dr. O Donnell is qualified to serve on our board of directors because of his long history with our company and his extensive experience in managing and investing in biopharmaceutical companies. Dr. O Donnell is a graduate of The Johns Hopkins School of Medicine and received his residency training at the Wilmer Ophthalmological Institute, Johns Hopkins Hospital. Dr. O Donnell is a former professor and Chairman of the Department of Ophthalmology, St. Louis University School of Medicine. He is a trustee of St. Louis University.

Mark A. Sirgo, Pharm.D., age 61, has been our President since January 2005 and Chief Executive Officer and Director since August 2005. He joined our company in August 2004 as Senior Vice President of Commercialization and Corporate Development upon our acquisition of Arius Pharmaceuticals, of which he was a co-founder and Chief Executive Officer. He has also served as our Executive Vice President, Corporate and Commercial Development and our Chief Operating Officer. Dr. Sirgo has over 30 years of experience in the pharmaceutical industry, including 16 years in clinical drug development, 7 years in marketing, sales, and business development and 12 years in executive management positions. Prior to his involvement with Arius Pharmaceuticals from 2003 to 2004, he spent 16 years in a variety of positions of increasing responsibility in both clinical development and marketing at Glaxo, Glaxo Wellcome, and GlaxoSmithKline, including Vice President of International OTC Development and Vice President of New Product Marketing. Dr. Sirgo was responsible for managing the development and FDA approval of Zantac 75 while at Glaxo Wellcome, among other accomplishments. From 1996 to 1999, Dr. Sirgo was Senior Vice President of Global Sales and Marketing at Pharmaceutical Product Development, Inc., a leading contract service provider to the pharmaceutical industry. Dr. Sirgo serves on the Board of Directors and as Chairman of the Compensation Committee

of Salix Pharmaceuticals, Ltd. (NASDAQ:SLXP), a specialty pharmaceutical company specializing in gastrointestinal products since 2008. Dr. Sirgo is qualified to serve on our board of directors because of his extensive experience in specialty biopharmaceutical companies. Dr. Sirgo received his BS in Pharmacy from The Ohio State University and his Doctorate from Philadelphia College of Pharmacy and Science.

Ernest R. De Paolantonio, *CPA, MBA*, age 61, has been our Chief Financial Officer and Secretary since October of 2013 and has over 35 years of varied financial and business experience in the pharmaceutical industry. Mr. De Paolantonio also became our Treasurer in January 2015. Prior to joining the company, he served as the Chief Financial Officer of CorePharma LLC, a private specialty generic company, and was directly involved in the financial and commercial strategy to establish Core s proprietary labeled portfolio of products. In addition, he previously served in finance and controllers positions in roles of increasing responsibility at Colombia Laboratories, where he was also responsible for business development and logistics, including supply chain management for the company s first commercial product launch. Mr. De Paolantonio has served in various financial positions in senior management at Taro Pharmaceuticals where he was the Corporate Controller, Watson Pharmaceuticals where he was Executive Director of Finance, Group Controller and responsible for managing the Corporation s supply chain of Active Pharmaceutical Ingredients, and GlaxoSmithKline where he began his career in finance and spent over 17 years in areas of increasing responsibility including; Manufacturing, Corporate Finance, R&D and U.S. Pharmaceuticals where he was Group Controller. Mr. De Paolantonio received his Bachelor of Arts Degree from Lycoming College; his MBA in Finance at Saint Joseph s University and is a licensed CPA.

Table of Contents

Andrew L. Finn, Pharm.D., age 65, has been our Executive Vice President of Product Development since January 2007. He joined the company in August 2004 upon our acquisition of Arius Pharmaceuticals, of which he was a co-founder. Dr. Finn has previously served as our Senior Vice President of Product Development and Executive Vice President of Clinical Development and Regulatory Affairs. Dr. Finn has over 30 years experience in pharmaceutical product development. Prior to his involvement with Arius, he was, from 2000 to 2003, Executive Vice President of Product Development at POZEN Inc. with responsibilities for formulation development, non-clinical development, clinical research and regulatory affairs. He participated in the POZEN activities leading up to the initial public offering and submitted marketing applications in Europe and the U.S. for two migraine products. From 1996 to 1999, Dr. Finn was Co-Founder and Chief Executive Officer of enVision Sciences, a regulatory and clinical service company. From 1991 to 1996, he was Vice President of Clinical Research and Biometrics for Solvay Pharmaceuticals, where he oversaw NDA submissions in the areas of inflammatory bowel disease, osteoporosis prevention and treatment of obsessive-compulsive disorder. Prior to this, he spent 10 years in positions of increasing responsibility at Glaxo Inc., where he oversaw a number of NDA submissions, including Zofran for chemotherapy induced nausea and vomiting. Dr. Finn is qualified to serve on our management team because of his extensive experience in specialty biopharmaceutical companies. Dr. Finn received his BS in Pharmacy from the University of North Carolina and his Doctorate from the University of Michigan.

William B. Stone, age 71, has been a member of our board of directors since October 2001 and is our Lead Director and Chairman of the Audit Committee of our board of directors. For thirty years, until his retirement in October 2000, Mr. Stone was employed with Mallinckrodt Inc. For the last twenty years of his career, he held positions of Vice President and Corporate Controller and Vice President and Chief Information Officer for 16 years and 4 years, respectively. During his tenure at Mallinckrodt, Mr. Stone was responsible for global accounting and reporting, financial organization, staffing and development, and systems of internal accounting control. In this capacity, he was responsible for Mallinckrodt s SEC and other financial filings, internal management performance reports, strategic and tactical financial planning and for evaluation of capital sources and investments. Mr. Stone presented financial analyses and special projects to Mallinckrodt s board of directors and audit committee, and reported to the audit committee regarding the conduct and effectiveness of the independent accountant s quarterly reviews and annual audit. In the capacity of Chief Information Officer, Mr. Stone was responsible for Mallinckrodt s worldwide computer information systems and organization, staffing and development. He assessed effectiveness and control for computer-assisted information systems and led a successful program for justification, selection and deployment of global standardized computer hardware and software. Further, Mr. Stone reported to the audit committee as leader of Mallinckrodt s successful global program to address Year 2000 implications associated with computer-assisted information, laboratory control and process control computer hardware and software. He also chaired Mallinckrodt s corporate employee benefits committee for over 8 years and has been a member of Financial Executives International since 1980. Mr. Stone is qualified to serve on our board of directors because of his extensive experience in accounting and with pharmaceutical companies. Mr. Stone is a graduate of the University of Missouri-Columbia where he earned BS and MA degrees in accounting, and is a Certified Public Accountant.

John J. Shea, age 88, has been a member of our board of directors since March 2002 and serves as Chairman of the Nominating and Corporate Governance Committee of our board of directors. He is currently the head of his own firm J. Shea Inc. and has previously served as a Quality Systems Adviser with Quintiles, a private consulting firm. Mr. Shea has also served in the capacity of Director of Quality Assurance and was responsible for the implementation of quality assurance procedures in a number of public companies. From 1987-1989, he served as Director of Quality Assurance at NeoRx Corporation. Mr. Shea was also the Director of Corporate Quality Assurance at Hexcel Corporation from 1980-1987. Mr. Shea has also served as the quality assurance person for other companies including, Teledyne Relays, Ortho Diagnostics, Inc. and Bio Reagents & Diagnostics, Inc. He is a member of the (North Carolina) Dare County Airport Authority and Audit Committee. Mr. Shea is qualified to serve on our board of directors because of his extensive business experience in the pharmaceutical industry. Mr. Shea earned a B.S. in

Chemistry at Bethany College.

Samuel P. Sears, Jr., age 71, was appointed as a member of our board of directors in October, 2011 and since 2013 serves as Chairman of the Compensation Committee. Mr. Sears has extensive experience in the biopharmaceutical, nutraceutical and biotechnology industries. Since 2006, Mr. Sears has been a partner at the law firm of Cetrulo LLP, where he currently serves as managing partner, and from 2000 to 2006, he provided private consulting and legal advisory services to start-up and early stage development companies. Since 2013, Mr. Sears has served as Director of HedgePath Pharmaceuticals, Inc. (OTCBB: HPPI), a clinical stage biopharmaceutical company which is developing therapeutics for cancer patients. From 2000 to 2013, Mr. Sears served as Director, Chairman of the Audit Committee, Chairman of the Executive Committee, and Member of the Compensation Committee of Commonwealth Biotechnologies, Inc., a research and development support services company. From 1998 to 2000, Mr. Sears served as Vice Chairman and treasurer of American Prescription Providers, Inc., a specialty pharmacy network offering prescriptions and nutraceuticals to patients with chronic diseases. From 1994 through May 1998, Mr. Sears was Chief Executive Officer and Chairman of Star Scientific, Inc. (NASDAQ: CIGX). From 1968 to 1993, Mr. Sears was in private law practice. Mr. Sears is qualified to serve on our board of directors because of his extensive legal and business experience, including in the pharmaceutical industry. Mr. Sears is a graduate of Harvard College and Boston College Law School.

Table of Contents

Thomas W. D Alonzo, age 71, has served as a member of our board since April 23, 2013. Prior to joining our company, Mr. D Alonzo served as a member of the board of directors of Salix Pharmaceuticals, Ltd. since May 2000 and has been the Chairman of the Board since June 2010. From March 2007 to February 2009, Mr. D Alonzo served as the Chief Executive Officer and a director of MiMedx Group, Inc. From May 2006 to April 2007, Mr. D Alonzo was Chief Executive Officer of DARA BioSciences, Inc., now known as DARA Pharmaceuticals, Inc., and he served on its board of directors from September 2005 to December 2008. From 2006 to 2008, he also served on our board of directors. From 2000 to 2007, Mr. D Alonzo acted as an independent consultant. Prior to that, from 1996 to 1999, Mr. D Alonzo served as President and Chief Operating Officer of Pharmaceutical Product Development (PPD), a global provider of discovery and development services to pharmaceutical and biotechnology companies. Before joining PPD, from 1993 to 1996, he served as President and Chief Executive Officer of GenVec, Inc., a clinical-stage, biopharmaceutical company. From 1983 to 1993, Mr. D Alonzo held positions of increasing responsibility within Glaxo, Inc., the U.S. division of GSK, including President. Mr. D Alonzo is qualified to serve on our board of directors because of his extensive experience in working with and managing biopharmaceutical companies. Mr. D Alonzo received his B.S. in Business Administration from the University of Delaware, and his J.D. from the University of Denver College of Law.

Charles J. Bramlage, age 54, has served as a member of our board since July 17, 2014. Mr. Bramlage has also served as Chief Executive Officer of Pearl Therapeutics, Inc. since February 2011. He previously served as president of pharmaceutical products at Covidien plc (NYSE: COV) from 2008 to 2011. Mr. Bramlage served as the President of European Operations at Valeant Pharmaceuticals International, Inc. (NYSE: VRX) from 2004 to 2008 and President and Chief Executive Officer of BattellePharma, Inc., a specialty pharmaceutical company developing inhaled products from 2001 to 2004. From 1983 to 2001, Mr. Bramlage held positions of increasing responsibility at GlaxoSmithKline plc (LSE/NYSE: GSK) in product management, sales management, sales, and sales training, ultimately becoming Vice-President of Respiratory Global Commercial Development and Vice-President of U.S. Respiratory and Cardiovascular Marketing, where he led the team responsible for the global launch of Seretide®/Advair® and the U.S. launch of Flovent®. Mr. Bramlage is qualified to serve on our board of directors because of his extensive experience in working with and managing biopharmaceutical companies. Mr. Bramlage received a B.S. in Marketing from The Ohio State University-The Max M. Fisher College of Business and received an M.B.A in Finance from the University of Dayton.

Barry I. Feinberg, M.D., age 60, has served as a member of our board since July 17, 2014. Dr. Feinberg is an expert in the area of pain management and has served as adjunct faculty member of the Department of Anesthesia at Saint Louis University since November 2013. Since 2008, he has also served as a member of the Board of Directors and Medical Executive Committee of the Frontenac Surgery and Spine Care Center, where he maintains his private practice under the name Injury Specialists. From 2003 to 2011, Dr. Feinberg served as a member of the Board of Directors of Professional Imaging, LLC. He has served as a staff member of the Department of Anesthesia at the Missouri Baptist Medical Center in St. Louis, Missouri since August 2004 and as an associated staff member of the Department of Anesthesia at the DePaul Health Center in Bridgeton, Missouri, since June 1995. From 1988 to 1994, Dr. Feinberg served as Director of the Physicians Pain Management Center in Bridgeton, Missouri, and the Chairman of the Department of Anesthesia at DePaul Heath Center in Bridgeton from 1986 to 1994. He has also served as Assistant Professor at the Department of Anesthesia at Mount Sinai Medical Center from 1984 to 1986 and staff member at the Intensive Care Unit of the Deborah Heart and Lung Center in Brows Mill, New Jersey, from 1983 to 1984. Dr. Feinberg is qualified to serve on our board of directors because of his medical degree and his specialty in the field of pain management. Dr. Feinberg received a Bachelor of Science in Biology from the State University of New York, Binghamton and a Doctor of Medicine from State University of New York Downstate Medical Center in Brooklyn, New York. Dr. Feinberg completed a residency in Anesthesiology at University of Pennsylvania School of Medicine. He also received a Juris Doctorate degree from the Washington University School of Law, St. Louis, Missouri.

Key Employees

Below are the biographies of certain key non-executive officer employees of our company:

Niraj Vasisht, Ph.D. has been our Senior Vice President of Product Development and Chief Technical Officer since October 2008. He joined the company in February 2005 as the Vice President of Product Development. Dr. Vasisht heads the chemistry, manufacturing and control operations for BDSI pipeline products. He directs and oversees the product design, formulation development, quality control, process engineering, validation and stability testing of the drug product and CTM and commercial manufacturing operations at our vendor sites worldwide. In addition, he is responsible for creation of relevant intellectual property, provides risk assessment for the development program, and provides technical and strategic leadership to the business development function. He evaluates technical suitability of drug delivery platforms and candidate molecules suitable for the technology. Dr. Vasisht serves as BDSI s pharmaceutical development representative for FDA interactions for NDA and MAA filings. Dr. Vasisht is known worldwide for his expertise in microencapsulation based controlled release and drug delivery technologies. From 1994 to 2005, Dr. Vasisht held positions of increasing responsibility at Southwest Research Institute where he ultimately served as the Director of Microencapsulation, Pharmaceutical Development and Nanomaterials and was responsible for leading the group that provides research and development and product development services to pharmaceutical, consumer health, and nutraceutical companies. Dr. Vasisht is the inventor/co-inventor on multiple patents in drug delivery. Dr. Vasisht received a BTech degree in Chemical Engineering from the Indian Institute of Technology at Kanpur, a Master s of Science from the University of New Hampshire and a Doctorate in Chemical Engineering from Rensselaer Polytechnic Institute.

Table of Contents

Albert J. Medwar, M.B.A. has been our Vice President of Marketing and Corporate Development since joining the company in April 2007, with over 20 years of experience in marketing, sales, and marketing research. Prior to joining the company, Mr. Medwar was the Head of Oncology Marketing at EMD Pharmaceuticals, the U.S. subsidiary of Merck KGaA, where he was responsible for developing the global market for a pipeline of oncology products. Mr. Medwar was also the Marketing Director for Triangle Pharmaceuticals, a start-up company focusing on the development and commercialization of compounds for HIV and hepatitis. Mr. Medwar s pharmaceutical career began in sales at Burroughs Wellcome, which later became Glaxo Wellcome. After six years of sales experience, he took on marketing research responsibilities, and then played an important role in the launch of a short acting opioid analgesic, remifentanil, and held increasing marketing responsibility for a number of products including a portfolio of anesthetic/analgesic agents, Zofran, and Wellbutrin SR. Mr. Medwar received a Bachelor of Science degree from Cornell University and a Masters of Business Administration from Bentley College.

George K. Ng, J.D. has been our Senior Vice President & General Counsel since joining the company in December 2012, with over 10 years of combined experience in pharmaceuticals and the law. Mr. Ng heads our legal, compliance and intellectual property functions. Prior to joining the company, Mr. Ng held various senior management positions, including Head of Legal, Chief Compliance Officer and Chief Intellectual Property Counsel, with publicly-traded, global biotechnology and pharmaceutical companies, including Spectrum Pharmaceuticals, Inc. and Alpharma, Inc., with oversight over legal, intellectual property, litigation and compliance matters. Additionally, Mr. Ng has held responsibility for being the legal lead in due diligence, negotiations, and contract preparation for multiple business development transactions, including U.S. and ex-U.S. licenses, global collaboration agreements and intellectual property and product acquisitions. Previously, in private practice, Mr. Ng was a partner in two AMLAW 200 law firms where he had leadership roles, including establishing the life sciences practice group for one firm and heading it as the national co-chair. In his private practice positions, Mr. Ng s responsibilities included patent and trademark prosecution, licensing and litigation support, with areas of expertise including drug delivery technologies and medical devices. Mr. Ng earned a Juris Doctor (J.D.) degree in law from the University of Notre Dame School of Law and a Bachelor of Arts and Sciences (B.A.S.) dual degree in Biochemistry & Economics from the University of California, Davis.

David Acheson has been our Vice President of Sales and Managed Markets since joining the company in December 2013, with over 18 years of sales and commercial experience. Prior to joining the company, Mr. Acheson was with CSL Behring as the National Director of Sales, Immunology and Pulmonary for two specialty teams focused in rare and orphan diseases. Mr. Acheson also led the full build and deployment of the sales organization for Pacira Pharmaceuticals Inc., an emerging specialty pharmaceutical company focused on the clinical and commercial development of products focused in the post-surgical pain market. Mr. Acheson s pharmaceutical and biotech career began with Roche Pharmaceuticals where he worked as a Sales Representative, Medical Center Representative, and Division Sales Manager. After his success in the hospital and oncology supportive care arena at Roche, Mr. Acheson joined MedPointe/Meda Pharmaceuticals where he worked in multiple areas of responsibility as a District Sales Manager, Regional Sales Director, and National Sales Director in the respiratory business. Also at Meda, Mr. Acheson served as the National Sales Director, Pain and Supportive Care Team and responsible for building a full pain and oncology supportive care division of the company from start-up operations, deploying a full sales team as well as operational needs within the company. Prior to his work in the pharmaceutical and biotech industry, Mr. Acheson was with American Cyanamid Company in their Ag-Chemical Division, serving in multiple levels of responsibility. Mr. Acheson has experience in a number of complex markets such as pain, palliative care, immunotherapy, and orphan disease state products, many of which had afforded him a great deal of involvement in the equally complex managed markets settings, developing and pulling through payer strategies as well as partnerships at the distribution and channel level. Mr. Acheson received a Bachelor degree in Business from the University of Nebraska at Lincoln.

Executive Chairman

On January 20, 2012, our board of directors, upon the recommendation of the Nominating and Corporate Governance Committee of the board, created the office of Executive Chairman of the Company and appointed Dr. Frank O Donnell, then our Chairman of the Board, as Executive Chairman of our company. In taking such action, our board was intending to formally memorialize the role that Dr. O Donnell has played with our company over the years.

As Executive Chairman of our company, Dr. O Donnell acts as an officer and employee and, as such, performs his duties subject in all instances to the oversight of our board of directors and the power of our board of directors to approve all applicable corporation actions (which powers shall not be vested in the office of Executive Chairman). The Executive Chairman is not an executive officer (as defined in SEC Rule 3b-7) of our company as the role of the Executive Chairman by design is not an officer who performs a policy making function for our company. Rather, the Executive Chairman serves as a conduit between our board and our executive management team and is available to act as an advisor and consultant to our executive management team, with ultimate responsibility for development and implementation of our corporate policies being vested in our executive officers (Dr. Sirgo, Dr. Finn and Mr. De Paolantonio) under the supervision of our board of directors.

Table of Contents

Subject to such other roles, duties and projects as may (consistent with the terms and provisions of our Amended and Restated Bylaws and the resolutions of our board that formed the office of Executive Chairman) be assigned by our board to the Executive Chairman, the primary responsibilities of the Executive Chairman are as follows:

1. Chair annual and special board meetings and annual stockholder meetings and, subject to availability, attend meetings of the committees of the board;

2. Provide overall board leadership and establish guiding principles for the board;

3. Manage the affairs of the board and facilitate board action in such a way that strategic and policy decisions are fully discussed, debated and decided by the board;

4. In cooperation with the President and Chief Executive Officer, ensure that our strategic orientation is defined and communicated to the board for its approval and that all material issues are dealt with by the board during the year;

5. Ensure that the board has efficient communication channels regarding all material issues concerning the business and see to it that directors are informed about these issues;

6. Act as a representative of the board and consult with board members outside the regularly scheduled meetings of the board and of board committees;

7. Meet and confer as often as required with our President and Chief Executive Officer to ensure that there is efficient communication between the Executive Chairman, the President and Chief Executive Officer and board members;

8. Offer advice and consultation to the President and Chief Executive Officer on the overall management of the business and affairs of our company as well as specific matters upon the request of the President and Chief Executive Officer;

9. In consultation and partnership with the President and Chief Executive Officer, the Executive Chairman may act as our representative with business partners of our company; and

10. At the request of the board or the President and Chief Executive Officer, and in consultation and partnership with the President and Chief Executive Officer, the Executive Chairman may be placed in charge of special corporate strategic initiatives or projects. The compensation of the Executive Chairman shall be determined from time to time by the Compensation Committee of the board in accordance with such committee s charter and practice. In March 2012, the Compensation Committee of our board (with input from our outside compensation consultant) determined and approved that Dr. O Donnell would receive compensation at a level equal to 50% of the President/CEO s salary, cash bonus and options. The salary portion would begin on January 1, 2012 and the cash bonus and option portion would be determined in the first quarter of 2013, when, under normal circumstances, the company 2012 objectives would be evaluated. Because of the change in his compensation, Dr. O Donnell will no longer receive cash retainers or option awards under the existing board of director remuneration program for his role as a member of our board of directors.

In 2014, Dr. O Donnell received the following compensation for his service as Executive Chairman: $234,720 in cash compensation, $140,988 bonus, $1,296,013 in stock awards and $19,924 in benefits paid in 2014. We do not have a written employment or similar agreement with Dr. O Donnell in connection with his service as our Executive Chairman.

Director Independence

We believe that William B. Stone, John J. Shea, Samuel P. Sears, Jr. Thomas W. D Alonzo, Charles J. Bramlage and Barry I. Feinberg qualify as independent directors for NASDAQ Stock Market purposes. This means that our board of directors is composed of a majority of independent directors as required by NASDAQ Stock Market rules.

Our former director, William S. Poole, served since April 2005 and retired in July 2014. His partial year participation is excluded from calculations noted below.

Meetings of the Board of Directors and Stockholders

Our board of directors met in person and telephonically 9 times during 2014 and also acted by unanimous written consent. Each member of our board of directors was present at one hundred (100%) percent of the board of directors meetings held. It is our policy that all directors must attend all stockholder meetings, barring extenuating circumstances. All directors were present at the 2014 Annual Meeting of Stockholders, either in person or telephonically.

Table of Contents

Board Committees

Our board of directors has established three standing committees: Audit, Compensation, and Nominating and Corporate Governance. Historically, all independent directors have been members of each board committee. In October 2013, our committees reorganized, and subsequently there were changes to the committee composition. All standing committees (as well as our Lead Director) operate under a charter that has been approved by the board. Our board of directors has also, from time to time, appointed non-standing committees to assist the board in its duties to our company.

Audit Committee

Our board of directors has an Audit Committee, composed of William B. Stone, Samuel P. Sears, Jr., and Barry I. Feinberg, all of whom are independent directors as defined in accordance with section 3(a)(58)(A) of the Exchange Act and the rules of NASDAQ. Mr. Stone serves as chairman of the committee. The board of directors has determined that Mr. Stone is an audit committee financial expert as defined in Item 407(d)(5)(ii) of Regulation S-K. The Audit Committee met four times during 2014. Each member of the Audit Committee was present at one hundred (100%) percent of the Audit Committee meetings held during such director s tenure as a member of the Audit Committee.

Our Audit Committee oversees our corporate accounting, financial reporting practices and the audits and reviews of financial statements. For this purpose, the Audit Committee has a charter (which is reviewed annually). As summarized below, the Audit Committee:

- evaluates the independence and performance of, and assesses the qualifications of, our independent auditor and engages such independent auditor;
- approves the plan and fees for the annual audit, quarterly reviews, tax and other audit-related services and approves in advance any non-audit service and fees therefor to be provided by the independent auditor;
- monitors the independence of the independent auditor and the rotation of partners of the independent auditor on our engagement team as required by law;
- reviews the financial statements to be included in our Annual Report on Form 10-K and Quarterly Reports on Form 10-Q and reviews with management and the independent auditors the results of the annual audit and reviews of our quarterly financial statements;
- oversees all aspects of our systems of internal accounting and financial reporting control and corporate governance functions on behalf of the board; and
- provides oversight in connection with legal, ethical and risk management compliance programs established by management and the board, including compliance with requirements of Sarbanes-Oxley and makes

recommendations to the board of directors regarding corporate governance issues and policy decisions.

Nominating and Corporate Governance Committee

Our board of directors has a Nominating and Corporate Governance Committee composed of John J. Shea, William B. Stone and Thomas W. D Alonzo. Mr. Shea serves as the chairman of the committee. The Nominating and Corporate Governance Committee is charged with the responsibility of reviewing our corporate governance policies and with proposing potential director nominees to the board of directors for consideration. The Nominating and Corporate Governance Committee met four times in 2014 and has a charter which is reviewed annually. All members of the Nominating and Corporate Governance Committee are independent directors as defined by the rules of the NASDAQ Stock Market. The Nominating and Corporate Governance Committee will consider director nominees recommended by security holders. To recommend a nominee please write to the Nominating and Corporate Governance Committee c/o Ernest R. De Paolantonio, BioDelivery Sciences International, Inc, 4131 ParkLake Avenue. Suite #225, Raleigh, NC. 27612. The Nominating and Corporate Governance Committee has established nomination criteria by which board candidates are to be evaluated. The Nominating and Corporate Governance Committee will assess all director nominees using the same criteria. During 2014, we did not pay any fees to any third parties to assist in the identification of nominees. During 2014, we did not receive any director nominee suggestions from stockholders.

In 2010, the Nominating and Corporate Governance Committee adopted a set of criteria by which it will seek to evaluate candidates to serve on our board of directors. The evaluation methodology includes a scored system based on criteria including items such as experience in the biotechnology sector, experience with public companies, executive managerial experience, operations and commercial experience, fundraising experience and contacts in the investment banking industry, personal and skill set compatibility with current board members, industry reputation, knowledge of our company generally, independence and ethnic and gender diversity. While diversity is considered as a board qualification criteria, it would not be weighted any more or less in an evaluation process than any other criteria. The established criteria do not distinguish board candidates based on whether the candidate is recommended by a stockholder of our company.

Table of Contents

Compensation Committee

Our board of directors also has a Compensation Committee, which reviews or recommends the compensation arrangements for our management and employees and also assists the board of directors in reviewing and approving matters such as company benefit and insurance plans, including monitoring the performance thereof. The Compensation Committee has a charter (which is reviewed annually) and is composed of three members: Samuel P. Sears, Jr., William B. Stone and Charles J Bramlage. Mr. Sears serves as chairman of this committee. The compensation committee met six times during 2014.

The Compensation Committee has the authority to directly engage, at our expense, any compensation consultants or other advisers as it deems necessary to carry out its responsibilities in determining the amount and form of employee, executive and director compensation. In 2014, the Compensation Committee engaged Radford, an AON Consulting Company, to obtain market data against which it has measured the competitiveness of our compensation programs. In determining the amount and form of employee, executive and director compensation, the Compensation Committee has reviewed and discussed historical salary information as well as salaries for similar positions at comparable companies. We paid consultant fees to Radford of $0.011 million in 2014.

Lead Director

On July 26, 2007, our board of directors created the position of Lead Director. Our board of directors designated William B. Stone, an existing director, as our Lead Director. Pursuant to the charter of the Lead Director, the Lead Director shall be an independent, non-employee director designated by our board of directors who shall serve in a lead capacity to coordinate the activities of the other non-employee directors, interface with and advise management, and perform such other duties as are specified in the charter or as our board of directors may determine.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires that our directors and executive officers and persons who beneficially own more than 10% of our common stock (referred to herein as the reporting persons) file with the SEC various reports as to their ownership of and activities relating to our common stock. Such reporting persons are required by the SEC regulations to furnish us with copies of all Section 16(a) reports they file.

Based solely upon a review of copies of Section 16(a) reports and representations received by us from reporting persons, and without conducting any independent investigation of our own, in fiscal year 2014, all Forms 3, 4 and 5 were timely filed with the SEC by such reporting persons.

Code of Ethics

We have adopted a code of ethics that applies to all employees, as well as each member of our Board. Our code of ethics is posted on our website, and we intend to satisfy any disclosure requirement under Item 5.05 of Form 8-K regarding an amendment to, or waiver from, a provision of our code of ethics by posting such information on our website, www.bdsi.com. A copy of our code of ethics is also available in print, without charge, upon written request to 4131 ParkLake Avenue, Suite #225, Raleigh, NC 27612. Attn: Ernest R. De Paolantonio.

Table of Contents

Compensation Discussion and Analysis

The Compensation Committee of our board of directors has the responsibility to review, determine and approve the compensation for our executive officers. Further, the Compensation Committee oversees our overall compensation strategy, including compensation policies, plans and programs that cover all employees.

We currently employ three executive officers, each of whom serves as a Named Executive Officer (or NEO) for purposes of SEC reporting: (1) Mark A. Sirgo, Pharm.D., our President and Chief Executive Officer (who we refer to in this Compensation Discussion and Analysis as our CEO); (2) Ernest R. DePaolantonio, CPA, MBA, our Secretary, Treasurer and Chief Financial Officer; and (3) Andrew L. Finn, Pharm.D., our Executive Vice President of Product Development.

This Compensation Discussion and Analysis sets forth a discussion of the compensation for our NEOs as well as a discussion of our philosophies underlying the compensation for our NEOs and our employees generally.

Objectives of Our Compensation Program

The Compensation Committee s philosophy seeks to align the interests of our stockholders, officers and employees by tying compensation to individual and company performance, both directly in the form of salary or annual cash incentive payments, and indirectly in the form of equity awards. The objectives of our compensation program enhance our ability to:

- attract and retain qualified and talented individuals; and
- provide reasonable and appropriate incentives and rewards to our team for building long-term value within our company, in each case in a manner comparable to companies similar to ours.

In addition, we strive to be competitive with other similarly situated companies in our industry. The process of developing pharmaceutical products and bringing those products to market is a long-term proposition and outcomes may not be measurable for several years. Therefore, in order to build long-term value for our company and its stockholders, and in order to achieve our business objectives, we believe that we must compensate our officers and employees in a competitive and fair manner that reflects current company activities but also reflects contributions to building long-term value.

We utilize the services of the Radford Group, an AON consulting company (which we refer to herein as Radford), to review compensation programs of peer companies in order to assist the Compensation Committee in determining the compensation levels for our NEOs, as well as for other employees of our company. Radford is a recognized independent consulting company and services clients throughout the United States.

The companies that comprise our peer group are selected and reviewed no less frequently than biennially. The current peer group used to evaluate compensation for the fiscal year ended December 31, 2014 includes the following companies:

Company	Location

Aegerion Pharmaceuticals, Inc.	Cambridge, MA
AMAG Pharmaceuticals, Inc.	Waltham, MA
Arena Pharmaceuticals, Inc.	San Diego, CA
ARIAD Pharmaceuticals, Inc.	Cambridge, MA
Avanir Pharmaceuticals, Inc.	Aliso Viejo, CA
BioCryst Pharmaceuticals, Inc.	Durham, NC
Corcept Therapeutics Incorporated	Menlo Park, CA
CTI BioPharma Corp.	Seattle, WA
Depomed, Inc.	Newark, NJ
Dyax Corp.	Burlington, MA
Galena BioPharma, Inc.	Lake Oswego, OR
Halozyme Therapeutics, Inc.	San Diego, CA
Horizon Pharma plc	Dublin, Ireland
Hyperion Therapeutics, Inc.	Brisbane, CA
ImmunoGen, Inc.	Waltham, MA
Insys Therapeutics, Inc.	Phoenix, AZ
Ligand Pharmaceuticals, Inc.	La Jolla, CA
Momenta Pharmaceuticals, Inc.	Cambridge, MA
Orexigen Therapeutics, Inc.	La Jolla, CA
Osiris Therapeutics, Inc.	Columbia, MD
Pozen Inc.	Chapel Hill, NC
Raptor Pharmaceuticals Corp.	Novato, CA
Sucampo Pharmaceuticals, Inc.	Bethesda, MD
Supernus Pharmaceuticals, Inc.	Rockville, MD
Vanda Pharmaceuticals, Inc.	Rockville, MD

Table of Contents

With respect to our employees and non-senior management, we will also take into consideration regional market data in determining appropriate compensation packages, and we have in the past relied on Radford to provide us with such data.

Elements of Our Compensation Program and Why We Chose Each

Main Compensation Components

Our company-wide compensation program, including for our NEOs, is broken down into three main components: base salary, performance cash bonuses and potential long-term compensation in the form of stock options or restricted stock units (RSUs). We believe these three components constitute the minimum essential elements of a competitive compensation package in our industry. We also have a Performance Long Term Incentive Plan for our NEOs and selected senior officers of our company.

Salary

Base salary is used to recognize the experience, skills, knowledge and responsibilities required of our NEOs as well as recognizing the competitive nature of the biopharmaceutical industry. This is determined partially by evaluating our peer companies as well as the degree of responsibility and experience levels of our NEOs and their overall contributions to our company. Base salary is one component of the compensation package for NEOs; the other components being cash bonuses, annual equity grants, a long-term incentive plan and company benefit programs. Base salary is determined in advance whereas the other components of compensation are awarded in varying degrees following an assessment of the performance of a NEO. This approach to compensation reflects the philosophy of our board of directors and its Compensation Committee to emphasize and reward, on an annual basis, performance levels achieved by our NEOs.

Performance Bonus Plan

We have a performance bonus plan under which bonuses are paid to our NEOs based on achievement of company performance goals and objectives established by the Compensation Committee and/or our board of directors as well as on individual performance. The bonus program is discretionary and is intended to: (i) strengthen the connection between individual compensation and our company s achievements; (ii) encourage teamwork among all disciplines within our company; (iii) reinforce our pay-for-performance philosophy by awarding higher bonuses to higher performing employees; and (iv) help ensure that our cash compensation is competitive. Depending on the cash position of the company, the Compensation Committee and our board of directors have the discretion after consulting with the Chief Executive Officer to not pay cash bonuses in order that we may conserve cash and support ongoing development programs and commercialization efforts. Regardless of our cash position, we consistently grant annual merit-based stock options (and, more recently, RSUs) to continue incentivizing both our senior management and our employees.

Based on their employment agreements, each NEO is assigned a target payout under the performance bonus plan, expressed as a percentage of base salary for the year. Actual payouts under the performance bonus plan are based on the achievement of corporate performance goals and an assessment of individual performance, each of which is separately weighted as a component of such officer s target payout. For the NEOs, the corporate goals receive the highest weighting in order to ensure that the bonus system for our management team is closely tied to our corporate performance. Each employee also has specific individual goals and objectives as well that are tied to the overall corporate goals. For employees, mid-year and end-of-year progress is reviewed with the employees managers.

Equity Incentive Compensation

We view long-term compensation, currently in the form of stock options and RSUs, generally vesting in annual increments over three years, as a tool to align the interests of our NEOs and employees generally with the creation of stockholder value, to motivate our employees to achieve and exceed corporate and individual objectives and to encourage them to remain employed by the company. While cash compensation is a significant component of employees overall compensation, the Compensation Committee and our board of directors (as well as our NEOs) believe that the driving force of any employee working in a small biotechnology company should be strong equity participation. We believe that this not only creates the potential for substantial longer term corporate value but also serves to motivate employees and retain their loyalty and commitment with appropriate personal compensation.

Table of Contents

Performance Long Term Incentive Plan

In December 2012, in anticipation of the commencement of substantial revenue generation operations by means of product commercialization, the Compensation Committee approved the BDSI Performance Long Term Incentive Plan (which we refer to as the LTIP). The LTIP is designed as an incentive for our senior management (including our NEOs) to generate revenue for our company.

The LTIP consists of Restricted Stock Units (as defined under our 2011 Equity Incentive Plan, and which we refer to as Performance RSUs) which are rights to acquire shares of our common stock. All Performance RSUs granted under the LTIP will be granted under our 2011 Equity Incentive Plan (as the same may be amended, supplemented or superseded from time to time) as Performance Compensation Awards under such plan. The participants in the LTIP are either NEOs or senior officers of our company.

The term of the LTIP began with our fiscal year ended December 31, 2012 and lasts through our fiscal year ended December 31, 2019. The total number of Performance RSUs covered by the LTIP is 1,078,000, of which 978,000 were awarded in 2012 (and 95,000 in 2015). The Performance RSUs under the LTIP did not vest upon granting, but instead are subject to potential vesting each year over the 8 year term of the LTIP depending on the achievement of revenue by our company, as reported in our Annual Report on Form 10-K. During 2013 and 2014, 8,986 and 4,447 Performance RSUs vested, respectively. Performance RSUs will be valued on the day of issuance and will vest annually on the last day preceding the first open trading window after filing our Annual Report on Form 10-K based on the revenue achieved during the prior fiscal year as a proportion of the total cumulative revenue target for the entire term of the LTIP (which we call the Predefined Cumulative Revenue). Predefined Cumulative Revenue is a predefined aggregate revenue target for the entire term of the LTIP that was determined by the Compensation Committee in conjunction with our executive management. The Predefined Cumulative Revenue may be adjusted by the Compensation Committee upon the occurrence of extraordinary corporate events during the term of the LTIP (such as acquisitions by our company of revenue generating businesses or assets).

Other Compensation

In addition to the main components of compensation outlined above, we also provide contractual severance and/or change in control benefits to the NEOs as well as Dr. Niraj Vasisht, our Senior Vice President Product Development and CTO, to Albert J. Medwar, our Vice President of Marketing, to George Ng, our Senior Vice President and General Counsel and to David L. Acheson, our Vice President Sales and Managed Markets. James A. McNulty, our former Senior Vice President, Finance and Treasurer, retired from the Company as of December 31, 2014 and received contractual severance benefits as a condition of his retirement. The change in control benefits for all applicable persons have a double trigger. A double-trigger means that the executive officers will receive the change in control benefits described in the agreements only if there is both (1) a Change in Control of our company (as defined in the agreements) and (2) a termination by us of the applicable person s employment without cause or a resignation by the applicable persons for good reason (as defined in the agreements) within a specified time period prior to or following the Change in Control. We believe this double trigger requirement creates the potential to maximize stockholder value because it prevents an unintended windfall to management as no benefits are triggered solely in the event of a Change in Control while providing appropriate incentives to act in furtherance of a change in control that may be in the best interests of the stockholders. We believe these severance or change in control benefits are important elements of our compensation program that assist us in retaining talented individuals at the executive and senior managerial levels and that these arrangements help to promote stability and continuity of our executives and senior management team. Further, we believe that the interests of our stockholders will be best served if the interests of these members of our management are aligned with theirs. We believe that providing change in control benefits lessens or eliminates any potential reluctance of members of our management to pursue potential change in control transactions

that may be in the best interests of the stockholders. We also believe that it is important to provide severance benefits to members of our management, to promote stability and focus on the job at hand.

We also provide benefits to the executive officers that are generally available to all regular full-time employees of our company, including our medical and dental insurance, life insurance and a 401(k) match for all individuals who participate in the 401(k) plan. At this time, we do not provide any perquisites to any of our NEOs. Further, we do not have deferred compensation plans, pension arrangements or post-retirement health coverage for our executive officers or employees. All of our employees not specifically under contract are at-will employees, which means that their employment can be terminated at any time for any reason by either us or the employee. Our NEOs (as well as certain of our senior managers) have employment agreements that provide lump sum compensation in the event of their termination without cause or, under certain circumstances, upon a Change of Control.

Determination of Compensation Amounts

A number of factors impact the determination of compensation amounts for our NEOs, including the individual s role in the company and individual performance, length of service with the company, competition for talent, individual compensation package, assessments of internal pay equity and industry data. Stock price performance has generally not been a factor in determining annual compensation because the price of our common stock is subject to a variety of factors outside of our control.

Table of Contents

Industry Survey Data

In collaboration with Radford, we establish and maintain a list of peer companies to best assure ourselves that we are compensating our executives on a fair and reasonable basis, as set forth above under the heading Objectives of our Compensation Program. We also utilize Radford-prepared data for below-executive level personnel, which data focuses on similarly-sized life science companies in the Southeastern region of the United States. The availability of peer data is used by the Compensation Committee strictly as a guide in determining compensation levels with regard to salaries, cash bonuses and performance related annual equity grants to all employees. However, the availability of this data does not imply that the Compensation Committee is under any obligation to exactly follow peer companies in compensation matters.

Determination of Base Salaries

As a guideline for NEO base salary, we perform formal benchmarks against respective comparable positions in our established peer group. Our guideline is to set targeted NEO salary ranges between the 25th and 50th percentile for comparable positions within our peer group. We then adjust salaries based on our assessment of our NEOs levels of responsibility, experience, overall compensation structure and individual performance. The Compensation Committee has the discretion if it believes circumstances warrant, to go above the 50th percentile of the peer group. The Compensation Committee is not obliged to raise salaries purely on the availability of data. Merit-based increases to salaries of executive officers are based on our assessment of individual performance and the relationship to applicable salary ranges. Cost of living adjustments may also be a part of that assessment. The Compensation Committee, in recent years, has tended to maintain cash compensation levels at or near the 50th percentile but to exceed that level in determining equity compensation. The emphasis on equity compensation reflects the Committee s objective, given that we are only presently engaging in revenue generating operations, to preserve cash in a prudent manner and yet reward personnel for outstanding performance.

Performance Bonus Plan

Concurrently with the beginning of each calendar year, preliminary corporate goals that reflect our business priorities for the coming year are prepared by the CEO with input from the other executive officers. These goals are weighted by relative importance. The draft goals and proposed weightings are presented to the Compensation Committee and the Board and discussed, revised as necessary, and then approved by our board of directors. The Compensation Committee then reviews the final goals and their weightings to determine and confirm their appropriateness for use as performance measurements for purposes of the bonus program. The goals and/or weightings may be re-visited during the year and potentially restated in the event of significant changes in corporate strategy or the occurrence of significant corporate events. Following the agreement of our board of directors on the corporate objectives, the goals are then shared with all employees in a formal meeting(s), and are reviewed periodically throughout the year at monthly staff meetings and quarterly board of director meetings.

The performance bonus plan for our executive officers and employees in 2014 was adopted by the Compensation Committee in January 2009. The plan sets forth target bonus opportunities, as a percentage of salary, based on the level of responsibility of the position, ranging up to 60% of salary for our CEO, and up to 40% of salary for our NEOs and up to 30% of salary for certain other officers. In setting these percentages, the Compensation Committee determined that the above percentages were reasonable and in line with our peer group. Each employee has the opportunity to achieve up to 100% of his targeted amount, depending on how corporate goals and objectives are achieved, with variances on an employee by employee basis to be determined by our CEO in conjunction with the employees direct report as applicable.

Determination of Equity Incentive Compensation

To assist us in assessing the reasonableness of our equity grant amounts, historically we have reviewed Radford supplied information and, prior to Radford, we used information supplied by Equilar. Such information included equity data from a cross-section of the companies in the above-mentioned surveys. Initial, on-hire stock option grant amounts have generally been targeted at the 25th to 50th percentile for that position or similar industry position, adjusted for internal equity, experience level of the individual and the individual s total mix of compensation and benefits provided in his or her offer package. Initial on-hire grants typically vest over three years.

In granting equity awards for years prior to 2014, the Compensation Committee utilized a methodology that computes the financial value of the equity granted, applying, as a general guideline, a peer group percentile (up to the 50th percentile for years up to and including 2012, and the 75th percentile for 2013). For 2014, for NEOs and other officers, the Compensation Committee utilized a methodology, based upon Radford supplied peer group data, that computes the number of RSUs granted as a percentage of outstanding common stock, again generally referencing the 75th percentile. For two NEOs and three other officers, however, the Committee granted awards for 2014 which exceed the 75th percentile. See Special Equity Awards under 2014 Compensation Decisions below.

Table of Contents

The change in calculation methodologies described above resulted in the issuance for 2014 of a higher number of RSUs, and therefore a higher financial value, than if the financial value methodology were used. The Compensation Committee believes that this change in methodology was warranted and is appropriate in light of the performance of the NEOs and other executives in 2014.

Equity Grant Practices

All stock options and/or RSUs granted to the NEOs and other executives are approved by the Compensation Committee. Exercise prices for options are set using a 30-day volume weighted average price method, which we define as the closing price of our common stock on the Nasdaq Capital Market on the trading day of the date of grant and the 30 trading days preceding that date. RSU grants are valued on the day of issuance and are vested on the last day preceding an open window after filing our annual report for equity trading. These RSU s will vest annually in one-third increments on the last day preceding an open window after filing our annual report for equity trading for company employees. Grants are generally made: (i) on the employee s start date and (ii) at board of director meetings held each January and following annual performance reviews. However, grants have been made at other times during the year. The size of year-end grants for each NEO is assessed against our internal equity guidelines. Current market conditions for grants for comparable positions and internal equity may also be assessed. Also, grants may be made in connection with promotions or job related changes in responsibilities. In addition, on occasion, the Compensation Committee may make additional special awards for extraordinary individual or company performance.

Compensation Setting Process

At the January meetings of our board of directors and the Compensation Committee, overall corporate performance and relative achievement of the corporate goals for the prior year are assessed. The relative achievement of each goal is assessed and quantified and the summation of the individual components results in a corporate goal rating, expressed as percentages. The Compensation Committee then approves the final disbursement of salary increases, cash bonuses and option or RSU grants.

Also near the end of the year, the CEO evaluates the individual performance of each NEO (other than himself) and provides the Compensation Committee with an assessment of the performance of such NEO. In determining the individual performance ratings of the NEOs, we assess performance against a number of factors, including each NEO s relative contributions to our corporate goals, demonstrated career growth, level of performance in the face of available resources and other challenges, and the respective officer s department s overall performance. This assessment is conducted in a holistic fashion, in contrast to the summation of individual components as is done to arrive at the corporate goal rating.

Following a qualitative assessment of individual NEO s performance, our policies provide guidelines for translating this performance assessment into a numerical rating. Both the initial qualitative assessment and the translation into a numerical rating are made by the Compensation Committee on a discretionary basis. We believe that conducting a discretionary assessment for the individual component of the NEOs performance provides for flexibility in the evaluation of our NEOs and their adaptability to addressing potential changes in company priorities throughout the year.

The Compensation Committee looks to the CEO s performance assessments of the other NEOs and his recommendations regarding a performance rating for each, as well as input from the other members of our board of directors. These recommendations may be adjusted by the Compensation Committee prior to finalization. For the CEO, the Compensation Committee evaluates his performance, taking into consideration input from the other members of our board of directors, and considers the achievement of overall corporate objectives by both the CEO

specifically and the company generally. The CEO is not present during the Compensation Committee s deliberations regarding his compensation.

The CEO also presents any recommended changes to base salary and recommendations for an annual equity grant amount, referencing the equity guidelines, for each of the NEOs (other than himself).

The Compensation Committee has the authority to directly engage, at our company s expense, any compensation consultants or other advisors (such as Radford) that it deems necessary to determine the amount and form of employee, executive and director compensation. In determining the amount and form of employee, executive and director compensation, the Compensation Committee has reviewed and discussed historical salary information as well as salaries for similar positions at comparable companies. However the availability of this data does not imply that the Compensation Committee is under any obligation to exactly follow peer companies compensation practices.

We paid consultant fees to Radford of $0.011 million in 2014. NEOs may have indirect input in the compensation results for other executive officers by virtue of their participation in the performance review and feedback process for the other executive officers.

Table of Contents

2014 Compensation Decisions

General Assessment of Management Performance in 2014

The Compensation Committee and our board of directors conducted the performance and compensation review for 2014 during January 2015. In assessing our performance towards the achievement of stated corporate goals for the year, the Compensation Committee and the Board agreed that the results, when compared to the objectives, were 100% achieved. There were many critical goals that needed to be addressed and followed with critical attention to detail throughout the year, and our company was able to achieve those goals.

The primary focus of management and employees in 2014 was (1) with respect to BUNAVAIL®, continuing the product developmental process, successfully obtaining FDA approval, and developing the administrative and personnel infrastructure, in conjunction with external, contracted resources, for the launch of market sales, (2) continuing the development, in conjunction with our partner Endo of our BELBUCA chronic pain program, and (3) continuing the development of our Clonidine Topical Gel product for PDN. Additional potential goals set at the beginning of 2014 also included the acquisition or in-licensing of additional product opportunities.

With respect to BUNAVAIL®: We completed key clinical studies; provided timely responses to the FDA regarding our NDA submission, obtaining FDA approval in June; made satisfactory arrangements for product manufacturing to support a market launch in the fourth quarter; developed a comprehensive product launch plan which included, in association with Quintiles, our contract sales organization, the recruitment of a dedicated sales force, the engagement of appropriate marketing resources, the hiring of additional in-house management and administrative personnel, and the development of several marketing programs; and commenced a nation-wide product launch in November.

With respect to our chronic pain program BELBUCA , we successfully completed several clinical studies, and assisted our partner Endo in the preparation of an NDA, resulting in the submission of the NDA in December 2014, which was accepted for filing in February 2015.

With respect to Clonidine Topical Gel, we initiated in the first quarter a 240-person Phase 3 clinical study and completed an interim data analysis in the fourth quarter, initiated a long-term safety study, and identified, and worked with, manufacturing resources to assure future commercial product availability. The Phase 3 study also completed patient enrollment on schedule.

Other notable achievements in 2014 included: a $60 million equity financing on favorable terms; continuing success in the protection and enhancement of our intellectual property with additional company patent applications and several favorable court and U.S. Patent Office rulings; the consolidation of our financial and accounting operations at our Raleigh, North Carolina, headquarters and the implementation of appropriate accounting systems and protocols in anticipation of the commercial marketing and sales of BUNAVAIL®; and the licensing to the company by Evonik of a development-stage, buprenorphine depot injection product.

2014 Cash Bonus Calculations

Our performance bonus plan for 2014 provided for target payouts to all employees expressed as a percentage of base salary. For our CEO, the target bonus opportunity was 60% of base salary, for our Chief Financial Officer it was 35% of base salary, and for our Executive Vice President of Product Development it was 40% of base salary.

Our board of directors and its Compensation Committee concluded that the achievements described above, which reflect the efforts of all our employees, including the NEOs, constituted the attainment by the company of 100% of its

2014 corporate goals and therefore awarded 100% payment of performance cash bonuses. The cost of all such bonuses was approximately $1.6 million.

2014 Equity Awards

In February 2015, equity awards for performance in 2014 were granted to nine corporate officers (including our NEOs) in the form of RSUs. Five of these officers, including two NEOs, all of whom have served the company in high-level management positions from the early stages of the company s development, were granted special awards, as will be described below under the heading Special Equity Awards. The other four officers were granted RSUs based upon the 75th percentile of the company s peer group, as measured by the number of shares awarded as a percentage of total outstanding shares of common stock awarded. The RSUs awarded to the nine officers vest annually in one-third equal increments beginning one year after the date of grant. The total amount of the RSUs awarded is 2,102,615 having an approximate value of $30.3 million.

All other employees of the company (excluding only certain recently-hired persons) were granted stock options priced at the 30-day volume weighted average price of our common stock as of the close the market on February 23, 2015. The amount of options granted was based upon the 50-75th percentile of our peer group, as measured by the salary of the recipient. All options vest annually in one-third equal increments beginning one year after the date of grant. The total amount of options awarded was 77,357, having an approximate value of $1.1 million.

Table of Contents

Individual Performance and Compensation of the President and CEO

Dr. Sirgo s base salary in 2014 of $479,357 had been established in July 2013, effective January 1, 2014, and has been increased by the Compensation Committee to $550,000, effective January 1, 2015. His 2015 salary is approximately at the 50th percentile of the company s peer group and therefore is consistent with the company s compensation philosophy.

For 2014, the Compensation Committee acted to compensate Dr. Sirgo in an appropriate manner for his long-standing leadership of the company resulting in several notable achievements during the year, in particular: FDA approval of BUNAVAIL® following years of development; the building of an organization of sales, marketing and related administrative staffs and external resources to support the company s launch of BUNAVAIL® into the marketplace; working with the company s partner Endo to achieve the NDA submission of BELBUCA in December 2014; his continuing exemplary relationship with the investment community and company shareholders; the in-licensing of a new product opportunity in the form of our buprenorphine depot injection, a successful $60 million equity financing; and his overall advancement of the company s short and long-term objectives. Consequently, in addition to the above-mentioned increase in base salary, the Committee awarded Dr. Sirgo 100% of his cash target bonus (60% of base salary), one-half of which was paid in July 2014, and a significant equity award, which is described below under Special Equity Awards.

Individual Performance and Compensation of the Chief Financial Officer

Mr. De Paolantonio, who joined our company in October, 2013, received a base salary of $300,000 in 2014, which was increased to $350,000, effective January 1, 2015. In assessing Mr. De Paolantonio s 2014 performance, the Compensation Committee concluded that he had done an outstanding job in the following areas: the consolidation of accounting and financial functions, which previously had been divided between company offices in Tampa, Florida, and company headquarters in Raleigh, North Carolina, to the company headquarters in Raleigh; his leadership and expertise in developing appropriate accounting systems and controls with respect to the commencement of commercial operations with the market launch of BUNAVAIL®, which began in November, 2014; his assistance to the CEO with respect to company financings; and his management of accounting, budget and forecasting functions. The Compensation Committee therefore acted to increase his base salary, as set forth above, to approve payment to him of 100% of his cash target bonus, one-half of which was paid in July 2014, and to award to him 103,175 RSUs. His 2015 salary and cash bonus are at the 50th percentile of the company s peer group and his equity award is at the 75th percentile.

Individual Performance and Compensation of the Executive Vice President-Product Development

Dr. Finn s base salary in 2014 of $324,000 had been established in July, 2014, effective January 1, 2014, and has been increased by the Compensation Committee to $375,000, effective January 1, 2015. His 2015 salary is approximately at the 50th percentile of the company s peer group and therefore is consistent with the company s compensation philosophy.

For 2014, the Compensation Committee acted to compensate Dr. Finn in an appropriate manner for his long-standing management of the company s drug development activities which is exemplified by the FDA approval of BUNAVAIL® in June 2014, and, additionally, for the following: the advancement, in association with the company s partner Endo of the development of BELBUCA leading to FDA acceptance in February 2015 of an NDA submission the continuing development of the company s Clonidine Topical Gel product for PDN; and the acquisition from Evonik of licensing and development rights to a buprenorphine depot injection product opportunity. Consequently, in addition to the above-mentioned increase in base salary, the Compensation Committee awarded Dr. Finn 100% of his

cash target bonus (40% of base salary), one-half of which was paid in July, 2014, and a significant equity award, which is described below under Special Equity Awards.

Special Equity Awards

In February, 2015, equity awards which are significantly higher when compared to prior years were granted for 2014 to two NEOs, Mark A. Sirgo, our CEO (800,000 RSUs), and Andrew L. Finn, our Executive Vice President (400,000 RSUs), and to three other officers (an aggregate of 720,000 shares). We refer in this section to such five officers as the Awardees. The financial value to the Awardees of these special equity awards is well above the 100th percentile of the company s peer group; however, the Compensation Committee considered these awards in light of the significant corporate achievements during 2014 as well as in the context of the company s gross equity burn rate and equity overhang , each of which is discussed further below. These awards followed discussions initiated in early October 2014, among the Chairman of the Compensation Committee, the CEO, and the Executive Chairman of the Board of Directors. Those discussions focused on the following considerations:

Company performance in 2014 culminated the realization of strategic objectives first established over ten years earlier and the progression of the company from a predominantly research and development enterprise to one launching its first commercial product.

Table of Contents

These achievements were attained notwithstanding an especially low number of company personnel throughout the ten-year period (consistently below 25) when compared to its peer group.

In 2014, BUNAVAIL® was approved by the FDA for the maintenance treatment of opioid addiction with a subsequent product launch in November with the company s own sales force; two pivotal efficacy trials for BELBUCA for chronic pain were completed and met their endpoints, with a subsequent NDA submission in December and the receipt of $20 million in milestone payments from the company s commercial partner Endo; patient enrollment in a Phase 3 clinical trial for Clonidine Topical Gel was completed; the company in-licensed a new product opportunity (buprenorphine depot injection); and the company completed a $60 million equity offering on favorable terms.

Each of the Awardees had served the company during that ten-year period, except one who joined the company in 2007. Because of the three-year vesting provisions of RSUs, the special awards will likely act as a strong incentive for those executives to remain with the company during a critical stage of transition from product development only to product commercialization.

During the years before 2012, company executives received equity awards well below peer group levels.

The market capitalization of the company and shareholder value of the company has increased significantly since 2011 and yet the Awardees had not benefitted to the extent they would have if equity grants had been at peer-group levels in the years before 2012.

The matter of these special equity awards was first discussed among the Compensation Committee members in mid-October, 2014, and the matter was further discussed by the entire board of directors at its October 2014, meeting, at which time there was a broad consensus that special awards were appropriate provided no adversely material events were to occur prior to a final decision to be made in early 2015. The matter was again discussed by the Compensation Committee and the board of directors at their late January 2015 meetings.

In February 2015, prior to voting upon the proposed special equity awards, the Compensation Committee evaluated the awards in the context of guidelines issued by Institutional Shareholder Services (or ISS), a widely recognized provider of corporate governance solutions to the global financial community. In particular, the Committee examined the company s gross equity burn rate (defined as total options and RSUs granted divided by the weighted-average total common shares). The gross equity burn rate for 2015 is projected to be 4.4%, compared to 3.2% in 2014, and the three-year average gross burn rate for 2013 to 2015 is projected to be 3.8%, compared to 3.3% for 2012-2014. The 75th percentile among the company s peer group is a 5.6% one-year gross burn rate and a 5.5% three-year average gross burn rate. The ISS three-year average gross burn rate maximum is 6.7% for pharmaceutical and biotech companies listed on the Russell 3000, which includes the company.

The Compensation Committee also examined the company s issued equity overhang (defined as total options and RSUs outstanding divided by total common shares issued and outstanding). At December 31, 2014, the company s issued equity overhang was 9.65% which increased to 13.9% at February 28, 2015, still well below the 75th percentile among the company s peer group which is 19.9%.

Consequently, the company s gross equity burn rate and issued equity overhang, as affected by the 2014 awards to the Awardees, was still well below the 75th percentile of the company s peer group and, in the case of its gross burn rate, well within ISS guidelines.

Taking into account all of the factors recited above, on February 23, 2015, the Compensation Committee unanimously acted by written consent to grant the special equity awards to the Awardees.

Table of Contents

Accounting and Tax Considerations

ASC 718. On January 1, 2006, we began accounting for share-based payments in accordance with the requirements of Accounting Standards Codification 718 (ASC 718), Share-Based Payments. To date, the adoption of ASC 718 has not impacted our stock option granting practices.

Internal Revenue Code Section 162(m). At this time, we do not have a policy to factor in 162(m) limitations into the determination of base salary or bonus amounts since the aggregate salary and bonus payments for each individual are below the $1,000,000 deductibility limitation.

Section 409A. Section 409A of the Internal Revenue Code of 1986, as amended generally changes the tax rules that affe ct most forms of deferred compensation that were not earned and vested prior to 2005. Under Section 409(A), deferred compensation is defined broadly and may potentially cover compensation arrangements such as severance or change in control pay outs and the extension of the post-termination exercise periods of stock options. We take Code Section 409A into account, where applicable, in determining the timing of compensation paid to our executive officers.

Code Sections 280G and 4999. Sections 280G and 4999 of the Internal Revenue Code of 1986, as amended (Code Sections 280G and 4999) limit our ability to take a tax deduction for certain excess parachute payments (as defined in Code Sections 280G and 4999) and impose excise taxes on each NEO who receives excess parachute payments in connection with his or her severance from our company in connection with a change in control. We consider the adverse tax liabilities imposed by Code Sections 280G and 4999, as well as other competitive factors, when structuring post-termination compensation payable to our executive officers and generally provide a mechanism for a better after tax result for the NEO, which we believe is a reasonable balance between our interests, on the one hand, and the executive s compensation on the other.

Compensation Risk Assessment

In reviewing our compensation policy and practices for its NEOs as well as for other employees, the Compensation Committee evaluated whether any unnecessary risk-taking was associated with our compensation policies. The Compensation Committee did not identify any risks arising from our compensation policies and practices reasonably likely to have a material adverse effect on our company.

Compensation Committee Independence

All members of the Compensation Committee are independent directors and do not have any formal ties or relationship with any members of management or their relatives.

Table of Contents

Item 11. Executive Compensation.

The following table sets forth all compensation paid to our named executive officers at the end of the fiscal years ended December 31, 2014, 2013 and 2012. Individuals we refer to as our named executive officers include our Chief Executive Officer and our most highly compensated executive officers whose salary and bonus for services rendered in all capacities exceeded $100,000 during the fiscal year ended December 31, 2014.

Name and principal position	Year	Salary ($)	Bonus ($)	Stock Awards ($) (14)	Option Awards ($) (14)	Non-Equity Incentive Plan Compensation ($)	Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
Mark A. Sirgo, Pharm.D. President, Chief Executive Officer and Director	2014	$ 469,441	$ 281,976(1)	$ 2,591,977(2)				$ 33,286(3)	$ 3,376,680
	2013	$ 462,734	$ 276,552	$ 1,760,708(4)				$ 23,849(5)	$ 2,523,843
	2012	$ 435,612	$ 184,842		$ 116,709			$ 48,940(6)	$ 786,103
Ernest R. De Paolantonio, CPA MBA Chief Financial Officer, Secretary and Treasurer (7)	2014	$ 294,231	$ 76,664(8)	$ 227,054(2)				$ 33,716(9)	$ 631,665
	2013	$ 61,154			$ 213,870				$ 275,024
	2012								
Andrew L. Finn, Pharm.D. Executive VP of Product Development	2014	$ 307,013	$ 127,140(10)	$ 1,365,995(2)				$ 38,958(11)	$ 1,839,106
	2013	$ 313,514	$ 124,680	$ 672,961(4)				$ 28,185(12)	$ 1,139,340
	2012	$ 296,785	$ 87,900		$ 73,684			$ 36,755(13)	$ 495,124

(1) The bonus disclosed in this item of $281,976 includes $138,276 related to 2013, but was contingent upon board approval, which occurred January 2014.

(2) The stock awards disclosed in this item consists of unvested executive RSU grants during 2014, which will vest in equal amounts over three years, and vested RSUs as issued during 2014 from the LTIP.

(3) Includes: Vacation payout of $11,076, $7,825 of health insurance premiums paid and 401(k) matching of $14,385 paid in 2014.

(4) The stock awards disclosed in this item consists of unvested executive RSU grants during 2013, which will vest in equal amounts over three years, and vested RSUs as issued during 2013 from the LTIP.

(5) Includes: $9,392 of health insurance premiums paid and 401(k) matching of $14,457 paid in 2013.

(6) Includes: Vacation payout of $26,618, $9,822 of health insurance premiums paid and 401(k) matching of $12,500 paid in 2012.

(7) Ernest R. DePaolantonio was hired as Chief Financial Officer on October 9, 2013

(8) The bonus disclosed in this item of $76,664 includes $24,164 related to 2013, but was contingent upon board approval, which occurred January 2014.

(9) Includes: $18,099 of health insurance premiums paid, 401(k) matching of $11,417 and $4,200 of relocation expenses paid in 2014.

(10) The bonus disclosed in this item of $127,140 includes $62,340 related to 2013, but was contingent upon board approval, which occurred January 2014.
(11) Includes: Vacation payout of $6,585, $9,810 of health insurance premiums paid and 401(k) matching of $22,563 paid in 2014.
(12) Includes: $9,392 of health insurance premiums paid and 401(k) matching of $18,793 paid in 2013.
(13) Includes: Vacation payout of $13,894, $10,361 of health insurance premiums paid and 401(k) matching of $12,500 paid in 2012.
(14) The reported amounts represent the aggregate grant date fair value of the awards computed in accordance with Financial Accounting Standards Board Account Standards Codification Topic 718, Stock Compensation, as modified or supplemented, or FASB ASC Topic 718.

Narrative Disclosure to Summary Compensation Table

Employment Agreements

Except as set forth below, we currently have no written employment agreements with any of our officers, directors, or key employees. All directors and officers have executed confidentiality and noncompetition agreements with us.

Table of Contents

The following is a description of our current executive employment agreements:

Mark A. Sirgo, Pharm.D., President and Chief Executive Officer - Dr. Sirgo s current employment agreement, dated February 22, 2007, as amended, is subject to successive, automatic one-year extensions unless either party gives notice of non-extension to the other party at least 30 days prior to the end of the applicable term. The agreement includes a base salary, target bonus of up to 50% of his base salary (which was subject to modification with the approval of our Compensation Committee and is now 60%), and other employee benefits. Under the terms of his agreement, Dr. Sirgo received base salary in 2014 of $469,441 per year and a bonus of $281,976, which bonus was composed of $138,276 related to 2013 and $143,700 related to 2014 performance.

We may terminate Dr. Sirgo s employment agreement without cause and Dr. Sirgo may resign upon 30 days advance written notice. We may immediately terminate Dr. Sirgo s employment agreement for Good Cause (as defined in the agreement). Upon the termination of Dr. Sirgo s employment for any reason, Dr. Sirgo will continue to receive payment of any base salary earned but unpaid through the date of termination and any other payment or benefit to which he is entitled under the applicable terms of any applicable company arrangements. If Dr. Sirgo is terminated during the term of the employment agreement other than for Good Cause (as defined in the employment agreement), or if Dr. Sirgo terminates his employment for Good Reason (as defined in the employment agreement), Dr. Sirgo is entitled to a lump sum severance payment equal to 1 times the sum of his annual base salary plus a pro-rata annual bonus based on his target annual bonus. In the event that such termination is within six months following a Change of Control (as defined in the employment agreement), the lump sum paid to Dr. Sirgo will equal the sum of his then current annual base salary plus an amount equal to fifty percent (50%) of his then current annual base salary, multiplied by 2. In addition, Dr. Sirgo s employment agreement will terminate prior to its scheduled expiration date in the event of Dr. Sirgo s death or disability.

Dr. Sirgo s employment agreement also includes a 2 year non-competition and non-solicitation and confidentiality covenants on terms identical to the existing employment agreement. Under the terms of this agreement, he is also entitled to the following benefits: medical, dental and disability and 401(k).

Ernest R. De Paolantonio, CPA, MBA, Chief Financial Officer, Secretary and Treasurer - Mr. De Paolantonio s current employment agreement, dated October 1, 2013 includes a base salary of $300,000, target bonus of up to 35% of his base salary (which is subject to modification by our Compensation Committee), and other employee benefits. Under the terms of his agreement, Mr. De Paolantonio received base salary in 2014 of $294,231 per year and a bonus of $76,664, which bonus was composed of $24,164 related to 2013 and $52,500 related to 2014 performance.

We may terminate Mr. De Paolantonio s employment agreement without cause and Mr. De Paolantonio may resign without notice. We may immediately terminate Mr. De Paolantonio s employment agreement for Good Cause (as defined in the agreement). Upon the termination of Mr. De Paolantonio s employment for any reason, Mr. De Paolantonio will continue to receive payment of any base salary earned but unpaid through the date of termination and any other payment or benefit to which he is entitled under the applicable terms of any applicable company arrangements. If Mr. De Paolantonio is terminated during the term of the employment agreement other than for Good Cause (as defined in the employment agreement), or if Mr. De Paolantonio terminates his employment for Good Reason (as defined in the employment agreement), Mr. De Paolantonio is entitled to a lump sum severance payment equal to 1 times the sum of his annual base salary. In the event that such termination is within six months following a Change of Control (as defined in the employment agreement), the lump sum paid to Mr. De Paolantonio will equal to 1 times the sum of his then current annual base salary. In addition, Mr. De Paolantonio s employment agreement will terminate prior to its scheduled expiration date in the event of Mr. De Paolantonio s death or disability.

Andrew L. Finn, Pharm.D., Executive Vice President of Product Development Dr. Finn s current employment agreement, dated February 22, 2007, as amended, is subject to successive, automatic one-year extensions unless either party gives notice of non-extension to the other party at least 30 days prior to the end of the applicable term. The agreement includes a base salary, target bonus of up to 50% of his base salary (which was subject to modification with the approval of our Compensation Committee and is now 40%), and other employee benefits. Under the terms of his agreement, Dr. Finn received base salary in 2014 of $307,013 per year and a bonus of $127,140, which bonus composed of $62,340 related to 2013 and $64,800 related to 2014 performance.

We may terminate Dr. Finn s employment agreement without cause and Dr. Finn may resign upon 30 days advance written notice. We may immediately terminate Dr. Finn s employment agreement for Good Cause (as defined in the agreement). Upon the termination of Dr. Finn s employment for any reason, Dr. Finn will continue to receive payment of any base salary earned but unpaid through the date of termination and any other payment or benefit to which he is entitled under the applicable terms of any applicable company arrangements. If Dr. Finn is terminated during the term of the employment agreement other than for Good Cause (as defined in the employment agreement), or if Dr. Finn terminates his employment for Good Reason (as defined in the employment agreement), Dr. Finn is entitled to a lump sum severance payment equal to 1 times the sum of his annual base salary plus a pro-rata annual bonus based on his target annual bonus. In the event that such termination is within six months following a Change of Control (as defined in the employment agreement), the lump sum paid to Dr. Finn will equal the sum of his then current annual base salary plus an amount equal to fifty percent (50%) of his then current annual base salary, multiplied by 1.5. In addition, Dr. Finn s employment agreement will terminate prior to its scheduled expiration date in the event of Dr. Finn s death or disability.

Table of Contents

Dr. Finn s employment agreement also includes a 2 year non-competition and non-solicitation and confidentiality covenants on terms identical to the existing employment agreement, except that if Dr. Finn s employment is terminated upon a Change of Control, the non-competition period will be 18 months. Under the terms of this agreement, he is also entitled to the following benefits: medical, dental and disability and 401(k).

Outstanding equity awards

The following table summarizes outstanding unexercised options, unvested stocks and equity incentive plan awards held by each of our name executive officers, as of December 31, 2014.

OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

	OPTION AWARDS					STOCK AWARDS			
Name	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#)	Option Exercise Prices ($)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested ($)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not vested (#)
Mark A. Sirgo, Pharm.D								369,849[3]	$ 4,445,585
								280,000[4]	$ 3,365,600
								290,511[5]	$ 3,491,942
	33,026			$ 1.96	2/15/22				
	30,280	15,141[1]		$ 1.78	2/9/22				
	25,000			$ 3.47	7/20/21				
	22,369			$ 3.55	2/25/21				
	25,000			$ 2.26	7/21/20				
	34,265			$ 2.43	7/21/20				
	37,348			$ 3.90	1/21/20				
	25,000			$ 5.40	7/22/19				
	100,000			$ 4.83	4/30/19				
	9,175			$ 3.05	1/22/19				
	13,661			$ 2.01	7/24/18				
	48,448			$ 2.85	1/31/18				
	20,000			$ 4.13	7/25/17				
	434,000			$ 6.63	4/13/17				
	45,891			$ 2.42	1/26/17				

49,000		$ 3.03	12/1/15			
20,000		$ 2.94	8/22/15			
Ernest R. De Paolantonio, CPA MBA				25,598(4)	$	307,688
18,553	37,106(2)	$ 5.39	10/17/23			
Andrew L. Finn, Pharm.D				133,146(3)	$	1,600,415
				107,067(4)	$	1,286,945
				153,387(5)	$	1,843,712
18,128		$ 1.96	2/15/22			
20,776	10,389(1)	$ 1.78	2/9/22			
15,348		$ 3.55	2/25/21			
20,873		$ 2.43	7/21/20			
22,751		$ 3.90	1/21/20			
7,439		$ 3.05	1/22/19			
33,231		$ 2.01	7/24/18			
39,282		$ 2.85	1/31/18			
100,000		$ 6.63	4/13/17			
37,209		$ 2.42	1/26/17			

(1) These unvested options will vest on February 9, 2015.

Table of Contents

(2) Of the unvested stock options, half of the unvested stock options will vest on October 17, 2015, and another half will vest on October 17, 2016.
(3) Unvested stock awards consist of Restricted Stock Units from our Long Term Incentive Plan (as defined under our 2011 Equity Incentive Plan) and which we refer to as Performance RSUs, which are rights to acquire shares of our common stock.
(4) Unvested stock awards consist of Restricted Stock Units (as defined under our 2011 Equity Incentive Plan) which are rights to acquire shares of our common stock. These unvested RSUs vest as to one half on February 20, 2015 and the remaining half on February 20, 2016.
(5) Unvested stock awards consist of Restricted Stock Units (as defined under our 2011 Equity Incentive Plan) which are rights to acquire shares of our common stock. These unvested RSUs vest as to one third on February 22, 2015, one third on February 22, 2016, and the remaining third on February 22, 2017.

Outstanding Equity Awards Narrative Disclosure

Amended and Restated 2001 Incentive Plan

In July 2011, our original Amended and Restated 2001 Incentive Plan expired. Options to purchase 2,073,039 shares of common stock were outstanding as of December 31, 2014 under the Amended and Restated 2001 Incentive Plan. Although the Amended and Restated 2001 Incentive Plan expired, the 2,073,039 options still outstanding under such plan are still exercisable. In April 2011, our board approved, and in July 2011, our stockholders approved a new 2011 Equity Incentive Plan, which is discussed below.

2011 Equity Incentive Plan

Our 2011 Equity Incentive Plan is comprised of 4,200,000 shares of our common stock. The purpose of the 2011 Equity Incentive Plan is: (i) to align our interests and recipients of options under the plan by increasing the proprietary interest of such recipients in our growth and success, and (ii) to advance our interests by providing additional incentives to officers, key employees and well-qualified non-employee directors and consultants who provide services to us, who are responsible for our management and growth, or otherwise contribute to the conduct and direction of our business, operations and affairs. The Compensation Committee of our board of directors administers our incentive plan, selects the persons to whom options are granted and fixes the terms of such options.

Options may be awarded during the ten-year term of the plan to our employees (including employees who are directors), or consultants who are not employees and our other affiliates. Our plan provides for the grant of options that qualify as incentive stock options, or Incentive Stock Options, under Section 422A of the Internal Revenue Code of 1986, as amended, and options which are not Incentive Stock Options, or Non-Statutory Stock Options, as well as restricted stock and other awards. Only our employees or employees of our subsidiaries may be granted Incentive Stock Options. Our affiliates or consultants or others as may be permitted by our board of directors, may be granted Non-Statutory Stock Options.

Options to purchase 2,950,100 shares of our common stock at prices ranging from $1.38 to $16.36 are outstanding at December 31, 2014. There were no options granted during 2014 whose exercise price was lower than the estimated market price of the stock at the grant date.

Options issued during 2014 to employees under the 2011 Equity Incentive Plan totaled 174,480 shares, at exercise prices ranging from $5.58 to $16.36. There were no options issued to directors and officers under the 2011 Equity Incentive Plan during 2014 as we have migrated to the issuance of RSUs.

Option Exercises and Stock Vested

The following information sets forth stock options exercised by the executive officers during the year ended December 31, 2014:

	OPTION AWARDS		STOCK AWARDS	
Name	**Number of Shares Acquired on Exercise (#)**	**Value Realized on Exercise ($)**	**Number of Shares Acquired on Vesting (#)**	**Value Realized on Vesting ($)**
Mark A. Sirgo, Pharm.D.	62,471	$ 401,079	141,705	$ 1,261,144
Ernest R. De Paolantonio, CPA MBA				
Andrew L. Finn, Pharm.D.	73,679	$ 429,022	54,148	$ 481,905

Pension Benefits

None of our employees participate in or have account balances in qualified or non-qualified defined benefit plans sponsored by us. Our Compensation Committee may elect to adopt qualified or non-qualified benefit plans in the future if it determines that doing so is in our company s best interests.

Table of Contents

Nonqualified Deferred Compensation

None of our employees participate in or have account balances in nonqualified defined contribution plans or other nonqualified deferred compensation plans maintained by us. Our Compensation Committee may elect to provide our officers and other employees with non-qualified defined contribution or other nonqualified deferred compensation benefits in the future if it determines that doing so is in our company s best interests.

Grants of Plan-Based Awards in 2014

		Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Stock Awards: Number of Shares of Stocks or Units	All Other Option Awards: Number of Securities Underlying Options	Exercise or Base Price of Option Awards	Closing stock price on Award date	Gra
	Grant Date	Threshold ($)	Target ($)	Maximum ($)	Threshold (#)	Target (#) (1)	Maximum (#)	(#)	(#)	($/Sh)	($/Sh)	Date Valu Stock Opt Awa
A. D.	2/22/14					290,511						$ 2,57
R. De tonio, IBA	2/22/14					25,598						$ 22
v L. D	2/22/14					153,387						$ 1,36

(1) The stock awards disclosed in this item consists of RSUs issued under our 2011 Equity Incentive Plan, which vest in thirds beginning February 2015.

Narrative to Grants of Plan Based Awards Table

See Compensation Discussion and Analysis above for complete description of the targets for payment of annual incentives, as well as performance criteria on which such payments were based.

Options granted to employees vest over 36 months beginning on the first anniversary of the grant date at which time 33% of such options vest. These options expire in 10 years and are outstanding for as long as the individual is an active employee. Employee options qualify as Incentive Stock Options.

Potential Payments Under Severance/Change in Control Arrangements

The table below sets forth potential payments payable to our current executive officers in the event of a termination of employment under various circumstances. For purposes of calculating the potential payments set forth in the table below, we have assumed that (i) the date of termination was December 31, 2014 and (ii) the stock price was $12.02, which was the closing market price of our common stock on December 31, 2014, the last business day of the 2014 fiscal year.

Name	If Company Terminates Executive Without Cause or Executive Resigns with Good Reason($)	Termination Following a Change in Control without Cause or Executive Resigns with Good Reason($)
Mark A. Sirgo, Pharm.D.		
Cash Payment	$ 736,923[1]	$ 1,455,423[1]
Acceleration of Options		$ 7,183,973[2]
Total Cash and Benefits	**$ 736,923**	**$ 8,639,396**
Ernest R. De Paolantonio, CPA		
Cash Payment	$ 459,046[1]	$ 309,046[1]
Acceleration of Options		$ 369,019[2]
Total Cash and Benefits	**$ 459,046**	**$ 678,065**

Table of Contents

Name	If Company Terminates Executive Without Cause or Executive Resigns with Good Reason($)	Termination Following a Change in Control without Cause or Executive Resigns with Good Reason($)
Andrew L. Finn, Pharm.D.		
Cash Payment	$ 495,957[1]	$ 738,957[1]
Acceleration of Options		2,672,198[2]
Total Cash and Benefits	**$ 495,957**	**$ 3,411,155**

(1) Includes severance payment and accrued and unused vacation time as of December 31, 2014.
(2) Determined by taking excess of the fair market value of our common stock on December 31, 2014, less the exercise price of each accelerated option.

For each of our executive officers, in their employment agreements the term change of control means the occurrence of any one or more of the following events (it being agreed that, with respect to paragraphs (i) and (iii) of this definition below, a change of control shall not be deemed to have occurred if the applicable third party acquiring party is an affiliate of our company within the meaning of Rule 405 promulgated under the Securities Act of 1933, as amended):

(i) An acquisition (whether directly from our company or otherwise) of any voting securities of our company by any person or entity, immediately after which such person or entity has beneficial ownership of forty percent (40%) or more of the combined voting power of our then outstanding voting securities.

(ii) The individuals who, as of the date hereof, are members of the our board of directors cease, by reason of a financing, merger, combination, acquisition, takeover or other non-ordinary course transaction affecting our company, to constitute at least fifty-one percent (51%) of the members of our board of directors; or

(iii) Approval by our board of directors and, if required, our stockholders of, or our execution of any definitive agreement with respect to, or the consummation of (it being understood that the mere execution of a term sheet, memorandum of understanding or other non-binding document shall not constitute a change of control):

(A) A merger, consolidation or reorganization involving our company, where either or both of the events described in clauses (i) or (ii) above would be the result;

(B) A liquidation or dissolution of or appointment of a receiver, rehabilitator, conservator or similar person for, or the filing by a third party of an involuntary bankruptcy against, our company; or

(C) An agreement for the sale or other disposition of all or substantially all of the assets of our company to any person or entity (other than a transfer to a subsidiary of our company).

The cash component (as opposed to option accelerations) of any change of control payment would be structured as a one-time cash severance payment.

Compensation of Directors Summary Table

DIRECTOR COMPENSATION

Name (a)	Fees Earned or Paid in Cash ($)	Stock Awards ($)(6)	Option Awards ($)	Non-Equity Incentive Plan Compensation ($)	Non-Qualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
Frank E. O Donnell, Jr.	$ 375,708(1)	$ 1,296,013(2)				$ 19,924(3)	$ 1,691,645
William B. Stone	$ 74,000	$ 398,400(4)					$ 472,400
John J. Shea	$ 51,250	$ 265,600(4)					$ 316,850
Samuel P. Sears, Jr.	$ 57,500	$ 265,600(4)					$ 323,100
Thomas W. D Alonzo	$ 47,750	$ 265,600(4)					$ 313,350
Charles J. Bramlage	$ 20,544	$ 93,675(5)					$ 114,219
Barry I. Feinberg	$ 21,685	$ 93,675(5)					$ 115,360

(1) Compensation for serving as Executive Chairman, which includes $140,988 as bonus, composed of $69,138 for 2013 and $71,850 for 2014.

(2) The stock awards disclosed in this item consists of vested RSUs issued in 2014 under our LTIP and RSUs issued as executive grants in 2014 which vest in thirds beginning in 2015. Does not include 185,418 unvested RSUs to be issued under our LTIP upon the achievement of certain performance criteria.

(3) Includes $19,924 in health benefits paid in 2014.

Table of Contents

(4) The stock awards disclosed in this item consists of RSUs issued in 2014 for serving on the board which half vested in 2014 and the remaining half vest in 2015.

(5) The stock awards disclosed in this item consists of RSUs issued in 2014 as new director issuances which vest in 2015.

(6) The reported amounts represent the aggregate grant date fair value of the awards computed in accordance with Financial Accounting Standards Board Account Standards Codification Topic 718, Stock Compensation, as modified or supplemented, or FASB ASC Topic 718.

Narrative to Director Compensation

The Compensation Committee of our board of directors reviews the Director Remuneration Policy, which establishes the compensation our directors earn for serving on our board of directors and individual committees. The policy follows (all annual cash retainers are paid quarterly in advance):

$40,000 annual cash retainer to each board member.

$10,000 annual cash retainer to the Lead Director.

$15,000 annual cash retainer to the Chairman of the Audit Committee.

$10,000 annual cash retainer to the Chairman of the Compensation Committee.

$7,500 annual cash retainer to the Chairman of the Nominating & Corporate Governance Committee.

$7,500 annual cash retainer to each non-Chairman Audit Committee member.

$7,500 annual cash retainer to each non-Chairman of the Strategic Development Committee

$5,000 annual cash retainer to each non-Chairman Compensation Committee member.

$4,000 annual cash retainer to each non-Chairman Nominating & Corporate Governance Committee member.

20,000 restricted stock units of our common stock per year, to each director.

10,000 additional restricted stock units of our common stock per year to the Lead Director.

New directors will earn a pro-rated portion (based on months to be served in the fiscal year in which they join) of cash and restricted stock units.

Options granted previously to directors have vested immediately. These options expire in 10 years and are outstanding for the life of the option. Director options qualify as Non-Statutory Stock Options.

In July 2013, we amended our Director Remuneration Policy to reflect the new cash retainer to directors, plus the migration to RSUs instead of options. The total number of RSUs granted during the year ended December 31, 2014 was 125,000, of which 55,000 vested upon issuance in August 2014 and 70,000 vest in August 2015.

Performance Long Term Incentive Plan

In December 2012, by unanimous written consent following significant planning and discussion (as well as discussion with our outside compensation consultant Radford), the Committee approved the LTIP. The LTIP is designed as an incentive for our senior management (including our NEOs) to generate revenue for our company.

The LTIP consists of RSUs (as defined under our 2011 Equity Incentive Plan) which are rights to acquire shares of our common stock. All Performance RSUs granted under the LTIP will be granted under our 2011 Equity Incentive Plan (as the same may be amended, supplemented or superseded from time to time) as Performance Compensation Awards under such plan. The participants in the LTIP are either NEOs or senior officers of our company.

The term of the LTIP began with our fiscal year ended December 31, 2012 and lasts through our fiscal year ended December 31, 2019. The total number of Performance RSUs covered by the LTIP is 1,078,000, of which 978,000 were awarded in 2012 and 85,000 were awarded February 2015 (the remaining 15,000 Performance RSUs being reserved for future hires). A total of 4,447 and 8,986 RSUs vested during the years ended December 31, 2014 and 2013, respectively. The Performance RSUs under the LTIP did not vest upon granting, but instead are subject to potential vesting each year over the 8 year term of the LTIP depending on the achievement of revenue by our company, as reported in our Annual Report on Form 10-K. Performance RSUs will be valued on the day of issuance and will vest annually on the last day preceding the first open window after filing our Annual Report on Form 10-K based on the revenue achieved during the prior fiscal year as a proportion of the total cumulative revenue target for the entire term of the LTIP (which we call the Predefined Cumulative Revenue). Predefined Cumulative Revenue is a predefined aggregate revenue target for the entire term of the LTIP that was determined by the Committee in conjunction with our executive management. The Predefined Cumulative Revenue may be adjusted by the Committee upon the occurrence of extraordinary corporate events during the term of the LTIP (such as acquisitions by our company of revenue generating businesses or assets).

Table of Contents

Compensation Committee Interlocks and Insider Participation

None of our executive officers serves as a member of the Compensation Committee of our board of directors, or other committee serving an equivalent function. None of the members of our Compensation Committee has ever been our employee or one of our officers.

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

The following table sets forth, as of March 12, 2015, by: (i) each of our directors, (ii) all persons who, to our knowledge, are the beneficial owners of more than 5% of the outstanding shares of common stock, (iii) each of the executive officers, and (iv) all of our directors and executive officers, as a group. Each person named in this table has sole investment power and sole voting power with respect to the shares of common stock set forth opposite such person s name, except as otherwise indicated. Unless otherwise indicated, the address for each person listed below is in care of BioDelivery Sciences International, Inc., 4131 ParkLake Avenue, Suite #225, Raleigh, NC 27612.

	Percentage of Class as of March 12, 2015[1]

SURVIVAL OF COVENANTS, REPRESENTATIONS AND WARRANTIES. The Company's and the Buyer's covenants, agreemen
ive the execution and delivery of this Agreement and the other Transaction Documents and the Closing hereunder for the maximum tim
efit of the Buyer and the Company and their respective successors and permitted assigns.

[Remainder of the page intentionally left blank; signature page to follow]

9

VITNESS WHEREOF, each of the undersigned represents that the foregoing statements made by it above are true and correct and that
lf (if an entity, by one of its officers thereunto duly authorized) as of the date first above written.

RCHASE PRICE: $500,000.00

THE BUYER:

Tonaquint, Inc.

By:
John M. Fife, President

THE COMPANY:

Seven Arts Entertainment Inc.

By:
Name:
Title:

nature Page To Securities Purchase Agreement]

0

TACHMENTS:

NEX I	WIRE INSTRUCTIONS
NEX II	FORM OF NOTE 1
NEX III	FORM OF NOTE 2
NEX IV	TRANSFER AGENT LETTER 1
NEX V	SECRETARY'S CERTIFICATE
NEX VI	SHARE ISSUANCE RESOLUTION
NEX VII	TRANSFER AGENT LETTER 2
NEX VIII	FORM OF ANTI-DILUTION CERTIFICATION

1

Seven Arts Entertainment Inc.
Convertible Promissory Note #1

ance Date: August 22, 2012 U.S. $310,000.00

R VALUE RECEIVED, Seven Arts Entertainment Inc., a Nevada corporation (the "Company"), hereby promises to pay to the order of T
gns (the "Holder"), the initial principal sum of $310,000.00 (the "Original Principal Amount"), and any additional advances and other a
Convertible Promissory Note (this "Note") when due, whether upon the Maturity Date, on any Installment Date with respect to the Insta
ned below), acceleration, redemption or otherwise (in each case in accordance with the terms hereof), and to pay interest ("Interest") on
icable interest rate as set forth herein, whether upon any Installment Date, the Maturity Date or acceleration, conversion, redemption or
of). Certain capitalized terms used herein are defined in Section 27 hereof. For purposes hereof, the term "Outstanding Balance" means
e case may be, pursuant to the terms hereof for redemption, conversion or otherwise, plus any accrued but unpaid Interest, collection an
luding without limitation Late Charges (as defined below)) incurred under this Note or under the Agreement (defined below).

Note is issued pursuant to that certain Securities Purchase Agreement dated August 22, 2012, as the same may be amended from time t
the Holder.

AYMENTS OF PRINCIPAL; PREPAYMENT. On each Installment Date (which includes the Maturity Date), the Company shall pay to
ount due on such Installment Date in accordance with Section 8. Additionally, so long as no Event of Default (as defined below) shall h
olute discretion and upon giving the Holder not less than five (5) Trading Days written notice (a "Prepayment Notice"), pay in cash all o
r to the Maturity Date; provided that in the event the Company elects to prepay all or any portion of the Outstanding Balance, it shall pa
ance the Company elects to prepay (the "Prepayment Premium").

NTEREST; INTEREST RATE. The Company acknowledges that the Original Principal Amount of this Note exceeds the Purchase Price
sists of (a) an original issue discount of $50,000.00 and (b) the Transaction Expense Amount (as defined in the Agreement) in the amou
charged to the Company as of the Issuance Date and paid to the Holder as part of the Original Principal Amount as set forth in this Note
the date set forth above as the Issuance Date (the "Issuance Date") at the rate of eight percent (8%) per annum, provided that upon the
e Outstanding Balance at the rate of twenty-two percent (22%) per annum, as set forth in Section 4.2(d) hereof. All Interest calculation
-day year comprised of twelve (12) thirty (30) day months, shall compound daily and shall be payable in accordance with the terms of th
rary herein, in no event shall the applicable interest rate at any time exceed the maximum interest rate allowed under applicable law. Al
e United States of America or Conversion Shares, as provided for herein, and delivered to Holder at the address furnished to the Compa
) costs of collection, if any, then to (b) fees and charges, if any, then to (c) accrued and unpaid Interest, and thereafter to (d) principal.

2

ONVERSION OF NOTE. At the option of the Holder, this Note is convertible into validly issued, fully paid and non-assessable shares
n in this Section 3.

Conversion Right.

Subject to the provisions of Section 3.4, at any time or times on or after the Issuance Date, the Holder shall be entitled to convert any po
y paid and non-assessable shares of Common Stock (the "Section 3 Conversion Shares") in accordance with Section 3.3, calculated usin

The Company shall not issue any fraction of a share of Common Stock upon any conversion. All shares issuable upon each conversion o
rmining whether such conversion would result in the issuance of a fractional share. If the issuance would result in the issuance of a frac
d such fraction of a share of Common Stock up to the nearest whole share. The Company shall pay any and all transfer, stamp, issuanc
ssuance and delivery of Section 3 Conversion Shares.

Conversion Rate. The number of Section 3 Conversion Shares issuable upon conversion of any portion of the Outstanding Balance purs
he applicable Conversion Amount by (y) the Conversion Price (such formula is referred to herein as the "Conversion Rate").

"Conversion Amount" means the portion of the Outstanding Balance to be converted.

"Conversion Price" means, as of any Conversion Date or other date of determination, $0.04, subject to adjustment as provided herein.

Mechanics of Conversion.

Conversion Prior to Maturity Date. To convert any Conversion Amount into shares of Common Stock on any date, the Holder shall deli
ipt on or prior to 11:59 p.m., New York time, on such date (a "Conversion Date"), a copy of an executed notice of conversion substanti
nversion Notice") to the Company. If required by Section 3.3(c), within five (5) Trading Days following a conversion of this Note as af
table overnight courier for delivery to the Company (or an indemnification undertaking with respect to this Note in the case of its loss,
or before the first (1st) Trading Day following the date of receipt of a Conversion Notice, the Company shall transmit by facsimile or em
ched hereto as Exhibit B, of receipt of such Conversion Notice to the Holder and the Company's transfer agent (the "Transfer Agent").
ling Day following the date of receipt of a Conversion Notice (the "Delivery Date"), the Company shall, provided that all DWAC Eligi
ber of Section 3 Conversion Shares to which the Holder shall be entitled to the account specified on the Conversion Notice via the DW
satisfied, the Company shall instead issue and deliver (via reputable overnight courier) to the address as specified in the Conversion No
s designee, for the number of Section 3 Conversion Shares to which the Holder shall be entitled; provided, however, that, in addition to
er this Note, such number of shares issued by certificate rather than via the DWAC system shall be increased by 5% for each conversion
ance Date. For the avoidance of doubt, the Company has not met its obligation to deliver Section 3 Conversion Shares by the Delivery
ally received the shares electronically into the applicable account, or if the DWAC Eligible Conditions are not then satisfied, has actual
ion 3 Conversion Shares no later than the close of business on the relevant Delivery Date pursuant to the terms set forth above. If this N
ection 3.3(c) and the Outstanding Balance of this Note is greater than the principal portion of the Conversion Amount being converted,
vent later than three (3) Trading Days after receipt of this Note and at its own expense, issue and deliver to the Holder (or its designee)
esenting the Outstanding Balance not converted. The Person or Persons entitled to receive the shares of Common Stock issuable upon a
oses as the record holder or holders of such shares of Common Stock on the Conversion Date. In the event of a partial conversion of th
l be deducted from the Installment Amount(s) relating to the Installment Date(s) as set forth in the applicable Conversion Notice.

3

Company's Failure to Timely Deliver. Failure for any reason whatsoever to issue any portion of the Section 3 Conversion Shares to Hol
ired under this Note shall be a "Conversion Failure". Upon the occurrence of a Conversion Failure, in addition to all other remedies ava
Holder on each day after such third (3rd) Trading Day that the issuance of such shares of Common Stock is not timely effected an amou
of the product of (i) the sum of the number of Section 3 Conversion Shares not issued to the Holder on a timely basis and to which the H
e of the Common Stock on the Trading Day immediately preceding the last possible date which the Company could have issued such sh
ion 3.3(a); and (2) the Holder, upon written notice to the Company, may void its Conversion Notice with respect to, and retain or have r
has not been converted pursuant to such Conversion Notice, provided that the voiding of a Conversion Notice shall not affect the Comp
ued or are owed to the Holder prior to the date of such notice pursuant to this Section 3.3(b) or otherwise. Notwithstanding the foregoin
ion 3 Conversion Shares are not issued by the Company in order to comply with the limitations set forth in Section 3.4 hereof. Upon the
ts to void the Conversion Notice), in addition to such failure being considered an Event of Default hereunder, for purposes of Section 7.
ion 3 Conversion Shares to Holder on the latest possible permitted date and pursuant to the terms set forth in this Section 3, with Holde
deemed issued shares (the "Deemed Conversion Issuance").

Registration; Book-Entry. The Company shall maintain a register (the "Register") for the recordation of the name and address of the hol
unt of this Note held by such holder (the "Registered Note"). The entries in the Register shall be conclusive and binding for all purpose
l treat each Person whose name is recorded in the Register as the owner of this Note for all purposes (including, without limitation, the r
under) notwithstanding notice to the contrary. The Registered Note may be assigned, transferred or sold in whole or in part only by regi
n its receipt of a request to assign, transfer or sell all or part of the Registered Note by the holder thereof, the Company shall record the
or more new Registered Notes in the same aggregate principal amount as the principal amount of the surrendered Registered Note to the
ion 14. Notwithstanding anything to the contrary in this Section 3.3(c), the Holder may assign this Note or any portion thereof to its Aff
e to the Company and the recordation of such assignment or sale in the Register (a "Related Party Assignment"); provided, that (A) the
gning or selling Holder unless and until such Holder has delivered a request to assign or sell this Note or portion thereof to the Company
gning or selling Holder to deliver a request to assign or sell such Note or portion thereof to the Company shall not affect the legality, val
such assigning or selling Holder shall, acting solely for this purpose as a non-fiduciary agent of the Company, maintain a register (the "
alf of the Company, and any such assignment or sale shall be effective upon recordation of such assignment or sale in the Related Party
n in this Section 3, upon conversion of any portion of this Note in accordance with the terms hereof, the Holder shall not be required to p
the entire Outstanding Balance of this Note is being converted (in which event this Note shall be delivered to the Company as contempl
Company with prior written notice (which notice may be included in a Conversion Notice) requesting reissuance of this Note upon phys
mpany shall maintain records showing the Outstanding Balance and Late Charges converted and/or paid (as the case may be) and the dat
be) or shall use such other method, reasonably satisfactory to the Holder and the Company, so as not to require physical surrender of th

4

Limitations on Conversions.

Notwithstanding anything to the contrary contained in this Note (except as set forth below in this subsection), this Note shall not be conv effect any conversion of this Note or otherwise issue any shares of Common Stock pursuant to Section 3 or Section 8 hereof, to the exte of its Affiliates would beneficially own in excess of 4.99% (the "Maximum Percentage") of the Common Stock outstanding. Notwithst ditions are not then satisfied, the term "4.99%" shall be replaced in the preceding sentence with "9.99%" at such time as the Market Ca 00,000.00, but (ii) if all of the DWAC Eligible Conditions are then satisfied, the term "4.99%" shall be replaced in the preceding senter italization of the Common Stock is less than $1,500,000.00. For the avoidance of any doubt, notwithstanding any other provision conta uant to the preceding sentence, such change to "9.99%" shall be permanent. For purposes of this Agreement, the term "Market Capitali) the average VWAP of the Common Stock for the immediately preceding thirty (30) Trading Days, multiplied by (ii) the aggregate nu rted on the Company's most recently filed Form 10-Q or Form 10-K.

To the extent the limitation set forth in subsection (a) immediately above applies, the determination of whether this Note shall be conver hangeable securities owned by the Holder or any of its Affiliates) and of which such securities shall be convertible, exercisable or excha der and its Affiliates) shall, subject to such Maximum Percentage limitation, be determined on the basis of the first submission to the Co may be). No prior inability to convert this Note, or to issue shares of Common Stock, pursuant to this Section 3.4 shall have any effect with respect to any subsequent determination of convertibility. For purposes of this Section 3.4, beneficial ownership and all determinat respect to calculations of percentage ownership) shall be determined in accordance with Section 13(e) of the 1934 Act (as defined in th mulgated thereunder. The provisions of this Section 3.4 shall be implemented in a manner otherwise than in strict conformity with the te portion hereof) which may be defective or inconsistent with the intended Maximum Percentage beneficial ownership limitation herein c esirable to properly give effect to such Maximum Percentage limitation. The limitations contained in this Section 3.4 shall apply to a su k shall be third party beneficiaries of this Section 3.4 and the Company may not waive this Section 3.4 without the consent of holders o time, upon the written or oral request of the Holder, the Company shall within one (1) Trading Day confirm orally and in writing to the tanding, including by virtue of any prior conversion or exercise of convertible or exercisable securities into Common Stock, including,

5

IGHTS UPON EVENT OF DEFAULT.

Event of Default. Each of the following events shall constitute an "Event of Default":

Failure to Pay. The Company shall fail to make any payment when due and payable under the terms of this Note including, without limi
luding, without limitation, the Company's failure to deliver any Installment Amount when due or to pay any redemption payments or an
er any other Transaction Document (as defined in the Agreement).

Failure to Deliver or Process Shares. The Company (or its Transfer Agent, as applicable) (i) fails to issue Section 3 Conversion Shares b
Installment Conversion Shares, Post-Installment Conversion Shares, Pre-Installment Certificated Shares, or Post-Installment Certificate
ired by Section 8; (iii) announces (or threatens in writing) that it will not honor its obligation to issue shares to Holder in accordance wi
sfer or cause its Transfer Agent to transfer or issue (electronically or in certificated form, as applicable) any Section 3 Conversion Share
version Shares, Pre-Installment Certificated Shares, or Post-Installment Certificated Shares, as applicable, issued to the Holder upon co
n required by this Note; (v) directs its Transfer Agent not to transfer, or delays, impairs, and/or hinders its Transfer Agent in transferrin
icable) any Section 3 Conversion Shares, Pre-Installment Conversion Shares, Post-Installment Conversion Shares, Pre-Installment Cert
pplicable, to be issued to the Holder upon conversion of or otherwise pursuant to this Note as and when required by this Note; or (vi) as
nt not to remove or impairs, delays, and/or hinders its Transfer Agent from removing) any restrictive legend (or to withdraw any stop tr
ny Section 3 Conversion Shares, Pre-Installment Certificated Shares or Post-Installment Certificated Shares as and when required by th
ement or threat that it does not intend to honor any such obligations).

udgment. A final judgment or judgments for the payment of money aggregating in excess of $100,000 are rendered against the Compa
not, within thirty (30) calendar days after the entry thereof, bonded, discharged or stayed pending appeal, or are not discharged within th
; provided, however, any judgment which is covered by insurance or an indemnity from a credit worthy party shall not be included in ca
he Company provides the Holder a written statement from such insurer or indemnity provider (which written statement shall be reasonab
ment is covered by insurance or an indemnity and the Company or such Subsidiary (as the case may be) will receive the proceeds of su
s of the issuance of such judgment.

6

Breach of Obligations; Covenants. The Company or its Subsidiaries, if any, shall fail to observe or perform any other covenant, obligati of the other Transaction Documents, including without limitation (i) all reporting covenants and covenants to timely file all required qu ired pursuant to Rule 144, and (ii) strict compliance with all provisions of Sections 3, 8, and 10 of this Note.

Breach of Representations and Warranties. Any representation, warranty, certificate, or other statement (financial or otherwise) made or der in writing included in this Note or in connection with any of the Transaction Documents, or as an inducement to the Holder to enter uments, shall be false, incorrect, incomplete or misleading in any material respect when made or furnished or becomes false thereafter.

Receiver or Trustee. The Company shall make an assignment for the benefit of creditors, or apply for, or consent to, or otherwise be subj idator, assignee, custodian, sequestrator, or other similar official for a substantial part of its property or business.

Failure to Pay Debts. If any of the Company's assets are assigned to its creditors, or upon the occurrence of any default under, redemptio btedness of the Company or any of its Subsidiaries in an amount equal to $100,000 or more.

Bankruptcy. Bankruptcy, insolvency, reorganization or liquidation proceedings or other proceedings, voluntary or involuntary, for relief ors shall be instituted by or against the Company.

Delisting of Common Stock. The suspension from trading or the failure of the Common Stock to be trading on an Eligible Market for a p an aggregate of ten (10) Trading Days in any 365-day period.

Liquidation. Any dissolution, liquidation, or winding up of the Company or any substantial portion of its business.

Cessation of Operations. Any cessation of operations by the Company or the Company admits it is otherwise generally unable to pay its any disclosure of the Company's ability to continue as a "going concern" shall not be an admission that the Company cannot pay its de

Maintenance of Assets. The failure by the Company to maintain any material intellectual property rights, personal, real property or other ether now or in the future).

7

Financial Statement Restatement. The restatement of any financial statements filed by the Company with the SEC for any date or perio
Note is no longer outstanding, if the result of such restatement would, by comparison to the unrestated financial statement, have constit
npany with respect to this Note or the Agreement.

Reverse Split. The Company effectuates a reverse split of its Common Stock without twenty (20) Trading Days prior written notice to th

Replacement of Transfer Agent. In the event that the Company proposes to replace its Transfer Agent, the Company fails to provide, pri
cuted Transfer Agent Letter (as defined by the Agreement) in a form as required to be initially delivered pursuant to the Agreement (inc
rve shares of Common Stock in the Reserved Amount) signed by the successor transfer agent and delivered to the Company and the Ho

Governmental Action. If any governmental or regulatory authority takes or institutes any action against the Company, a Subsidiary, or a
materially affect the Company's financial condition, operations or ability to pay or perform the Company's obligations under this Note

Share Reserve. The Company's failure to maintain the Share Reserve (as defined in the Agreement).

Certification of Equity Conditions. A false or inaccurate certification (including, without limitation, a false or inaccurate deemed certific
sfied, that there has been no Equity Conditions Failure or as to whether any Event of Default has occurred.

DWAC Eligibility. The failure of any of the DWAC Eligible Conditions to be satisfied at any time during which the Company has oblig

Cross Default. Notwithstanding anything to the contrary contained in this Note or the other Transaction Documents, a breach or default b
dition contained in (i) any of the other Transaction Documents, or (ii) any Other Agreements (defined below); shall, at the option of the
ch event the Holder shall be entitled (but in no event required) to apply all rights and remedies of the Holder under the terms of this Not
ing within three (3) Trading Days after any such default; provided, however, any filing of an 8-K that identifies any such default shall n
eements" means, collectively, (1) all existing and future agreements and instruments between, among or by the Company (or a Subsidia
der), on the other hand, and (2) any financing agreement or a material agreement that affects the Company's ongoing business operation
transactions between the Company and the Holder and its Affiliates will be cross-defaulted with each other loan transaction and with a
der.

8

n subsection of this Section 4.1 shall be interpreted and applied independently, and no such subsection shall be deemed to limit or qualif

Notice of an Event of Default; Redemption Right.

Upon the occurrence of an Event of Default, the Company shall within one (1) Trading Day deliver written notice thereof via facsimile a
ified) (an "Event of Default Notice") to the Holder.

At any time and from time to time after the earlier of the Holder's receipt of an Event of Default Notice and the Holder becoming aware
npany to redeem (regardless of whether such Event of Default has been cured) all or any portion of this Note by delivering written notic
Company, which Event of Default Redemption Notice shall indicate the portion of the Outstanding Balance the Holder is electing to red
ired by this Section 4.2(b) shall be made in accordance with the provisions of Section 10. Notwithstanding anything to the contrary in t
ault Redemption Amount (together with Late Charges thereon) is paid in full pursuant to and in accordance with the terms set forth in S
Charges thereon), may be converted, in whole or in part from time to time, by the Holder into Common Stock pursuant to the other ter
Note pursuant hereto, the applicable Default Redemption Amount shall be deducted from the Installment Amount(s) relating to the appl
ault Redemption Notice. Notwithstanding the foregoing, this Section 4.2(b) shall not apply to an Event of Default arising under Section

Upon the occurrence of an Event of Default occurring under Section 4.1(h) due to the institution by or against the Company of any bank
ny law for the relief of debtors, (i) the Outstanding Balance shall automatically increase to an amount equal to the Outstanding Balance
he Redemption Premium, and (ii) all amounts owed under this Note shall accelerate and be immediately due and payable, all without the
under.

Upon the occurrence of any Event of Default, this Note shall thereafter accrue interest at the rate of 1.8% per month (or 22% per annum
ment; provided, however, that notwithstanding any provision to the contrary herein, in no event shall the applicable interest rate at any
icable law.

Notwithstanding and in addition to any other provision contained herein, if Section 3 Conversion Shares are delivered to Holder in certif
standing Balance shall automatically increase by an amount equal to the decline in Value (as defined below), if any, of such shares betw
required to be delivered to the Holder hereunder, and the date the certificate representing such shares becomes Free Trading. The Comp
ome Free Trading. "Value", as used in this subsection, shall mean the five (5) Trading Day trailing average VWAP for the applicable sh

9

IGHTS UPON FUNDAMENTAL TRANSACTION.

Assumption. The Company shall not enter into or be party to a Fundamental Transaction unless (i) the Successor Entity assumes in wri
e and the other Transaction Documents in accordance with the provisions of this Section 5.1 pursuant to written agreements in form and
Holder, in its sole discretion, prior to such Fundamental Transaction, including agreements to deliver to the Holder in exchange for this
ten instrument substantially similar in form and substance to this Note, including, without limitation, having a principal amount and inte
tanding and the interest rates of this Note, having similar conversion rights as this Note and having similar ranking to this Note, and bei
he Successor Entity is a publicly traded corporation whose common stock is quoted on or listed for trading on an Eligible Market, and (
sent to enter into such Fundamental Transaction. Upon the occurrence of any Fundamental Transaction, the Successor Entity shall succe
of such Fundamental Transaction, the provisions of this Note and the other Transaction Documents referring to the "Company" shall re
y right and power of the Company and shall assume all of the obligations of the Company under this Note and the other Transaction Do
ty had been named as the Company herein. Upon consummation of a Fundamental Transaction, the Successor Entity shall deliver to the
version or redemption of this Note at any time after the consummation of such Fundamental Transaction, in lieu of the shares of the Co
ther property (except such items still issuable under Section 6, which shall continue to be receivable thereafter) issuable upon the conve
damental Transaction), such shares of the publicly traded common stock (or their equivalent) of the Successor Entity (including its Pare
ceive upon the happening of such Fundamental Transaction had this Note been converted immediately prior to such Fundamental Trans
version of this Note), as adjusted in accordance with the provisions of this Note. The provisions of this Section 5 shall apply similarly a
l be applied without regard to any limitations on the conversion of this Note.

Notice of a Fundamental Transaction; Redemption Right. No sooner than twenty (20) Trading Days nor later than ten (10) Trading Day
nsaction, but not prior to the public announcement of such Fundamental Transaction, the Company shall deliver written notice thereof v
der (a "Fundamental Transaction Notice"). At any time during the period beginning after the Holder's receipt of a Fundamental Transac
damental Transaction if a Fundamental Transaction Notice is not delivered to the Holder in accordance with the immediately preceding
nty (20) Trading Days after (i) consummation of such Fundamental Transaction and (ii) the date of receipt of such Fundamental Transac
em all or any portion of this Note by delivering written notice thereof ("Fundamental Transaction Redemption Notice") to the Company
l indicate the portion of the Outstanding Balance the Holder is electing to redeem (the "Fundamental Transaction Redemption Amount"
l be redeemed by the Company in cash pursuant to and in accordance with Section 10 and shall have priority to payments to stockholde
withstanding anything to the contrary in this Section 5, but subject to Section 3.4, until the Fundamental Transaction Redemption Amou
the Outstanding Balance (together with any Late Charges thereon), may be converted, in whole or in part from time to time, by the Hol
t of a partial redemption of this Note pursuant hereto, the Fundamental Transaction Redemption Amount shall be deducted from the In
allment Date(s) as set forth in the Fundamental Transaction Redemption Notice.

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ISTRIBUTION OF ASSETS; RIGHTS UPON ISSUANCE OF PURCHASE RIGHTS AND OTHER CORPORATE EVENTS.

Distribution of Assets. Without the prior written consent of Holder, the Company agrees not to declare or make any dividend or other d
ny or all holders of shares of Common Stock, by way of return of capital or otherwise (including, without limitation, any distribution of
of a dividend, spin off, reclassification, corporate rearrangement, scheme of arrangement or other similar transaction).

Purchase Rights. In addition to any adjustments pursuant to Section 7 below, if at any time the Company grants, issues or sells any Opt
rants, securities or other property pro rata to the record holders of any class of Common Stock (the "Purchase Rights"), then the Holder
Purchase Rights, the aggregate Purchase Rights which the Holder could have acquired if the Holder had held the number of shares of C
his Note (without taking into account any limitations or restrictions on the convertibility of this Note) immediately before the date on wh
Purchase Rights, or, if no such record is taken, the date as of which the record holders of Common Stock are to be determined for the g
ever, to the extent that the Holder's right to participate in any such Purchase Right would result in the Holder exceeding the Maximum
icipate in such Purchase Right to such extent (or beneficial ownership of such shares of Common Stock as a result of such Purchase Rig
nt shall be held in abeyance for the Holder until such time, if ever, as its right thereto would not result in the Holder exceeding the Max

Other Corporate Events. In addition to and not in substitution for any other rights hereunder, prior to the consummation of any Fundam
ommon Stock are entitled to receive securities or other assets with respect to or in exchange for shares of Common Stock (a "Corporate
sure that the Holder will thereafter have the right to receive upon a conversion of this Note (i) in addition to the shares of Common Stoc
r assets to which the Holder would have been entitled with respect to such shares of Common Stock had such shares of Common Stock
Corporate Event (without taking into account any limitations or restrictions on the convertibility of this Note) or (ii) in lieu of the share
version, such securities or other assets received by the holders of shares of Common Stock in connection with the consummation of such
e been entitled to receive had this Note initially been issued with conversion rights for the form of such consideration (as opposed to sha
sideration commensurate with the Conversion Rate. Provision made pursuant to the preceding sentence shall be in a form and substance
ion 6 shall apply similarly and equally to successive Corporate Events and shall be applied without regard to any limitations on the con

IGHTS UPON ISSUANCE OF SECURITIES.

Adjustment of Conversion Price upon Issuance of Common Stock. Except with respect to Excluded Securities, if and whenever on or a
mmon Stock, Options, Convertible Securities, or upon any conversion or Deemed Issuance, or in accordance with subsections (a) throug
es of Common Stock (including without limitation the issuance or sale of shares of Common Stock owned or held by or for the account
urities issued or sold or deemed to have been issued or sold) for a consideration per share (the "New Issuance Price") less than a price ec
uch issue, conversion, or sale or deemed issuance or sale (such Conversion Price then in effect is referred to herein as the "Applicable P
mediately after such Dilutive Issuance, the Conversion Price then in effect shall be reduced to an amount equal to the New Issuance Price
e is greater than the Applicable Price, there shall be no adjustment to the Conversion Price. For purposes of determining the adjusted Co
l be applicable:

ssuance of Options. If the Company in any manner grants or sells any Options and the lowest price per share for which one share of Co
ion or upon conversion, exercise or exchange of any Convertible Securities issuable upon exercise of any such Option is less than the A
l be deemed to be outstanding and to have been issued and sold by the Company at the time of the granting or sale of such Option for su
"lowest price per share for which one share of Common Stock is issuable upon the exercise of any such Options or upon conversion, exe
able upon exercise of any such Option" shall be equal to (1) the lower of (x) the sum of the lowest amounts of consideration (if any) rec
share of Common Stock upon the granting or sale of such Option, upon exercise of such Option and upon conversion, exercise or excha
uch Option and (y) the lowest exercise price set forth in such Option for which one share of Common Stock is issuable upon the exercis
hange of any Convertible Securities issuable upon exercise of any such Option minus (2) the sum of all amounts paid or payable to the h
ting or sale of such Option, upon exercise of such Option and upon conversion, exercise or exchange of any Convertible Security issua
r consideration received or receivable by, or benefit conferred on, the holder of such Option (or any other Person). Except as contempla
e shall be made upon the actual issuance of such share of Common Stock or of such Convertible Securities upon the exercise of such Op
mmon Stock upon conversion, exercise or exchange of such Convertible Securities.

2

ssuance of Convertible Securities. If the Company in any manner issues or sells any Convertible Securities, and the lowest price per sha
n the conversion, exercise or exchange thereof is less than the Applicable Price, then such share of Common Stock shall be deemed to b
npany at the time of the issuance or sale of such Convertible Securities for such price per share. For the purposes of this Section 7.1(b),
mmon Stock is issuable upon the conversion, exercise or exchange thereof" shall be equal to (1) the lower of (x) the sum of the lowest ar
he Company with respect to one share of Common Stock upon the issuance or sale of the Convertible Security and upon conversion, ex
he lowest conversion price set forth in such Convertible Security for which one share of Common Stock is issuable upon conversion, ex
unts paid or payable to the holder of such Convertible Security (or any other Person) upon the issuance or sale of such Convertible Secu
eceivable by, or benefit conferred on, the holder of such Convertible Security (or any other Person). Except as contemplated below, no f
e upon the actual issuance of such share of Common Stock upon conversion, exercise or exchange of such Convertible Securities, and i
ade upon exercise of any Options for which adjustment of the Conversion Price has been or is to be made pursuant to other provisions o
her adjustment of the Conversion Price shall be made by reason of such issue or sale.

Change in Option Price or Rate of Conversion. If the purchase or exercise price provided for in any Options, the additional consideration
xchange of any Convertible Securities, or the rate at which any Convertible Securities are convertible into or exercisable or exchangeab
ny time, the Conversion Price in effect at the time of such increase or decrease shall be adjusted to the Conversion Price which would ha
vertible Securities provided for such increased or decreased purchase price, additional consideration or increased or decreased conversio
ted, issued or sold. For purposes of this Section 7.1(c), if the terms of any Option or Convertible Security that was outstanding as of the
ner described in the immediately preceding sentence, then such Option or Convertible Security and the shares of Common Stock deeme
eof shall be deemed to have been issued as of the date of such increase or decrease. No adjustment pursuant to this Section 7.1 shall be
Conversion Price then in effect.

Calculation of Consideration Received. If any Option or Convertible Security is issued or deemed issued in connection with the issuance
rities of the Company, together comprising one integrated transaction, (x) such Option or Convertible Security (as applicable) will be d
Black Scholes Consideration Value thereof and (y) the other securities issued or sold or deemed to have been issued or sold in such inte
consideration equal to the difference of (I) the aggregate consideration received by the Company minus (II) the Black Scholes Considera
urity (as applicable). If any shares of Common Stock, Options or Convertible Securities are issued or sold or deemed to have been issue
be deemed to be the net amount received by the Company therefor. If any shares of Common Stock, Options or Convertible Securities
amount of such consideration received by the Company will be the fair value of such consideration, except where such consideration co
unt of consideration received by the Company for such securities will be the average VWAP of such security for the five (5) Trading D
shares of Common Stock, Options or Convertible Securities are issued to the owners of the non-surviving entity in connection with any
amount of consideration therefor will be deemed to be the fair value of such portion of the net assets and business of the non-surviving e
k, Options or Convertible Securities (as the case may be). The fair value of any consideration other than cash or publicly traded securiti
der. If such parties are unable to reach agreement within ten (10) Trading Days after the occurrence of an event requiring valuation (the
be determined within five (5) Trading Days after the tenth (10th) day following such Valuation Event by an independent, reputable app
determination of such appraiser shall be final and binding upon all parties absent manifest error and the fees and expenses of such appra

3

Record Date. If the Company takes a record of the holders of shares of Common Stock for the purpose of entitling them (A) to receive a
k, Options or in Convertible Securities or (B) to subscribe for or purchase shares of Common Stock, Options or Convertible Securities,
ssue or sale of the shares of Common Stock deemed to have been issued or sold upon the declaration of such dividend or the making of
right of subscription or purchase (as the case may be).

Adjustment of Conversion Price upon Subdivision or Combination of Common Stock. Without limiting any provision of Section 5 or S
ance Date subdivides (by any stock split, stock dividend, recapitalization or otherwise) one or more classes of its outstanding shares of
version Price in effect immediately prior to such subdivision will be proportionately reduced. Without limiting any provision of Section
the Issuance Date combines (by combination, reverse stock split or otherwise) one or more classes of its outstanding shares of Commo
version Price in effect immediately prior to such combination will be proportionately increased. Any adjustment pursuant to this Sectio
ctive date of such subdivision or combination. If any event requiring an adjustment under this Section 7.2 occurs during the period that
ulation of such Conversion Price shall be adjusted appropriately to reflect such event.

Other Events. In the event that the Company (or any Subsidiary) shall take any action to which the provisions hereof are not strictly app
Holder from dilution or if any event occurs of the type contemplated by the provisions of this Section 7 but not expressly provided for b
ting of stock appreciation rights, phantom stock rights or other rights with equity features), then the Company's board of directors shall
stment in the Conversion Price so as to protect the rights of the Holder, provided that no such adjustment pursuant to this Section 7.3 w
rmined pursuant to this Section 7, provided further that if the Holder does not accept such adjustments as appropriately protecting its in
pany's board of directors and the Holder shall agree, in good faith, upon an independent investment bank of nationally recognized stan
rmination shall be final and binding and whose fees and expenses shall be borne by the Company.

OMPANY INSTALLMENT CONVERSION OR REDEMPTION. Beginning on the date that is one hundred eighty (180) calendar day
e"), and on each applicable Installment Date thereafter, the Company shall pay to the Holder of this Note the applicable Installment Am
ount in accordance with this Section 8 (a "Company Conversion"); provided, however, the Company may, at its option as described bel
eming such Installment Amount in cash (a "Company Redemption") or by any combination of a Company Conversion and a Company
allment Amount due shall be converted and/or redeemed by the Company on the applicable Installment Date, subject to the provisions o
l not be entitled to effect a Company Conversion with respect to any portion of such Installment Amount and shall be required to pay th
uant to a Company Redemption if on the applicable Pre-Installment Notice Due Date (defined below) or on the applicable Installment D
ure, and such failure is not waived by Holder as permitted herein.

4

General. On or prior to the date which is the twenty-third (23rd) Trading Day prior to each Installment Date (each, a "Pre-Installment N
ce to the Holder substantially in the form attached hereto as Exhibit C-1 (each, a "Pre-Installment Notice"), and such Pre-Installment No
allment Amount of this Note shall be converted in whole pursuant to a Company Conversion, or (B) (1) state that the Company elects to
provisions of this Note, in whole or in part, the applicable Installment Amount pursuant to a Company Redemption and (2) specify the p
mpany elects, or is required to redeem, pursuant to a Company Redemption (such amount to be redeemed in cash, the "Company Redem
allment Amount, if any, with respect to which the Company will, and is permitted to, effect a Company Conversion (such amount of the
verted pursuant to this Section 8 is referred to herein as the "Company Conversion Amount"), which amounts when added together, mus
f the applicable Installment Amount is to be paid, in whole or in part, pursuant to a Company Conversion, certify that there is not an Eq
ce Due Date. Each Pre-Installment Notice shall be irrevocable and may not be revoked by the Company. If the Company does not time
Installment Notice Due Date that complies with this Section 8, then the Company shall be deemed to have delivered on such Pre-Install
ce confirming a Company Conversion of the entire Installment Amount payable as required hereunder and shall be deemed to have cert
e applicable Pre-Installment Notice Due Date. The applicable Company Conversion Amount (whether set forth in the applicable Pre-In
l be converted in accordance with Section 8.2 or Section 8.4, as applicable and the applicable Company Redemption Amount shall be re

Mechanics of Company Conversion. Subject to Section 3.4, if the Company delivers a Pre-Installment Notice and elects, or is deemed t
ave elected, in whole or in part, a Company Conversion in accordance with Section 8.1, then this Section 8.2 shall apply. Notwithstandi
urred as of the applicable Pre-Installment Notice Due Date, then the Company shall identify each such Equity Conditions Failure in the
n Holder pursuant to Section 8.6 hereof. (i) If such waiver is obtained, and all DWAC Eligible Conditions are then satisfied and a Comp
r provision of this Note, then the remainder of this Section 8.2 shall apply to the Company Conversion; (ii) if such waiver is obtained, b
sfied, then the remainder of this Section 8.2 shall not apply and the Company must deliver certificated Common Stock to Holder pursua
ined, then the remainder of this Section 8.2 shall not apply and the Company must elect a Company Redemption and deliver cash to the
such lessor amount authorized by the Holder in writing) pursuant to Section 8.3 hereof. To the extent applicable as set forth above:

No later than three (3) Trading Days after each applicable Pre-Installment Notice Due Date, the Company shall deliver to the Holder's a
ch the Holder shall be the owner thereof as of the applicable Pre-Installment Notice Due Date.

5

No later than three (3) Trading Days after each Installment Date, the Company shall deliver to the Holder's account a number of shares
Post-Installment Conversion Shares exceed the Pre-Installment Conversion Shares previously delivered to Holder, registered in the nam
ault has occurred regarding payment, conversion or redemption under this Note (each a "Payment Default"), if the Pre-Installment Conv
Post-Installment Conversion Shares, then the excess will be applied towards the next Conversion Shares to be issued by the Company (u
, in which case Holder will return such excess shares to the Company). If a Payment Default has occurred and the Pre-Installment Conv
eed the Post-Installment Conversion Shares, then Holder shall not be required to return to the Company any of the excess shares or appl
version of shares hereunder. The Company agrees to deliver to the Holder such information and calculations required under this Section
ibit C-2 (each, an "Installment Date Notice").

f an Event of Default occurs during any applicable Company Conversion Measuring Period (defined below), then Holder may elect to e
vered in connection with the applicable Installment Date, or (ii) retain such Pre-Installment Conversion Shares and reduce the Outstandi
l to the Market Price of such retained Pre-Installment Conversion Shares as of the Installment Date, but in no event shall such reduction
l to calculate such Pre-Installment Conversion Shares. "Company Conversion Measuring Period" means the period beginning on the ap
applicable Installment Date.

f no Equity Conditions Failure existed as of the Pre-Installment Notice Due Date, but an Equity Conditions Failure exists as of the appl
nitted herein, or a Company Conversion is not otherwise permitted as of the Installment Date under any other provision of this Note, the
Company, the Holder may require the Company to do any one or more of the following:

he Company must redeem all or any part designated by the Holder of the Company Conversion Amount for which shares have not yet b
rred to as the "Designated Redemption Amount") and the Company shall pay to the Holder within three (3) Trading Days of such Instal
ls, an amount in cash equal to the Redemption Premium multiplied by the Designated Redemption Amount (the "Designated Redemptio
emption Price by the third (3rd) Trading Day following such written notice to the Company, then such failure to pay shall be an Event o

he Company Conversion shall be null and void with respect to the Company Conversion Amount for which shares have not yet been de
rights of a holder of this Note with respect to such remaining Company Conversion Amount; provided, however, the Conversion Price f
eafter be adjusted to equal the lesser of (Y) the Default Conversion Price as in effect on the date on which the Holder voided the Compa
would be in effect on the date on which the Holder delivers a subsequent Conversion Notice relating thereto as if such date was an Insta

6

Notwithstanding anything to the contrary in this Section 8.2, but subject to Section 3.4, until the Company delivers Common Stock repr
der pursuant to the terms of this Section 8.2, the Company Conversion Amount may be converted by the Holder into Common Stock pu
onvert the Company Conversion Amount prior to the applicable Installment Date as set forth in the immediately preceding sentence, the
ucted from the Installment Amount(s) relating to the applicable Installment Date(s) as set forth in the applicable Conversion Notice.

All Common Stock to be delivered to the Holder under this Section 8.2 shall be transferred via the DWAC system. Failure to do so shal
of.

Mechanics of Company Redemption. If the Company elects, or is required to elect, a Company Redemption, in whole or in part, in acc
mpany Redemption Amount, if any, which is to be paid to the Holder on the applicable Installment Date shall be redeemed by the Comp
Company shall pay to the Holder on such Installment Date, by wire transfer of immediately available funds an amount, equal to the appl
to pay the applicable Company Redemption Amount on the applicable Installment Date, then, at the option of the Holder designated in
Conversion Notice" for purposes of this Note), the Holder may require the Company to convert all or any part of the Company Redempti
f the date of such designation as if such date were an Installment Date). Conversions required by this Section 8.3 shall be made in accor
withstanding anything to the contrary in this Section 8.3, but subject to Section 3.4 and the Holder's right to require the Company to co
ount at the Default Conversion Price as set forth above, until the Company Redemption Amount (together with any Late Charges thereo
ether with any Late Charges thereon) may be converted, in whole or in part, by the Holder into Common Stock pursuant to Section 3. In
ion of the Company Redemption Amount prior to the applicable Installment Date as set forth in the immediately preceding sentence, th
ucted from the Installment Amounts relating to the applicable Installment Date(s) as set forth in the applicable Conversion Notice.

DWAC Eligibility. If, when the Company delivers a Pre-Installment Notice and elects, or is deemed to have delivered a Pre-Installmen
a Company Conversion in accordance with Section 8.1, and the DWAC Eligible Conditions are not then satisfied but Holder waives th
ion 8.6, then, in accordance with Section 8.2, although such status will constitute an Event of Default hereunder, shares required to be i
hout limiting any of Holder's rights with respect to the Event of Default) as follows:

No later than three (3) Trading Days after delivery or deemed delivery (as applicable) of the applicable Pre-Installment Notice setting fo
l deliver to the Holder or its broker, via reputable overnight courier, the Pre-Installment Certificated Shares by original share certificate,
vided, however, that so long as shares are not provided electronically to the Holder under Section 8, the Pre-Installment Certificated Sha
Installment Conversion Shares that would otherwise be transferred electronically to the Holder.

7

The Company agrees to use its best efforts to cause such shares to become Free Trading (the first date such occurs, the "Free Trading Da
ding Date via email within two (2) Trading Days after the occurrence of the Free Trading Date.

Provided that there is no Equity Conditions Failure as of the date that is twenty-three (23) Trading Days after the applicable Free Tradin
failure is waived as permitted herein) and a Company Conversion is not otherwise prohibited under any other provision of this Note, n
ificated Shares Installment Date, the Company shall deliver to the Holder or its broker via reputable overnight courier the Post-Installm
ificated Shares previously delivered to the Holder, by original share certificate, registered in the name of the Holder or its designee. So
Installment Certificated Shares for the applicable Certificated Shares Installment Date exceed the Post-Installment Certificated Shares,
version Shares to be issued by the Company (unless the Outstanding Balance has been reduced to zero, in which case Holder will return
ault has occurred and the Pre-Installment Certificated Shares for the applicable Certificated Shares Installment Date exceed the Post-Ins
ired to return to the Company any of the excess shares or apply such excess shares to any future issuance or conversion of shares hereu

Deemed Issuance. If Company fails to deliver shares as required by any portion of this Section 8, in addition to such failure to act being
poses of Section 7.1, the Company shall also be deemed to have issued the Pre-Installment Conversion Shares, Post-Installment Convers
-Installment Certificated Shares, as applicable, to Holder on the latest possible permitted date pursuant to the terms set forth in this Sect
ileges associated with such deemed issued shares (the "Deemed Installment Issuance").

Waiver of Equity Conditions Failure. Notwithstanding anything in this Note to the Contrary, the Holder may waive in writing any Equi
ity Conditions (defined below). For purposes of this Section 8, "Non-Waivable Equity Conditions" refers to (A) the Equity Condition s
own more than the Maximum Percentage set forth in Section 3.4 of this Note), and (B) the Equity Condition set forth in Section 27.19(v
s of the Eligible Market). Any such waiver shall only be made for the purposes of permitting a Company Conversion to occur under this
erlying default or a continuing waiver of a future Equity Conditions Failure. Any such waiver shall not excuse the Company from the pe
er this Note.

Preparation of Installment Notices. Because of the complexity of the calculations contemplated under this Note, the Holder may, at its s
or the Installment Date Notice for the benefit of the Company, including the calculation of Pre-Installment Conversion Shares, Post-Ins
ificated Shares, Post-Installment Certificated Shares; provided, however, that no error or mistake in the preparation of such notices or in
t to enforce the terms of this Note, even if such error or mistake arises from the Holder's own calculation. Nothing in this Section shall
notices or information, or a waiver of any of its rights and remedies under this Note.

8

Transfer Fees. The Company shall pay any and all transfer, stamp, issuance and similar taxes that may be payable with respect to the is
res, Post-Installment Conversion Shares, Pre-Installment Certificated Shares, and Post-Installment Certificated Shares.

ONCIRCUMVENTION. The Company hereby covenants and agrees that the Company will not, by amendment of its Certificate of Inc
ugh any reorganization, transfer of assets, consolidation, merger, scheme of arrangement, dissolution, issue or sale of securities, or any
ervance or performance of any of the terms of this Note, and will at all times in good faith carry out all of the provisions of this Note and
ne Holder of this Note. Without limiting the generality of the foregoing, the Company (i) shall not increase the par value of any shares o
e above the Conversion Price then in effect, (ii) shall take all such actions as may be necessary or appropriate in order that the Company
-assessable shares of Common Stock upon the conversion of this Note, and (iii) shall, so long as this Note is outstanding, take all action
Agreement).

HOLDER'S REDEMPTIONS. If the Holder has submitted to the Company an Event of Default Redemption Notice in accordance with
within ten (10) Trading Days after the Company's receipt of such Event of Default Redemption Notice an amount equal to the Default
mium (the "Event of Default Redemption Price"); provided, however, that the Redemption Premium may only be applied in computing
two Events of Default under this Note, and not to any subsequent Events of Default. If the Holder has submitted to Company a Fundam
Section 5.2, then the Company shall pay to Holder in cash prior to the consummation of such Fundamental Transaction if such notice i
damental Transaction and within ten (10) Trading Days after the Company's receipt of such notice otherwise, an amount equal to the Fu
ne Redemption Premium (the "Fundamental Transaction Redemption Price"). Notwithstanding anything in this Note to the contrary, su
er this Section 10 shall not be considered a separate Event of Default hereunder. In the event that the Company does not pay the applica
od required, at any time thereafter and until the Company pays such unpaid Redemption Price in full, the Holder shall have the option, i
emption Notice or the Fundamental Transaction Redemption Notice, as applicable, by written notice to the Company (the "Redemption
emption Cancellation Notice, (y) the Outstanding Balance of this Note as of the date of the Redemption Notice shall be increased by an
emption Price, or Fundamental Transaction Redemption Price (as the case may be), minus (2) the principal portion of the Outstanding B
version Price of this Note shall be automatically adjusted with respect to each conversion under this Note effected thereafter by the Hol
e of the Common Stock during the period beginning on and including the date on which the applicable Redemption Notice is delivered
ne Redemption Cancellation Notice, (B) the Market Price as of the date of the Redemption Cancellation Notice, (C) the then current Ma
Holder's delivery of a Redemption Cancellation Notice and exercise of its rights following such notice shall not affect the Company's
e accrued prior to the date of such Redemption Cancellation Notice.

9

VOTING RIGHTS. The Holder shall have no voting rights as the holder of this Note, except as required by law and as expressly provid

AMENDING THE TERMS OF THIS NOTE. The prior written consent of the Holder shall be required for any change or amendment to

TRANSFER. This Note and any shares of Common Stock issued upon conversion of this Note may be offered, sold, assigned or transfe
mpany.

REISSUANCE OF THIS NOTE.

. Transfer. If this Note is to be transferred, the Holder shall surrender this Note to the Company, whereupon the Company will forthwit
e (in accordance with Section 14.4), registered as the Holder may request, representing the Outstanding Balance being transferred by the
ance is being transferred, a new Note (in accordance with Section 14.4) to the Holder representing the Outstanding Balance not being tra

. Lost, Stolen or Mutilated Note. Upon receipt by the Company of evidence reasonably satisfactory to the Company of the loss, theft, de
tten certification and the indemnification contemplated below shall suffice as such evidence), and, in the case of loss, theft or destruction
Company in customary and reasonable form and, in the case of mutilation, upon surrender and cancellation of this Note, the Company s
ordance with Section 14.4) representing the Outstanding Balance.

. Note Exchangeable for Different Denominations. This Note is exchangeable, upon the surrender hereof by the Holder at the principal
ordance with Section 14.4 and in principal amounts of at least $1,000) representing in the aggregate the Outstanding Balance of this Not
uch Outstanding Balance as is designated by the Holder at the time of such surrender.

. Issuance of New Notes. Subject to Section 10, whenever the Company is required to issue a new Note pursuant to the terms of this No
e, (ii) shall represent, as indicated on the face of such new Note, the Outstanding Balance (or in the case of a new Note being issued pur
standing Balance designated by the Holder which, when added to the outstanding balance represented by the other new Notes issued in
standing Balance under this Note immediately prior to such issuance of new Notes), (iii) shall have an issuance date, as indicated on the
ance Date of this Note, (iv) shall have the same rights and conditions as this Note, and (v) shall represent accrued and unpaid Interest an
ance as permitted hereunder from the Issuance Date.

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REMEDIES, CHARACTERIZATIONS, OTHER OBLIGATIONS, BREACHES AND INJUNCTIVE RELIEF. The remedies, includin
ayment Premium, and all other charges, fees, and collection costs provided for in this Note, shall be cumulative and in addition to all ot
r Transaction Documents at law or in equity (including a decree of specific performance and/or other injunctive relief), and nothing her
sequential damages for any failure by the Company to comply with the terms of this Note. The Company covenants to the Holder that th
ument other than as expressly provided herein. Amounts set forth or provided for herein with respect to payments, conversion and the l
e received by the Holder and shall not, except as expressly provided herein, be subject to any other obligation of the Company (or the pe
each by it of its obligations hereunder will cause irreparable harm to the Holder and that the remedy at law for any such breach may be i
t of any such breach or threatened breach, the Holder shall be entitled, in addition to all other available remedies, to an injunction restra
out the necessity of showing economic loss and without any bond or other security being required. The Company shall provide all infor
ested by the Holder to enable the Holder to confirm the Company's compliance with the terms and conditions of this Note (including, v

PAYMENT OF COLLECTION, ENFORCEMENT AND OTHER COSTS. If (a) this Note is placed in the hands of an attorney for coll
ugh any legal proceeding or the Holder otherwise takes action to collect amounts due under this Note or to enforce the provisions of thi
ganization, receivership of the Company or other proceedings affecting Company creditors' rights and involving a claim under this Not
der for such collection, enforcement or action or in connection with such bankruptcy, reorganization, receivership or other proceeding, i
ursements. The Company expressly acknowledges and agrees that no amounts due under this Note shall be affected, or limited, by the f
the Original Principal Amount.

CONSTRUCTION; HEADINGS. This Note shall be deemed to be jointly drafted by the Company and the Holder and shall not be cons
lings of this Note are for convenience of reference and shall not form part of, or affect the interpretation of, this Note. Terms used in thi
l have the meanings ascribed to such terms on the Issuance Date in such other Transaction Documents unless otherwise consented to in

FAILURE OR INDULGENCE NOT WAIVER. No failure or delay on the part of the Holder in the exercise of any power, right or privi
l any single or partial exercise of any such power, right or privilege preclude other or further exercise thereof or of any other right, powe
riting and signed by an authorized representative of the waiving party.

DISPUTE RESOLUTION. In the case of a dispute as to the determination of the Conversion Price, Default Conversion Price, Pre-Instal
Price, the Closing Sale Price, VWAP or fair market value (as the case may be) or the arithmetic calculation of Conversion Shares or the
mpany or the Holder (as the case may be) shall submit the disputed determinations or arithmetic calculations (as the case may be) via fac
applicable notice giving rise to such dispute to the Company or the Holder (as the case may be) or (ii) if no notice gave rise to such disp
umstances giving rise to such dispute (including, without limitation, as to whether any issuance or sale or deemed issuance or sale was a
luded Securities). If the Holder and the Company are unable to agree upon such determination or calculation within two (2) Trading Da
ulation (as the case may be) being submitted to the Company or the Holder (as the case may be), then the Company shall, within two (2
rmination of the Conversion Price, Default Conversion Price, Pre-Installment Conversion Price, Conversion Rate, the Closing Bid Price
he case may be) to an independent, reputable investment bank selected by the Holder or (b) the disputed arithmetic calculation of the C
be) to the Company's independent, outside accountant. The Company shall cause at its expense the investment bank or the accountant
ulations (as the case may be) and notify the Company and the Holder of the results no later than ten (10) Trading Days from the time it
he case may be). Such investment bank's or accountant's determination or calculation with respect to the disputes set forth in this Secti
es absent demonstrable error.

NOTICES; PAYMENTS.

. Notices. Whenever notice is required to be given under this Note, unless otherwise provided herein, such notice shall be given in acco
tices." The Company shall provide the Holder with prompt written notice of all actions taken pursuant to this Note, including in reason
efore. Without limiting the generality of the foregoing, the Company will give written notice to the Holder (i) immediately upon any ad
onable detail, and certifying, the calculation of such adjustment and (ii) at least fifteen (15) Trading Days prior to the date on which the
ect to any dividend or distribution upon the Common Stock, (B) with respect to any grant, issuances, or sales of any Options, Convertib
rities or other property to all holders of shares of Common Stock, or (C) for determining rights to vote with respect to any Fundamental
case that such information shall be made known to the public prior to or in conjunction with such notice being provided to the Holder.

. Currency. All dollar amounts referred to in this Note are in United States Dollars ("U.S. Dollars"), and all amounts owing under this N
ominated in other currencies (if any) shall be converted into the U.S. Dollar equivalent amount in accordance with the Exchange Rate o
tion to any amount of currency to be converted into U.S. Dollars pursuant to this Note, the U.S. Dollar exchange rate as published in Th
eing understood and agreed that where an amount is calculated with reference to, or over, a period of time, the date of calculation shall

. Payments. Whenever any payment of cash is to be made by the Company to any Person pursuant to this Note, unless otherwise expres
ful money of the United States of America by wire transfer of immediately available funds pursuant to wire transfer instructions deliver
amount expressed to be due by the terms of this Note is due on any day which is not a Trading Day, the same shall instead be due on th
unt due under the Transaction Documents which is not paid when due shall result in a late charge being incurred and payable by the Co
e rate of eighteen percent (18%) per annum from the date such amount was due until the same is paid in full ("Late Charge").

CANCELLATION. After repayment or conversion of the entire Outstanding Balance, this Note shall automatically be deemed canceled
shall not be reissued.

WAIVER OF NOTICE. To the extent permitted by law, the Company hereby irrevocably waives demand, notice, presentment, protest a
delivery, acceptance, performance, default or enforcement of this Note and the Agreement.

2

GOVERNING LAW. This Note shall be construed and enforced in accordance with, and all questions concerning the construction, vali overned by, the internal laws of the State of Utah, without giving effect to any choice of law or conflict of law provision or rule (whethe ld cause the application of the laws of any jurisdictions other than the State of Utah. The Company hereby irrevocably submits to the ex ng in Salt Lake City for the adjudication of any dispute hereunder or in connection herewith or with any transaction contemplated hereb agrees not to assert in any suit, action or proceeding, any claim that it is not personally subject to the jurisdiction of any such court, that nvenient forum or that the venue of such suit, action or proceeding is improper. Nothing contained herein shall be deemed to limit in an nitted by law. In the event that any provision of this Note is invalid or unenforceable under any applicable statute or rule of law, then su it may conflict therewith and shall be deemed modified to conform with such statute or rule of law. Any such provision which may pro ct the validity or enforceability of any other provision of this Note. Nothing contained herein shall be deemed or operate to preclude the nst the Company or any of its Subsidiaries in any other jurisdiction to collect on the Company's obligations to the Holder, to realize on enforce a judgment or other court ruling in favor of the Holder. THE COMPANY HEREBY IRREVOCABLY WAIVES ANY RIGH QUEST, A JURY TRIAL FOR THE ADJUDICATION OF ANY DISPUTE HEREUNDER OR IN CONNECTION WITH OR ARISIN NTEMPLATED HEREBY.

SEVERABILITY. If any provision of this Note is prohibited by law or otherwise determined to be invalid or unenforceable by a court o rwise be prohibited, invalid or unenforceable shall be deemed amended to apply to the broadest extent that it would be valid and enforc vision shall not affect the validity of the remaining provisions of this Note so long as this Note as so modified continues to express, with es as to the subject matter hereof and the prohibited nature, invalidity or unenforceability of the provision(s) in question does not substa gations of the parties or the practical realization of the benefits that would otherwise be conferred upon the parties. The parties will end ibited, invalid or unenforceable provision(s) with one or more valid provisions, the effect of which comes as close as possible to that of

FEES AND CHARGES. The parties acknowledge and agree that upon Company's failure to comply with the provisions of this Note, th mate because of the parties' inability to predict future interest rates, the Holder's increased risk, and the uncertainty of the availability of der. Accordingly, any fees, charges, and interest due under this Note, including without limitation the Prepayment Premium and the Rec shall be deemed, a reasonable estimate of the Holder's actual loss of its investment opportunity and not a penalty, and shall not be deem have hereunder, at law or in equity.

8

UNCONDITIONAL OBLIGATION. Subject to the terms of the Agreement, no provision of this Note shall alter or impair the obligatio
onditional, to pay the principal of, and interest on, this Note at the time, place, and rate, and in the coin or currency or where contemplat
erein prescribed. This Note is the direct obligation of the Company and not subject to offsets, counterclaims, defenses, credits or deduc

CERTAIN DEFINITIONS. For purposes of this Note, the following terms shall have the following meanings:

. "Affiliate" means, with respect to any Person, any other Person that directly or indirectly controls, is controlled by, or is under commo
poses of this definition that "control" of a Person means the power directly or indirectly either to vote 10% or more of the stock having o
on or direct or cause the direction of the management and policies of such Person whether by contract or otherwise.

. "Agreement" means that certain Securities Purchase Agreement, dated as of August 22, 2012, as may be amended from time to time,
ch the Company issued this Note.

. "Approved Stock Plan" means any stock option plan which has been approved by the Board of Directors of the Company, pursuant to
loyee, officer or director for services provided to the Company.

. "Black Scholes Consideration Value" means the value of the applicable Option or Convertible Security (as the case may be) as of the
oles Option Pricing Model obtained from the "OV" function on Bloomberg utilizing (i) an underlying price per share equal to the Closi
ediately preceding the public announcement of the execution of definitive documents with respect to the issuance of such Option or Co
rest rate corresponding to the U.S. Treasury rate for a period equal to the remaining term of such Option or Convertible Security (as the
onvertible Security (as the case may be), and (iii) an expected volatility equal to the greater of 100% and the 100 day volatility obtaine
zing a 365 day annualization factor) as of the Trading Day immediately following the date of issuance of such Option or Convertible Se

. "Bloomberg" means Bloomberg, L.P.

4

. "Closing Bid Price" and "Closing Sale Price" means, for any security as of any date, the last closing bid price and last closing trade pr
eported by Bloomberg, or, if the Principal Market begins to operate on an extended hours basis and does not designate the closing bid pr
ast bid price or last trade price, respectively, of such security prior to 4:00:00 p.m., New York time, as reported by Bloomberg, or, if the
hange or trading market for such security, the last closing bid price or last trade price, respectively, of such security on the principal secu
sted or traded as reported by Bloomberg, or if the foregoing do not apply, the last closing bid price or last trade price, respectively, of su
tronic bulletin board for such security as reported by Bloomberg, or, if no closing bid price or last trade price, respectively, is reported f
es, or the ask prices, respectively, of any market makers for such security as reported in "OTC Pink" by Pink OTC Markets Inc. (former
sing Bid Price or the Closing Sale Price cannot be calculated for a security on a particular date on any of the foregoing bases, the Closin
of such security on such date shall be the fair market value as mutually determined by the Company and the Holder. If the Company and
e of such security, then such dispute shall be resolved in accordance with the procedures in Section 19. All such determinations shall be
, stock combination or other similar transaction during such period.

. "Common Stock" means (i) the Company's shares of common stock, $0.01 par value per share, and (ii) any capital stock into which s
tal resulting from a reclassification of such common stock.

. "Contingent Obligation" means as to any Person, any direct or indirect liability, contingent or otherwise, of that Person with respect to
her Person if the primary purpose or intent of the Person incurring such liability, or the primary effect thereof, is to provide assurance to
or discharged, or that any agreements relating thereto will be complied with, or that the holders of such liability will be protected (in w

. "Conversion Shares" means shares of Common Stock issuable by the Company upon any conversion of this Note, including without l
version Shares, Post-Installment Conversion Shares, Pre-Installment Certificated Shares, and Post-Installment Certificated Shares.

0. "Convertible Securities" means any stock, preferred stock, stock appreciation rights, phantom stock, equity related rights, equity link
time and under any circumstances, directly or indirectly, convertible into, exercisable or exchangeable for, or which otherwise entitles t
k.

1. "Current Subsidiary" means any Person in which the Company on the Issuance Date, directly or indirectly, (i) owns any of the outsta
uch Person or (ii) controls or operates all or any part of the business, operations or administration of such Person, and all of the foregoin

5

2. “Deemed Issuance” means (i) a Deemed Conversion Issuance as defined in Section 3.3(b) hereof, (ii) a Deemed Installment Issuance
rant Issuance as defined in Section 7.1(e) hereof.

3. “Default Conversion Price” means, with respect to a particular date of determination, the lower of (i) the Conversion Price then in ef
Installment Notice Due Date or the Installment Date, as applicable. All such determinations to be appropriately adjusted for any stock s
saction during any applicable Measuring Period.

4. “DTC” means the Depository Trust Company.

5. “DTC/FAST Program” means the DTC’s Fast Automated Securities Transfer Program.

6. “DWAC” means Deposit Withdrawal at Custodian as defined by the DTC.

7. “DWAC Eligible Conditions” means that (i) the Common Stock is eligible at DTC for full services pursuant to DTC’s Operational A
C’s DWAC system, (ii) the Company has been approved (without revocation) by the DTC’s underwriting department, and (iii) the Trans
gram.

8. “Eligible Market” means The New York Stock Exchange, NYSE Amex, the Nasdaq Global Select Market, the Nasdaq Global Marke
OTCQX or the OTCQB, or the Principal Market. In no event shall quotations provided in OTC Pink by Pink OTC Markets Inc., or its su

9. “Equity Conditions” means: (i) with respect to the applicable date of determination all of the Conversion Shares are freely tradable u
applicable federal or state securities laws (in each case, disregarding any limitation on conversion of this Note); (ii) on each day during
of determination and ending on and including the applicable date of determination (the “Equity Conditions Measuring Period”), the Co
d or designated for quotation (as applicable) on an Eligible Market and shall not have been suspended from trading on an Eligible Mark
Trading Days and occurring prior to the applicable date of determination due to business announcements by the Company); (iii) on each
Company shall have delivered all shares of Common Stock issuable upon conversion of this Note on a timely basis as set forth in Sectio
e delivered by the Company on a timely basis as set forth in the other Transaction Documents; (iv) any shares of Common Stock to be i
rmination may be issued in full without violating Section 3.4 hereof (the Holder acknowledges that the Company shall be entitled to ass
under absent written notice from the Holder); (v) any shares of Common Stock to be issued in connection with the event requiring dete
s or regulations of the Eligible Market on which the Common Stock is then listed or designated for quotation (as applicable); (vi) on eac
ublic announcement of a pending, proposed or intended Fundamental Transaction shall have occurred which has not been abandoned, t
e no knowledge of any fact that would reasonably be expected to cause any of the Conversion Shares to not be freely tradable without th
rities laws (in each case, disregarding any limitation on conversion of this Note); (viii) on each day during the Equity Conditions Measu
erial compliance with each, and shall not have breached any, term, provision, covenant, representation or warranty of any Transaction D
day during the Equity Conditions Measuring Period, there shall not have occurred an Event of Default or an event that with the passag
efault; (x) all DWAC Eligible Conditions shall be satisfied as of each applicable Pre-Installment Notice Due Date and Installment Date
Installment Date, the average and median daily dollar volume of the Common Stock on its Principal Market for the previous twenty-th
000.00; (xii) the ten (10) day average VWAP of the Common Stock is greater than $0.005; and (xiii) Market Capitalization of the Com

6

0. “Equity Conditions Failure” means, with respect to a particular date of determination, that on any day during the period commencing
date of determination and ending on such date of determination, the Equity Conditions have not been satisfied (or waived in writing by
lt of an Event of Default, then the Equity Conditions Failure shall be deemed permanent and may not be cured by the Company.

1. “Excluded Securities” means any shares of Common Stock, options, or convertible securities issued or issuable (i) in connection with
, exercise price or similar provisions of any issuances pursuant to such Approved Stock Plan are not amended, modified or changed on
gers, acquisitions, strategic licensing arrangements, strategic business partnerships or joint ventures, in each case with non-affiliated thi
ose of which is not to raise additional capital; provided, that such third parties are not granted any registration rights. Notwithstanding
e capital for the Company or its Subsidiaries, directly or indirectly, in connection with any transaction contemplated by clause (ii) above
ore related transactions or that result in similar economic consequences, shall not be deemed to be Excluded Securities.

2. “Free Trading” means that (i) the certificate representing the applicable shares of Common Stock has been cleared and approved for
kerage firm and the clearing firm servicing such brokerage, and (ii) such shares are held in the name of the clearing firm servicing Holde
ring firm’s account for the benefit of Holder.

3. “Fundamental Transaction” means that (i) (1) the Company or any of its Subsidiaries shall, directly or indirectly, in one or more rela
ether or not the Company or any of its Subsidiaries is the surviving corporation) any other Person, or (2) the Company or any of its Sig
ore related transactions, sell, lease, license, assign, transfer, convey or otherwise dispose of all or substantially all of its respective prop
ny of its Subsidiaries shall, directly or indirectly, in one or more related transactions, allow any other Person to make a purchase, tender
e than 50% of the outstanding shares of Voting Stock of the Company (not including any shares of Voting Stock of the Company held b
ciated or affiliated with the Persons making or party to, such purchase, tender or exchange offer), or (4) the Company or any of its Subs
ted transactions, consummate a stock or share purchase agreement or other business combination (including, without limitation, a reorga
ngement) with any other Person whereby such other Person acquires more than 50% of the outstanding shares of Voting Stock of the Co
Company held by the other Person or other Persons making or party to, or associated or affiliated with the other Persons making or party
ness combination), or (5) the Company or any of its Subsidiaries shall, directly or indirectly, in one or more related transactions, reorga
r than an increase in the number of authorized shares of the Company’s Common Stock, or (ii) any “person” or “group” (as these terms
4 Act and the rules and regulations promulgated thereunder) is or shall become the “beneficial owner” (as defined in Rule 13d-3 under t
regate ordinary voting power represented by issued and outstanding Voting Stock of the Company.

7

4. “GAAP” means United States generally accepted accounting principles, consistently applied.

5. “Indebtedness” of any Person means, without duplication (i) all indebtedness for borrowed money, (ii) all obligations issued, underta
perty or services, including, without limitation, “capital leases” in accordance with GAAP (other than trade payables entered into in the
ment obligations with respect to letters of credit, surety bonds and other similar instruments, (iv) all obligations evidenced by notes, bon
gations so evidenced incurred in connection with the acquisition of property, assets or businesses, (v) all indebtedness created or arising
ement, or incurred as financing, in either case with respect to any property or assets acquired with the proceeds of such indebtedness (e
er such agreement in the event of default are limited to repossession or sale of such property), (vi) all monetary obligations under any le
AP, consistently applied for the periods covered thereby, is classified as a capital lease, (vii) all indebtedness referred to in clauses (i) th
Indebtedness has an existing right, contingent or otherwise, to be secured by) any mortgage, lien, pledge, charge, security interest or ot
luding accounts and contract rights) owned by any Person, even though the Person which owns such assets or property has not assumed
btedness, and (viii) all Contingent Obligations in respect of indebtedness or obligations of others of the kinds referred to in clauses (i) t

6. “Installment Amount” means the greater of (i) $77,500 (310,000.00 ÷ 4), plus the sum of any accrued and unpaid Interest as of the ap
rges, if any, under this Note as of the applicable Installment Date, and any other amounts accruing or owing to Holder under this Note a
standing Balance divided by the number of Installment Dates remaining prior to the Maturity Date. In the event the Holder shall sell or
sferee shall be allocated a pro rata portion (based on the portion of this Note transferred compared with the Outstanding Balance of this
ount hereunder.

7. “Installment Date” means the Initial Installment Date and the same day on each of the following calendar months following the Initia
nt of Default (or the issuance of any Redemption Cancellation Notice). If the Outstanding Balance is not paid on the Maturity Date, ther
nsaction Documents, the Installment Dates will continue on the same day of each calendar month until the Outstanding Balance is paid i
vide Pre-Installment Notices to the Holder pursuant to Section 8 hereof.

8. “Market Price” means 75% of the arithmetic average of the three (3) lowest VWAPs of the shares of Common Stock during the twen
eding the date of such determination (the “Measuring Period”). All such determinations are to be appropriately adjusted for any stock s
saction during such Measuring Period.

9. “Maturity Date” shall mean the date that is ten (10) months after the Issuance Date.

0. “New Subsidiary” means, as of any date of determination, any Person in which the Company after the Issuance Date, directly or indi
k or holds any equity or similar interest of such Person or (ii) controls or operates all or any part of the business, operations or administ
ectively, “New Subsidiaries.”

8

1. “Options” means any rights, warrants or options to subscribe for or purchase shares of Common Stock or Convertible Securities.

2. “Parent Entity” of a Person means an entity that, directly or indirectly, controls the applicable Person and whose common stock or eq
ket, or, if there is more than one such Person or Parent Entity, the Person or Parent Entity with the largest public market capitalization a
saction.

3. “Person” means an individual, a limited liability company, a partnership, a joint venture, a corporation, a trust, an unincorporated org
rtment or agency thereof.

4. “Post-Installment Certificated Shares” means a number of shares of Common Stock equal to one (1) times the greater of (i) the Post-
icable Installment Date, and (ii) the Post-Installment Conversion Shares calculated using the Certificated Shares Installment Date (as if

5. “Post-Installment Conversion Price” means, with respect to a particular date of determination, the lower of (i) the Conversion Price t
llment Date. All such determinations to be appropriately adjusted for any stock split, stock dividend, stock combination or other simila

6. “Post-Installment Conversion Shares” means that number of shares of Common Stock that would be required to be delivered pursuar
g into account the delivery of any Pre-Installment Conversion Shares. The Post-Installment Conversion Shares are equal to the quotien
he Post-Installment Conversion Price as of the applicable Installment Date.

7. “Pre-Installment Certificated Shares” means the number of shares of Common Stock to be delivered pursuant to Section 8.4(a). The
s the number of Pre-Installment Conversion Shares that would otherwise be required to be delivered to the Holder pursuant to Section 8

8. “Pre-Installment Conversion Price” means, with respect to a particular date of determination, the lower of (i) the Conversion Price th
Installment Notice Due Date. All such determinations to be appropriately adjusted for any stock split, stock dividend, stock combinatio
suring Period.

9. “Pre-Installment Conversion Shares” means the number of shares of Common Stock to be delivered pursuant to Section 8.1. The Pre
) the Company Conversion Amount divided by (ii) the Pre-Installment Conversion Price as of the applicable Pre-Installment Notice Du

0. “Principal Market” means the Nasdaq Capital Market.

1. “Redemption Notices” means, collectively, Event of Default Redemption Notices and Fundamental Transaction Redemption Notices
ce.”

2. “Redemption Premium” means 135%.

9

3. “Redemption Price” means either the Event of Default Redemption Price or the Fundamental Transaction Redemption Price, as the c

4. “SEC” means the United States Securities and Exchange Commission or the successor thereto.

5. “Significant Subsidiaries” means, as of any date of determination, collectively, all Subsidiaries that would constitute a “significant su
he SEC, and each of the foregoing, individually, a “Significant Subsidiary.”

6. “Subsidiaries” means, as of any date of determination, collectively, all Current Subsidiaries and all New Subsidiaries, and each of the

7. “Successor Entity” means the Person, which may be the Company, formed by, resulting from or surviving any Fundamental Transac
nsaction shall have been made, provided that if such Person is not a publicly traded entity whose common stock or equivalent equity sec
ket, Successor Entity shall mean such Person's Parent Entity.

8. “Trading Day” means any day on which the Common Stock is traded on the Principal Market, or, if the Principal Market is not the p
principal securities exchange or securities market on which the Common Stock is then traded, provided that “Trading Day” shall not inc
ade on such exchange or market for less than 4.5 hours or any day that the Common Stock is suspended from trading during the final ho
hange or market does not designate in advance the closing time of trading on such exchange or market, then during the hour ending at 4:
rwise designated as a Trading Day in writing by the Holder.

9. “Voting Stock” of a Person means capital stock of such Person of the class or classes pursuant to which the holders thereof have the
oint, at least a majority of the board of directors, managers, trustees or other similar governing body of such Person (irrespective of whe
ses shall have or might have voting power by reason of the happening of any contingency).

0. “VWAP” means, for any security as of any date, the dollar volume-weighted average price for such security on the Principal Market
ket for such security, then on the principal securities exchange or securities market on which such security is then traded) during the per
ng at 4:00:00 p.m., New York time, as reported by Bloomberg through its “Volume at Price” function or, if the foregoing does not appl
rity in the over-the-counter market on the electronic bulletin board for such security during the period beginning at 9:30:01 a.m., New Y
eported by Bloomberg, or, if no dollar volume-weighted average price is reported for such security by Bloomberg for such hours, the av
ing ask price of any of the market makers for such security as reported in “OTC Pink” by Pink OTC Markets Inc. (formerly Pink Sheets
alculated for such security on such date on any of the foregoing bases, the VWAP of such security on such date shall be the fair market
der. If the Company and the Holder are unable to agree upon the fair market value of such security, then such dispute shall be resolved i
determinations shall be appropriately adjusted for any stock dividend, stock split, stock combination or other similar transaction during

0

DISCLOSURE. Upon receipt or delivery by the Company of any notice in accordance with the terms of this Note, unless the Company
notice do not constitute material, non-public information relating to the Company or any of its Subsidiaries, the Company shall within
icly disclose such material, non-public information on a Current Report on Form 8-K or otherwise. In the event that the Company belie
rmation relating to the Company or any of its Subsidiaries, the Company so shall indicate to such Holder contemporaneously with deliv
cation, the Holder shall be allowed to presume that all matters relating to such notice do not constitute material, non-public information

MAXIMUM PAYMENTS. Nothing contained in this Note shall, or shall be deemed to, establish or require the payment of a rate of inte
nitted by applicable law. In the event that the rate of interest required to be paid or other charges under this Note exceeds the maximum
imum shall be credited against amounts owed by the Company to the Holder and thus refunded to the Company.

[Remainder of page intentionally left blank]

WITNESS WHEREOF, the Company has caused this Note to be duly executed as of the Issuance Date set forth above.

THE COMPANY:

Seven Arts Entertainment Inc.

By:_____
Name:_____
Title:_____

KNOWLEDGED, ACCEPTED AND AGREED:

aquint, Inc.

_____
John M. Fife, President

[Signature page to Convertible Promissory Note]

2

EXHIBIT A

Tonaquint, Inc.
303 East Wacker Drive, Suite 1200
Chicago, Illinois 60601

en Arts Entertainment Inc. Date:_____

: _____
9 Sunset Boulevard 4th Floor
Angeles, California 90069

CONVERSION NOTICE

above-captioned Holder hereby gives notice to Seven Arts Entertainment Inc., a Nevada corporation (the "Company"), pursuant to that
npany in favor of the Holder on August 22, 2012 (the "Note"), that the Holder elects to convert the portion of the Note balance set forth
mmon Stock of the Company as of the date of conversion specified below. Said conversion shall be based on the Conversion Price set fo
version Notice and the Note, the Note shall govern, or, in the alternative, at the election of the Holder in its sole discretion, the Holder m
form to the Note. Capitalized terms used in this notice without definition shall have the meanings given to them in the Note.

A. Date of conversion:
B. Conversion #:
C. Conversion Amount:
D. Conversion Price: _____
E. Section 3 Conversion Shares: _____ (C d
F. Remaining Outstanding Balance of Note: ____

_____ of the Conversion Amount converted hereunder shall be deducted from the Installment Amount(s) relating to the foll
_____.

se transfer the Section 3 Conversion Shares electronically (via DWAC) to the following account:

ker: _____ Address: _____
C#:_____ _____
ount #: _____ _____
ount Name:_____

he extent the Section 3 Conversion Shares are not able to be delivered to the Holder electronically via the DWAC system, please add ad
ent (5%) of the number of Section 3 Conversion Shares so converted (per Section 3.3(a) of the Note), and deliver all such certificated sh
ipt of this Conversion Notice (by facsimile transmission or otherwise) to:
_____
_____
_____

erely,

der: Tonaquint, Inc.

_____

John M. Fife, President

3

EXHIBIT B
ACKNOWLEDGMENT

Company hereby acknowledges this Conversion Notice and hereby directs _____ to issue the above indicated numbe
vocable Instructions to Transfer Agent dated August 22, 2012 from the Company and acknowledged and agreed to by _____

en Arts Entertainment Inc.

_____
ne: _____
e: _____

4

EXHIBIT C-1

Seven Arts Entertainment Inc.
8439 Sunset Boulevard, Suite 402
West Hollywood, California 90069

aquint, Inc. Date:_____

: John Fife
E. Wacker Dr., Suite 1200
cago, IL 60657

PRE-INSTALLMENT NOTICE

above-captioned Company hereby gives notice to Tonaquint, Inc., a Utah corporation (the "Holder"), pursuant to that certain Convertib
Holder on August 22, 2012 (the "Note"), of certain Company elections and certifications related to payment of the Installment Amount
tallment Date"). In the event of a conflict between this Installment Notice and the Note, the Note shall govern, or, in the alternative, at t
provide a new form of Installment Notice to conform to the Note. Capitalized terms used in this notice without definition shall have th

PRE-INSTALLMENT ELECTIONS AND CERTIFICATIONS
AS OF THE PRE-INSTALLMENT NOTICE DUE DATE

A. COMPANY ELECTIONS

Company elects to pay the Installment Amount as follows (check one):

___(i) Redeeming the Installment Amount in cash in accordance with Section 8 of the Note ("Company Redemption") (if selected, no c

___(ii) Converting the Installment Amount in accordance with Section 8 of the Note ("Company Conversion") (if selected, comple

___(iii) Combination of Company Redemption and Company Conversion (if selected, complete Section B(2) and

B. COMPANY CONVERSION (if applicable)

1. Company Conversion:

A. Pre-Installment Notice Due Date: _____
B. Company Conversion Amount:
C. Pre-Installment Conversion Price: _____ (lower of (i) Conversion Price in effect and (ii) Market Price
D. Pre-Installment Conversion Shares: _____ (E
E. Excess shares to be applied from previous installment (if any):
F. Installment shares to be delivered: _____
G. Remaining Note balance: _____

5

2. Combination of Company Redemption and Company Conversion (if elected above)

A. Pre-Installment Notice Due Date: _____

B. Installment Amount:

C. Company Redemption Amount: _____

D. Company Conversion Amount: _____ (

E. Pre-Installment Conversion Price: _____ (lower of (i) Conversion Price in effect and (ii) Market Price

F. Pre-Installment Conversion Shares: _____ (D

G. Excess shares to be applied from previous installment (if any):

H. Installment shares to be delivered: _____

I. Remaining Note balance: _____

C. EQUITY CONDITIONS CERTIFICATION (if applicable)

1. Market Capitalization of the Common Stock:_____

eck One)

2. _____The Company herby certifies that no Equity Conditions Failure exists as of the Pre-Installme

_____The Company hereby gives notice that an Equity Conditions Failure has occurred and requests a waiver from the Holder wi
ollows:

erely,

npany: Seven Arts Entertainment Inc.

_____

ne: _____

e: _____

6

EXHIBIT C-2

Seven Arts Entertainment Inc.
8439 Sunset Boulevard, Suite 402
West Hollywood, California 90069

aquint, Inc.
: John Fife
E. Wacker Dr., Suite 1200
cago, IL 60657

Date:_____

INSTALLMENT DATE NOTICE

above-captioned Company hereby gives notice to Tonaquint, Inc., a Utah corporation (the "Holder"), pursuant to that certain Convertib
Holder on August 22, 2012 (the "Note"), of Post-Installment Conversion Shares and Equity Conditions Certifications related to _____
flict between this Installment Notice and the Note, the Note shall govern, or, in the alternative, at the election of the Holder in its sole di
allment Notice to conform to the Note. Capitalized terms used in this notice without definition shall have the meanings given to them in

POST-INSTALLMENT CONVERSION SHARES AND CERTIFICATIONS
AS OF THE INSTALLMENT DATE

1. POST-INSTALLMENT CONVERSION SHARES

A. Pre-Installment Notice Due Date: _____, 201_

B. Company Conversion Amount: _____

C. Post-Installment Conversion Price: _____ (lower of (i) Conversion Price in effect and (ii) Market P

D. Post-Installment Conversion Shares: _____ (B divided by C)

E. Pre-Installment Conversion Shares delivered: _____

F. Post-Installment Conversion Shares to be delivered: _____ (only applicable if D minus E i

Pre-Installment Conversion Shares to be applied to next installment or returned:_____ (only applicable if D minus E is le

Pre-Installment Conversion Shares to be retained by the Holder because of a Payment Default: _____ (only applicable if
occurred)

7

2. EQUITY CONDITIONS CERTIFICATION

A. Market Capitalization of the Common Stock:_____

eck One)

B. _____The Company herby certifies that no Equity Conditions Failure exists as of the applicable

_____The Company hereby gives notice that an Equity Conditions Failure has occurred and requests a waiver from the Holder w
follows:

_____

_____

_____

erely,

npany: Seven Arts Entertainment Inc.

_____

ne: _____

e: _____

8

Seven Arts Entertainment Inc.
Convertible Promissory Note #2

ance Date: _____ __, 2012 U.S. $250,000.00

R VALUE RECEIVED, Seven Arts Entertainment Inc., a Nevada corporation (the "Company"), hereby promises to pay to the order of T
gns (the "Holder"), the initial principal sum of $250,000.00 (the "Original Principal Amount"), and any additional advances and other a
Convertible Promissory Note (this "Note") when due, whether upon the Maturity Date, on any Installment Date with respect to the Insta
ned below), acceleration, redemption or otherwise (in each case in accordance with the terms hereof), and to pay interest ("Interest") on
icable interest rate as set forth herein, whether upon any Installment Date, the Maturity Date or acceleration, conversion, redemption or
of). Certain capitalized terms used herein are defined in Section 27 hereof. For purposes hereof, the term "Outstanding Balance" means
e case may be, pursuant to the terms hereof for redemption, conversion or otherwise, plus any accrued but unpaid Interest, collection an
luding without limitation Late Charges (as defined below)) incurred under this Note or under the Agreement (defined below).

Note is issued pursuant to that certain Securities Purchase Agreement dated August 22, 2012, as the same may be amended from time t
the Holder.

AYMENTS OF PRINCIPAL; PREPAYMENT. On each Installment Date (which includes the Maturity Date), the Company shall pay to
ount due on such Installment Date in accordance with Section 8. Additionally, so long as no Event of Default (as defined below) shall h
olute discretion and upon giving the Holder not less than five (5) Trading Days written notice (a "Prepayment Notice"), pay in cash all o
r to the Maturity Date; provided that in the event the Company elects to prepay all or any portion of the Outstanding Balance, it shall pa
ance the Company elects to prepay (the "Prepayment Premium").

NTEREST; INTEREST RATE. Interest on the Outstanding Balance shall accrue from the date set forth above as the Issuance Date (the
um, provided that upon the occurrence of an Event of Default, Interest shall accrue on the Outstanding Balance at the rate of twenty-two
d) hereof. All Interest calculations hereunder shall be computed on the basis of a 360-day year comprised of twelve (12) thirty (30) day
ordance with the terms of this Note. Notwithstanding any provision to the contrary herein, in no event shall the applicable interest rate a
er applicable law. All payments owing hereunder shall be in lawful money of the United States of America or Conversion Shares, as pro
ished to the Company for that purpose. All payments shall be applied first to (a) costs of collection, if any, then to (b) fees and charges,
eafter to (d) principal.

9

ONVERSION OF NOTE. At the option of the Holder, this Note is convertible into validly issued, fully paid and non-assessable shares
n in this Section 3.

Conversion Right.

Subject to the provisions of Section 3.4, at any time or times on or after the Issuance Date, the Holder shall be entitled to convert any po
y paid and non-assessable shares of Common Stock (the "Section 3 Conversion Shares") in accordance with Section 3.3, calculated usin

The Company shall not issue any fraction of a share of Common Stock upon any conversion. All shares issuable upon each conversion o
rmining whether such conversion would result in the issuance of a fractional share. If the issuance would result in the issuance of a frac
d such fraction of a share of Common Stock up to the nearest whole share. The Company shall pay any and all transfer, stamp, issuanc
ssuance and delivery of Section 3 Conversion Shares.

Conversion Rate. The number of Section 3 Conversion Shares issuable upon conversion of any portion of the Outstanding Balance purs
he applicable Conversion Amount by (y) the Conversion Price (such formula is referred to herein as the "Conversion Rate").

"Conversion Amount" means the portion of the Outstanding Balance to be converted.

"Conversion Price" means, as of any Conversion Date or other date of determination, $0.04, subject to adjustment as provided herein.

Mechanics of Conversion.

Conversion Prior to Maturity Date. To convert any Conversion Amount into shares of Common Stock on any date, the Holder shall deli
ipt on or prior to 11:59 p.m., New York time, on such date (a "Conversion Date"), a copy of an executed notice of conversion substanti
nversion Notice") to the Company. If required by Section 3.3(c), within five (5) Trading Days following a conversion of this Note as af
table overnight courier for delivery to the Company (or an indemnification undertaking with respect to this Note in the case of its loss,
or before the first (1st) Trading Day following the date of receipt of a Conversion Notice, the Company shall transmit by facsimile or em
ched hereto as Exhibit B, of receipt of such Conversion Notice to the Holder and the Company's transfer agent (the "Transfer Agent").
ling Day following the date of receipt of a Conversion Notice (the "Delivery Date"), the Company shall, provided that all DWAC Eligi
ber of Section 3 Conversion Shares to which the Holder shall be entitled to the account specified on the Conversion Notice via the DW
satisfied, the Company shall instead issue and deliver (via reputable overnight courier) to the address as specified in the Conversion No
s designee, for the number of Section 3 Conversion Shares to which the Holder shall be entitled; provided, however, that, in addition to
er this Note, such number of shares issued by certificate rather than via the DWAC system shall be increased by 5% for each conversion
ance Date. For the avoidance of doubt, the Company has not met its obligation to deliver Section 3 Conversion Shares by the Delivery
ally received the shares electronically into the applicable account, or if the DWAC Eligible Conditions are not then satisfied, has actual
ion 3 Conversion Shares no later than the close of business on the relevant Delivery Date pursuant to the terms set forth above. If this N
ection 3.3(c) and the Outstanding Balance of this Note is greater than the principal portion of the Conversion Amount being converted,
vent later than three (3) Trading Days after receipt of this Note and at its own expense, issue and deliver to the Holder (or its designee)
esenting the Outstanding Balance not converted. The Person or Persons entitled to receive the shares of Common Stock issuable upon a
oses as the record holder or holders of such shares of Common Stock on the Conversion Date. In the event of a partial conversion of th
l be deducted from the Installment Amount(s) relating to the Installment Date(s) as set forth in the applicable Conversion Notice.

)

Company's Failure to Timely Deliver. Failure for any reason whatsoever to issue any portion of the Section 3 Conversion Shares to Hol
ired under this Note shall be a "Conversion Failure". Upon the occurrence of a Conversion Failure, in addition to all other remedies ava
Holder on each day after such third (3rd) Trading Day that the issuance of such shares of Common Stock is not timely effected an amou
of the product of (i) the sum of the number of Section 3 Conversion Shares not issued to the Holder on a timely basis and to which the H
e of the Common Stock on the Trading Day immediately preceding the last possible date which the Company could have issued such sh
ion 3.3(a); and (2) the Holder, upon written notice to the Company, may void its Conversion Notice with respect to, and retain or have r
has not been converted pursuant to such Conversion Notice, provided that the voiding of a Conversion Notice shall not affect the Comp
ued or are owed to the Holder prior to the date of such notice pursuant to this Section 3.3(b) or otherwise. Notwithstanding the foregoin
ion 3 Conversion Shares are not issued by the Company in order to comply with the limitations set forth in Section 3.4 hereof. Upon the
ts to void the Conversion Notice), in addition to such failure being considered an Event of Default hereunder, for purposes of Section 7.
ion 3 Conversion Shares to Holder on the latest possible permitted date and pursuant to the terms set forth in this Section 3, with Holde
deemed issued shares (the "Deemed Conversion Issuance").

Registration; Book-Entry. The Company shall maintain a register (the "Register") for the recordation of the name and address of the hol
unt of this Note held by such holder (the "Registered Note"). The entries in the Register shall be conclusive and binding for all purpose
l treat each Person whose name is recorded in the Register as the owner of this Note for all purposes (including, without limitation, the r
under) notwithstanding notice to the contrary. The Registered Note may be assigned, transferred or sold in whole or in part only by regi
n its receipt of a request to assign, transfer or sell all or part of the Registered Note by the holder thereof, the Company shall record the
or more new Registered Notes in the same aggregate principal amount as the principal amount of the surrendered Registered Note to the
ion 14. Notwithstanding anything to the contrary in this Section 3.3(c), the Holder may assign this Note or any portion thereof to its Aff
e to the Company and the recordation of such assignment or sale in the Register (a "Related Party Assignment"); provided, that (A) the
gning or selling Holder unless and until such Holder has delivered a request to assign or sell this Note or portion thereof to the Company
gning or selling Holder to deliver a request to assign or sell such Note or portion thereof to the Company shall not affect the legality, val
such assigning or selling Holder shall, acting solely for this purpose as a non-fiduciary agent of the Company, maintain a register (the "
alf of the Company, and any such assignment or sale shall be effective upon recordation of such assignment or sale in the Related Party
n in this Section 3, upon conversion of any portion of this Note in accordance with the terms hereof, the Holder shall not be required to
the entire Outstanding Balance of this Note is being converted (in which event this Note shall be delivered to the Company as contempl
Company with prior written notice (which notice may be included in a Conversion Notice) requesting reissuance of this Note upon phys
mpany shall maintain records showing the Outstanding Balance and Late Charges converted and/or paid (as the case may be) and the dat
be) or shall use such other method, reasonably satisfactory to the Holder and the Company, so as not to require physical surrender of th

Limitations on Conversions.

Notwithstanding anything to the contrary contained in this Note (except as set forth below in this subsection), this Note shall not be conv effect any conversion of this Note or otherwise issue any shares of Common Stock pursuant to Section 3 or Section 8 hereof, to the exte of its Affiliates would beneficially own in excess of 4.99% (the "Maximum Percentage") of the Common Stock outstanding. Notwithst ditions are not then satisfied, the term "4.99%" shall be replaced in the preceding sentence with "9.99%" at such time as the Market Ca 00,000.00, but (ii) if all of the DWAC Eligible Conditions are then satisfied, the term "4.99%" shall be replaced in the preceding senter italization of the Common Stock is less than $1,500,000.00. For the avoidance of any doubt, notwithstanding any other provision conta uant to the preceding sentence, such change to "9.99%" shall be permanent. For purposes of this Agreement, the term "Market Capitali) the average VWAP of the Common Stock for the immediately preceding thirty (30) Trading Days, multiplied by (ii) the aggregate nu rted on the Company's most recently filed Form 10-Q or Form 10-K.

To the extent the limitation set forth in subsection (a) immediately above applies, the determination of whether this Note shall be conver hangeable securities owned by the Holder or any of its Affiliates) and of which such securities shall be convertible, exercisable or excha der and its Affiliates) shall, subject to such Maximum Percentage limitation, be determined on the basis of the first submission to the Co may be). No prior inability to convert this Note, or to issue shares of Common Stock, pursuant to this Section 3.4 shall have any effect with respect to any subsequent determination of convertibility. For purposes of this Section 3.4, beneficial ownership and all determinat respect to calculations of percentage ownership) shall be determined in accordance with Section 13(e) of the 1934 Act (as defined in th mulgated thereunder. The provisions of this Section 3.4 shall be implemented in a manner otherwise than in strict conformity with the te portion hereof) which may be defective or inconsistent with the intended Maximum Percentage beneficial ownership limitation herein c esirable to properly give effect to such Maximum Percentage limitation. The limitations contained in this Section 3.4 shall apply to a su k shall be third party beneficiaries of this Section 3.4 and the Company may not waive this Section 3.4 without the consent of holders o time, upon the written or oral request of the Holder, the Company shall within one (1) Trading Day confirm orally and in writing to the tanding, including by virtue of any prior conversion or exercise of convertible or exercisable securities into Common Stock, including,

IGHTS UPON EVENT OF DEFAULT.

Event of Default. Each of the following events shall constitute an "Event of Default":

2

Failure to Pay. The Company shall fail to make any payment when due and payable under the terms of this Note including, without limi luding, without limitation, the Company's failure to deliver any Installment Amount when due or to pay any redemption payments or ar er any other Transaction Document (as defined in the Agreement).

Failure to Deliver or Process Shares. The Company (or its Transfer Agent, as applicable) (i) fails to issue Section 3 Conversion Shares b Installment Conversion Shares, Post-Installment Conversion Shares, Pre-Installment Certificated Shares, or Post-Installment Certificate ired by Section 8; (iii) announces (or threatens in writing) that it will not honor its obligation to issue shares to Holder in accordance wi sfer or cause its Transfer Agent to transfer or issue (electronically or in certificated form, as applicable) any Section 3 Conversion Share version Shares, Pre-Installment Certificated Shares, or Post-Installment Certificated Shares, as applicable, issued to the Holder upon co n required by this Note; (v) directs its Transfer Agent not to transfer, or delays, impairs, and/or hinders its Transfer Agent in transferrin icable) any Section 3 Conversion Shares, Pre-Installment Conversion Shares, Post-Installment Conversion Shares, Pre-Installment Cert pplicable, to be issued to the Holder upon conversion of or otherwise pursuant to this Note as and when required by this Note; or (vi) as nt not to remove or impairs, delays, and/or hinders its Transfer Agent from removing) any restrictive legend (or to withdraw any stop tr ny Section 3 Conversion Shares, Pre-Installment Certificated Shares or Post-Installment Certificated Shares as and when required by th ement or threat that it does not intend to honor any such obligations).

udgment. A final judgment or judgments for the payment of money aggregating in excess of $100,000 are rendered against the Compa not, within thirty (30) calendar days after the entry thereof, bonded, discharged or stayed pending appeal, or are not discharged within th ; provided, however, any judgment which is covered by insurance or an indemnity from a credit worthy party shall not be included in ca e Company provides the Holder a written statement from such insurer or indemnity provider (which written statement shall be reasonab ment is covered by insurance or an indemnity and the Company or such Subsidiary (as the case may be) will receive the proceeds of su s of the issuance of such judgment.

Breach of Obligations; Covenants. The Company or its Subsidiaries, if any, shall fail to observe or perform any other covenant, obligati of the other Transaction Documents, including without limitation (i) all reporting covenants and covenants to timely file all required qu ired pursuant to Rule 144, and (ii) strict compliance with all provisions of Sections 3, 8, and 10 of this Note.

8

Breach of Representations and Warranties. Any representation, warranty, certificate, or other statement (financial or otherwise) made or
der in writing included in this Note or in connection with any of the Transaction Documents, or as an inducement to the Holder to enter
uments, shall be false, incorrect, incomplete or misleading in any material respect when made or furnished or becomes false thereafter.

Receiver or Trustee. The Company shall make an assignment for the benefit of creditors, or apply for, or consent to, or otherwise be sub
idator, assignee, custodian, sequestrator, or other similar official for a substantial part of its property or business.

Failure to Pay Debts. If any of the Company's assets are assigned to its creditors, or upon the occurrence of any default under, redemptio
ebtedness of the Company or any of its Subsidiaries in an amount equal to $100,000 or more.

Bankruptcy. Bankruptcy, insolvency, reorganization or liquidation proceedings or other proceedings, voluntary or involuntary, for relief
ors shall be instituted by or against the Company.

Delisting of Common Stock. The suspension from trading or the failure of the Common Stock to be trading on an Eligible Market for a p
an aggregate of ten (10) Trading Days in any 365-day period.

Liquidation. Any dissolution, liquidation, or winding up of the Company or any substantial portion of its business.

Cessation of Operations. Any cessation of operations by the Company or the Company admits it is otherwise generally unable to pay its
any disclosure of the Company's ability to continue as a "going concern" shall not be an admission that the Company cannot pay its de

Maintenance of Assets. The failure by the Company to maintain any material intellectual property rights, personal, real property or other
ether now or in the future).

Financial Statement Restatement. The restatement of any financial statements filed by the Company with the SEC for any date or perio
Note is no longer outstanding, if the result of such restatement would, by comparison to the unrestated financial statement, have constit
mpany with respect to this Note or the Agreement.

Reverse Split. The Company effectuates a reverse split of its Common Stock without twenty (20) Trading Days prior written notice to th

4

Replacement of Transfer Agent. In the event that the Company proposes to replace its Transfer Agent, the Company fails to provide, pri
cuted Transfer Agent Letter (as defined by the Agreement) in a form as required to be initially delivered pursuant to the Agreement (incl
rve shares of Common Stock in the Reserved Amount) signed by the successor transfer agent and delivered to the Company and the Ho

Governmental Action. If any governmental or regulatory authority takes or institutes any action against the Company, a Subsidiary, or a
materially affect the Company's financial condition, operations or ability to pay or perform the Company's obligations under this Note

Share Reserve. The Company's failure to maintain the Share Reserve (as defined in the Agreement).

Certification of Equity Conditions. A false or inaccurate certification (including, without limitation, a false or inaccurate deemed certific
sfied, that there has been no Equity Conditions Failure or as to whether any Event of Default has occurred.

DWAC Eligibility. The failure of any of the DWAC Eligible Conditions to be satisfied at any time during which the Company has oblig

Cross Default. Notwithstanding anything to the contrary contained in this Note or the other Transaction Documents, a breach or default b
dition contained in (i) any of the other Transaction Documents, or (ii) any Other Agreements (defined below); shall, at the option of the
ch event the Holder shall be entitled (but in no event required) to apply all rights and remedies of the Holder under the terms of this Not
ing within three (3) Trading Days after any such default; provided, however, any filing of an 8-K that identifies any such default shall n
eements" means, collectively, (1) all existing and future agreements and instruments between, among or by the Company (or a Subsidia
der), on the other hand, and (2) any financing agreement or a material agreement that affects the Company's ongoing business operation
transactions between the Company and the Holder and its Affiliates will be cross-defaulted with each other loan transaction and with a
der.

n subsection of this Section 4.1 shall be interpreted and applied independently, and no such subsection shall be deemed to limit or qualif

5

Notice of an Event of Default; Redemption Right.

Upon the occurrence of an Event of Default, the Company shall within one (1) Trading Day deliver written notice thereof via facsimile a
ified) (an "Event of Default Notice") to the Holder.

At any time and from time to time after the earlier of the Holder's receipt of an Event of Default Notice and the Holder becoming aware
npany to redeem (regardless of whether such Event of Default has been cured) all or any portion of this Note by delivering written notic
Company, which Event of Default Redemption Notice shall indicate the portion of the Outstanding Balance the Holder is electing to red
ired by this Section 4.2(b) shall be made in accordance with the provisions of Section 10. Notwithstanding anything to the contrary in t
ault Redemption Amount (together with Late Charges thereon) is paid in full pursuant to and in accordance with the terms set forth in S
Charges thereon), may be converted, in whole or in part from time to time, by the Holder into Common Stock pursuant to the other ter
Note pursuant hereto, the applicable Default Redemption Amount shall be deducted from the Installment Amount(s) relating to the appl
ault Redemption Notice. Notwithstanding the foregoing, this Section 4.2(b) shall not apply to an Event of Default arising under Section

Upon the occurrence of an Event of Default occurring under Section 4.1(h) due to the institution by or against the Company of any bank
ny law for the relief of debtors, (i) the Outstanding Balance shall automatically increase to an amount equal to the Outstanding Balance
he Redemption Premium, and (ii) all amounts owed under this Note shall accelerate and be immediately due and payable, all without the
under.

Upon the occurrence of any Event of Default, this Note shall thereafter accrue interest at the rate of 1.8% per month (or 22% per annum
ment; provided, however, that notwithstanding any provision to the contrary herein, in no event shall the applicable interest rate at any
icable law.

Notwithstanding and in addition to any other provision contained herein, if Section 3 Conversion Shares are delivered to Holder in certif
standing Balance shall automatically increase by an amount equal to the decline in Value (as defined below), if any, of such shares betw
required to be delivered to the Holder hereunder, and the date the certificate representing such shares becomes Free Trading. The Comp
ome Free Trading. "Value", as used in this subsection, shall mean the five (5) Trading Day trailing average VWAP for the applicable sh

6

IGHTS UPON FUNDAMENTAL TRANSACTION.

Assumption. The Company shall not enter into or be party to a Fundamental Transaction unless (i) the Successor Entity assumes in wri
e and the other Transaction Documents in accordance with the provisions of this Section 5.1 pursuant to written agreements in form and
Holder, in its sole discretion, prior to such Fundamental Transaction, including agreements to deliver to the Holder in exchange for this
ten instrument substantially similar in form and substance to this Note, including, without limitation, having a principal amount and inte
tanding and the interest rates of this Note, having similar conversion rights as this Note and having similar ranking to this Note, and bei
he Successor Entity is a publicly traded corporation whose common stock is quoted on or listed for trading on an Eligible Market, and (
sent to enter into such Fundamental Transaction. Upon the occurrence of any Fundamental Transaction, the Successor Entity shall succe
of such Fundamental Transaction, the provisions of this Note and the other Transaction Documents referring to the "Company" shall re
y right and power of the Company and shall assume all of the obligations of the Company under this Note and the other Transaction Do
ty had been named as the Company herein. Upon consummation of a Fundamental Transaction, the Successor Entity shall deliver to the
version or redemption of this Note at any time after the consummation of such Fundamental Transaction, in lieu of the shares of the Co
ther property (except such items still issuable under Section 6, which shall continue to be receivable thereafter) issuable upon the conve
damental Transaction), such shares of the publicly traded common stock (or their equivalent) of the Successor Entity (including its Pare
ceive upon the happening of such Fundamental Transaction had this Note been converted immediately prior to such Fundamental Trans
version of this Note), as adjusted in accordance with the provisions of this Note. The provisions of this Section 5 shall apply similarly a
l be applied without regard to any limitations on the conversion of this Note.

Notice of a Fundamental Transaction; Redemption Right. No sooner than twenty (20) Trading Days nor later than ten (10) Trading Day
nsaction, but not prior to the public announcement of such Fundamental Transaction, the Company shall deliver written notice thereof v
der (a "Fundamental Transaction Notice"). At any time during the period beginning after the Holder's receipt of a Fundamental Transac
damental Transaction if a Fundamental Transaction Notice is not delivered to the Holder in accordance with the immediately preceding
nty (20) Trading Days after (i) consummation of such Fundamental Transaction and (ii) the date of receipt of such Fundamental Transac
em all or any portion of this Note by delivering written notice thereof ("Fundamental Transaction Redemption Notice") to the Company
l indicate the portion of the Outstanding Balance the Holder is electing to redeem (the "Fundamental Transaction Redemption Amount"
l be redeemed by the Company in cash pursuant to and in accordance with Section 10 and shall have priority to payments to stockholde
withstanding anything to the contrary in this Section 5, but subject to Section 3.4, until the Fundamental Transaction Redemption Amou
the Outstanding Balance (together with any Late Charges thereon), may be converted, in whole or in part from time to time, by the Hol
t of a partial redemption of this Note pursuant hereto, the Fundamental Transaction Redemption Amount shall be deducted from the In
allment Date(s) as set forth in the Fundamental Transaction Redemption Notice.

7

ISTRIBUTION OF ASSETS; RIGHTS UPON ISSUANCE OF PURCHASE RIGHTS AND OTHER CORPORATE EVENTS.

Distribution of Assets. Without the prior written consent of Holder, the Company agrees not to declare or make any dividend or other d
ny or all holders of shares of Common Stock, by way of return of capital or otherwise (including, without limitation, any distribution of
of a dividend, spin off, reclassification, corporate rearrangement, scheme of arrangement or other similar transaction).

Purchase Rights. In addition to any adjustments pursuant to Section 7 below, if at any time the Company grants, issues or sells any Opt
rants, securities or other property pro rata to the record holders of any class of Common Stock (the "Purchase Rights"), then the Holder
Purchase Rights, the aggregate Purchase Rights which the Holder could have acquired if the Holder had held the number of shares of C
his Note (without taking into account any limitations or restrictions on the convertibility of this Note) immediately before the date on wh
Purchase Rights, or, if no such record is taken, the date as of which the record holders of Common Stock are to be determined for the g
ever, to the extent that the Holder's right to participate in any such Purchase Right would result in the Holder exceeding the Maximum
icipate in such Purchase Right to such extent (or beneficial ownership of such shares of Common Stock as a result of such Purchase Rig
nt shall be held in abeyance for the Holder until such time, if ever, as its right thereto would not result in the Holder exceeding the Max

Other Corporate Events. In addition to and not in substitution for any other rights hereunder, prior to the consummation of any Fundam
ommon Stock are entitled to receive securities or other assets with respect to or in exchange for shares of Common Stock (a "Corporate
sure that the Holder will thereafter have the right to receive upon a conversion of this Note (i) in addition to the shares of Common Stoc
r assets to which the Holder would have been entitled with respect to such shares of Common Stock had such shares of Common Stock
Corporate Event (without taking into account any limitations or restrictions on the convertibility of this Note) or (ii) in lieu of the share
version, such securities or other assets received by the holders of shares of Common Stock in connection with the consummation of such
e been entitled to receive had this Note initially been issued with conversion rights for the form of such consideration (as opposed to sha
sideration commensurate with the Conversion Rate. Provision made pursuant to the preceding sentence shall be in a form and substance
ion 6 shall apply similarly and equally to successive Corporate Events and shall be applied without regard to any limitations on the con

8

IGHTS UPON ISSUANCE OF SECURITIES.

Adjustment of Conversion Price upon Issuance of Common Stock. Except with respect to Excluded Securities, if and whenever on or a
mmon Stock, Options, Convertible Securities, or upon any conversion or Deemed Issuance, or in accordance with subsections (a) throug
es of Common Stock (including without limitation the issuance or sale of shares of Common Stock owned or held by or for the account
urities issued or sold or deemed to have been issued or sold) for a consideration per share (the "New Issuance Price") less than a price ec
uch issue, conversion, or sale or deemed issuance or sale (such Conversion Price then in effect is referred to herein as the "Applicable P
ediately after such Dilutive Issuance, the Conversion Price then in effect shall be reduced to an amount equal to the New Issuance Price
e is greater than the Applicable Price, there shall be no adjustment to the Conversion Price. For purposes of determining the adjusted Co
l be applicable:

ssuance of Options. If the Company in any manner grants or sells any Options and the lowest price per share for which one share of Co
on or upon conversion, exercise or exchange of any Convertible Securities issuable upon exercise of any such Option is less than the A
l be deemed to be outstanding and to have been issued and sold by the Company at the time of the granting or sale of such Option for su
"lowest price per share for which one share of Common Stock is issuable upon the exercise of any such Options or upon conversion, exe
able upon exercise of any such Option" shall be equal to (1) the lower of (x) the sum of the lowest amounts of consideration (if any) rec
share of Common Stock upon the granting or sale of such Option, upon exercise of such Option and upon conversion, exercise or excha
uch Option and (y) the lowest exercise price set forth in such Option for which one share of Common Stock is issuable upon the exercis
hange of any Convertible Securities issuable upon exercise of any such Option minus (2) the sum of all amounts paid or payable to the h
ting or sale of such Option, upon exercise of such Option and upon conversion, exercise or exchange of any Convertible Security issua
r consideration received or receivable by, or benefit conferred on, the holder of such Option (or any other Person). Except as contempla
e shall be made upon the actual issuance of such share of Common Stock or of such Convertible Securities upon the exercise of such Op
mmon Stock upon conversion, exercise or exchange of such Convertible Securities.

9

ssuance of Convertible Securities. If the Company in any manner issues or sells any Convertible Securities, and the lowest price per sha
n the conversion, exercise or exchange thereof is less than the Applicable Price, then such share of Common Stock shall be deemed to b
npany at the time of the issuance or sale of such Convertible Securities for such price per share. For the purposes of this Section 7.1(b),
mmon Stock is issuable upon the conversion, exercise or exchange thereof" shall be equal to (1) the lower of (x) the sum of the lowest ar
he Company with respect to one share of Common Stock upon the issuance or sale of the Convertible Security and upon conversion, ex
he lowest conversion price set forth in such Convertible Security for which one share of Common Stock is issuable upon conversion, ex
unts paid or payable to the holder of such Convertible Security (or any other Person) upon the issuance or sale of such Convertible Secu
eceivable by, or benefit conferred on, the holder of such Convertible Security (or any other Person). Except as contemplated below, no f
e upon the actual issuance of such share of Common Stock upon conversion, exercise or exchange of such Convertible Securities, and i
ade upon exercise of any Options for which adjustment of the Conversion Price has been or is to be made pursuant to other provisions o
her adjustment of the Conversion Price shall be made by reason of such issue or sale.

Change in Option Price or Rate of Conversion. If the purchase or exercise price provided for in any Options, the additional consideration
xchange of any Convertible Securities, or the rate at which any Convertible Securities are convertible into or exercisable or exchangeab
y time, the Conversion Price in effect at the time of such increase or decrease shall be adjusted to the Conversion Price which would ha
vertible Securities provided for such increased or decreased purchase price, additional consideration or increased or decreased conversio
ted, issued or sold. For purposes of this Section 7.1(c), if the terms of any Option or Convertible Security that was outstanding as of the
ner described in the immediately preceding sentence, then such Option or Convertible Security and the shares of Common Stock deeme
eof shall be deemed to have been issued as of the date of such increase or decrease. No adjustment pursuant to this Section 7.1 shall be
Conversion Price then in effect.

Calculation of Consideration Received. If any Option or Convertible Security is issued or deemed issued in connection with the issuance
rities of the Company, together comprising one integrated transaction, (x) such Option or Convertible Security (as applicable) will be d
Black Scholes Consideration Value thereof and (y) the other securities issued or sold or deemed to have been issued or sold in such inte
consideration equal to the difference of (I) the aggregate consideration received by the Company minus (II) the Black Scholes Considera
urity (as applicable). If any shares of Common Stock, Options or Convertible Securities are issued or sold or deemed to have been issue
be deemed to be the net amount received by the Company therefor. If any shares of Common Stock, Options or Convertible Securities
amount of such consideration received by the Company will be the fair value of such consideration, except where such consideration co
unt of consideration received by the Company for such securities will be the average VWAP of such security for the five (5) Trading D
shares of Common Stock, Options or Convertible Securities are issued to the owners of the non-surviving entity in connection with any
amount of consideration therefor will be deemed to be the fair value of such portion of the net assets and business of the non-surviving e
k, Options or Convertible Securities (as the case may be). The fair value of any consideration other than cash or publicly traded securiti
der. If such parties are unable to reach agreement within ten (10) Trading Days after the occurrence of an event requiring valuation (the
be determined within five (5) Trading Days after the tenth (10th) day following such Valuation Event by an independent, reputable app
determination of such appraiser shall be final and binding upon all parties absent manifest error and the fees and expenses of such appra

)

Record Date. If the Company takes a record of the holders of shares of Common Stock for the purpose of entitling them (A) to receive a
k, Options or in Convertible Securities or (B) to subscribe for or purchase shares of Common Stock, Options or Convertible Securities,
ssue or sale of the shares of Common Stock deemed to have been issued or sold upon the declaration of such dividend or the making of
right of subscription or purchase (as the case may be).

Adjustment of Conversion Price upon Subdivision or Combination of Common Stock. Without limiting any provision of Section 5 or S
ance Date subdivides (by any stock split, stock dividend, recapitalization or otherwise) one or more classes of its outstanding shares of
version Price in effect immediately prior to such subdivision will be proportionately reduced. Without limiting any provision of Section
the Issuance Date combines (by combination, reverse stock split or otherwise) one or more classes of its outstanding shares of Commo
version Price in effect immediately prior to such combination will be proportionately increased. Any adjustment pursuant to this Sectio
ctive date of such subdivision or combination. If any event requiring an adjustment under this Section 7.2 occurs during the period that
ulation of such Conversion Price shall be adjusted appropriately to reflect such event.

Other Events. In the event that the Company (or any Subsidiary) shall take any action to which the provisions hereof are not strictly app
Holder from dilution or if any event occurs of the type contemplated by the provisions of this Section 7 but not expressly provided for b
ting of stock appreciation rights, phantom stock rights or other rights with equity features), then the Company's board of directors shall
stment in the Conversion Price so as to protect the rights of the Holder, provided that no such adjustment pursuant to this Section 7.3 w
rmined pursuant to this Section 7, provided further that if the Holder does not accept such adjustments as appropriately protecting its in
pany's board of directors and the Holder shall agree, in good faith, upon an independent investment bank of nationally recognized stan
rmination shall be final and binding and whose fees and expenses shall be borne by the Company.

OMPANY INSTALLMENT CONVERSION OR REDEMPTION. Beginning on the date that is one hundred eighty (180) calendar day
e"), and on each applicable Installment Date thereafter, the Company shall pay to the Holder of this Note the applicable Installment Am
ount in accordance with this Section 8 (a "Company Conversion"); provided, however, the Company may, at its option as described bel
eming such Installment Amount in cash (a "Company Redemption") or by any combination of a Company Conversion and a Company
allment Amount due shall be converted and/or redeemed by the Company on the applicable Installment Date, subject to the provisions o
l not be entitled to effect a Company Conversion with respect to any portion of such Installment Amount and shall be required to pay th
uant to a Company Redemption if on the applicable Pre-Installment Notice Due Date (defined below) or on the applicable Installment D
ure, and such failure is not waived by Holder as permitted herein.

General. On or prior to the date which is the twenty-third (23rd) Trading Day prior to each Installment Date (each, a "Pre-Installment N
ce to the Holder substantially in the form attached hereto as Exhibit C-1 (each, a "Pre-Installment Notice"), and such Pre-Installment No
allment Amount of this Note shall be converted in whole pursuant to a Company Conversion, or (B) (1) state that the Company elects to
provisions of this Note, in whole or in part, the applicable Installment Amount pursuant to a Company Redemption and (2) specify the p
mpany elects, or is required to redeem, pursuant to a Company Redemption (such amount to be redeemed in cash, the "Company Redem
allment Amount, if any, with respect to which the Company will, and is permitted to, effect a Company Conversion (such amount of the
verted pursuant to this Section 8 is referred to herein as the "Company Conversion Amount"), which amounts when added together, mus
f the applicable Installment Amount is to be paid, in whole or in part, pursuant to a Company Conversion, certify that there is not an Eq
ce Due Date. Each Pre-Installment Notice shall be irrevocable and may not be revoked by the Company. If the Company does not time
Installment Notice Due Date that complies with this Section 8, then the Company shall be deemed to have delivered on such Pre-Install
ce confirming a Company Conversion of the entire Installment Amount payable as required hereunder and shall be deemed to have cert
e applicable Pre-Installment Notice Due Date. The applicable Company Conversion Amount (whether set forth in the applicable Pre-In
l be converted in accordance with Section 8.2 or Section 8.4, as applicable and the applicable Company Redemption Amount shall be re

Mechanics of Company Conversion. Subject to Section 3.4, if the Company delivers a Pre-Installment Notice and elects, or is deemed t
ave elected, in whole or in part, a Company Conversion in accordance with Section 8.1, then this Section 8.2 shall apply. Notwithstandi
urred as of the applicable Pre-Installment Notice Due Date, then the Company shall identify each such Equity Conditions Failure in the
n Holder pursuant to Section 8.6 hereof. (i) If such waiver is obtained, and all DWAC Eligible Conditions are then satisfied and a Comp
r provision of this Note, then the remainder of this Section 8.2 shall apply to the Company Conversion; (ii) if such waiver is obtained, b
sfied, then the remainder of this Section 8.2 shall not apply and the Company must deliver certificated Common Stock to Holder pursua
ined, then the remainder of this Section 8.2 shall not apply and the Company must elect a Company Redemption and deliver cash to the
uch lessor amount authorized by the Holder in writing) pursuant to Section 8.3 hereof. To the extent applicable as set forth above:

No later than three (3) Trading Days after each applicable Pre-Installment Notice Due Date, the Company shall deliver to the Holder's a
ch the Holder shall be the owner thereof as of the applicable Pre-Installment Notice Due Date.

No later than three (3) Trading Days after each Installment Date, the Company shall deliver to the Holder's account a number of shares
Post-Installment Conversion Shares exceed the Pre-Installment Conversion Shares previously delivered to Holder, registered in the nam
ault has occurred regarding payment, conversion or redemption under this Note (each a "Payment Default"), if the Pre-Installment Conv
Post-Installment Conversion Shares, then the excess will be applied towards the next Conversion Shares to be issued by the Company (u
, in which case Holder will return such excess shares to the Company). If a Payment Default has occurred and the Pre-Installment Conv
eed the Post-Installment Conversion Shares, then Holder shall not be required to return to the Company any of the excess shares or appl
version of shares hereunder. The Company agrees to deliver to the Holder such information and calculations required under this Section
ibit C-2 (each, an "Installment Date Notice").

2

f an Event of Default occurs during any applicable Company Conversion Measuring Period (defined below), then Holder may elect to e
vered in connection with the applicable Installment Date, or (ii) retain such Pre-Installment Conversion Shares and reduce the Outstandi
l to the Market Price of such retained Pre-Installment Conversion Shares as of the Installment Date, but in no event shall such reductio
l to calculate such Pre-Installment Conversion Shares. "Company Conversion Measuring Period" means the period beginning on the ap
applicable Installment Date.

f no Equity Conditions Failure existed as of the Pre-Installment Notice Due Date, but an Equity Conditions Failure exists as of the appl
nitted herein, or a Company Conversion is not otherwise permitted as of the Installment Date under any other provision of this Note, the
Company, the Holder may require the Company to do any one or more of the following:

he Company must redeem all or any part designated by the Holder of the Company Conversion Amount for which shares have not yet b
rred to as the "Designated Redemption Amount") and the Company shall pay to the Holder within three (3) Trading Days of such Instal
ls, an amount in cash equal to the Redemption Premium multiplied by the Designated Redemption Amount (the "Designated Redemptio
emption Price by the third (3rd) Trading Day following such written notice to the Company, then such failure to pay shall be an Event o

he Company Conversion shall be null and void with respect to the Company Conversion Amount for which shares have not yet been de
rights of a holder of this Note with respect to such remaining Company Conversion Amount; provided, however, the Conversion Price f
eafter be adjusted to equal the lesser of (Y) the Default Conversion Price as in effect on the date on which the Holder voided the Compa
would be in effect on the date on which the Holder delivers a subsequent Conversion Notice relating thereto as if such date was an Insta

Notwithstanding anything to the contrary in this Section 8.2, but subject to Section 3.4, until the Company delivers Common Stock repre
der pursuant to the terms of this Section 8.2, the Company Conversion Amount may be converted by the Holder into Common Stock pu
onvert the Company Conversion Amount prior to the applicable Installment Date as set forth in the immediately preceding sentence, the
ucted from the Installment Amount(s) relating to the applicable Installment Date(s) as set forth in the applicable Conversion Notice.

All Common Stock to be delivered to the Holder under this Section 8.2 shall be transferred via the DWAC system. Failure to do so shal
of.

8

Mechanics of Company Redemption. If the Company elects, or is required to elect, a Company Redemption, in whole or in part, in acc
npany Redemption Amount, if any, which is to be paid to the Holder on the applicable Installment Date shall be redeemed by the Comp
Company shall pay to the Holder on such Installment Date, by wire transfer of immediately available funds an amount, equal to the appl
to pay the applicable Company Redemption Amount on the applicable Installment Date, then, at the option of the Holder designated in
Conversion Notice" for purposes of this Note), the Holder may require the Company to convert all or any part of the Company Redempti
f the date of such designation as if such date were an Installment Date). Conversions required by this Section 8.3 shall be made in accor
withstanding anything to the contrary in this Section 8.3, but subject to Section 3.4 and the Holder's right to require the Company to co
ount at the Default Conversion Price as set forth above, until the Company Redemption Amount (together with any Late Charges thereo
ether with any Late Charges thereon) may be converted, in whole or in part, by the Holder into Common Stock pursuant to Section 3. In
ion of the Company Redemption Amount prior to the applicable Installment Date as set forth in the immediately preceding sentence, th
ucted from the Installment Amounts relating to the applicable Installment Date(s) as set forth in the applicable Conversion Notice.

DWAC Eligibility. If, when the Company delivers a Pre-Installment Notice and elects, or is deemed to have delivered a Pre-Installmen
a Company Conversion in accordance with Section 8.1, and the DWAC Eligible Conditions are not then satisfied but Holder waives th
ion 8.6, then, in accordance with Section 8.2, although such status will constitute an Event of Default hereunder, shares required to be i
hout limiting any of Holder's rights with respect to the Event of Default) as follows:

No later than three (3) Trading Days after delivery or deemed delivery (as applicable) of the applicable Pre-Installment Notice setting fo
deliver to the Holder or its broker, via reputable overnight courier, the Pre-Installment Certificated Shares by original share certificate,
vided, however, that so long as shares are not provided electronically to the Holder under Section 8, the Pre-Installment Certificated Sha
Installment Conversion Shares that would otherwise be transferred electronically to the Holder.

The Company agrees to use its best efforts to cause such shares to become Free Trading (the first date such occurs, the "Free Trading Da
ling Date via email within two (2) Trading Days after the occurrence of the Free Trading Date.

Provided that there is no Equity Conditions Failure as of the date that is twenty-three (23) Trading Days after the applicable Free Tradin
failure is waived as permitted herein) and a Company Conversion is not otherwise prohibited under any other provision of this Note, n
ificated Shares Installment Date, the Company shall deliver to the Holder or its broker via reputable overnight courier the Post-Installm
ificated Shares previously delivered to the Holder, by original share certificate, registered in the name of the Holder or its designee. So
Installment Certificated Shares for the applicable Certificated Shares Installment Date exceed the Post-Installment Certificated Shares,
version Shares to be issued by the Company (unless the Outstanding Balance has been reduced to zero, in which case Holder will return
ault has occurred and the Pre-Installment Certificated Shares for the applicable Certificated Shares Installment Date exceed the Post-Ins
ired to return to the Company any of the excess shares or apply such excess shares to any future issuance or conversion of shares hereu

4

Deemed Issuance. If Company fails to deliver shares as required by any portion of this Section 8, in addition to such failure to act being
poses of Section 7.1, the Company shall also be deemed to have issued the Pre-Installment Conversion Shares, Post-Installment Convers
-Installment Certificated Shares, as applicable, to Holder on the latest possible permitted date pursuant to the terms set forth in this Sect
ileges associated with such deemed issued shares (the "Deemed Installment Issuance").

Waiver of Equity Conditions Failure. Notwithstanding anything in this Note to the Contrary, the Holder may waive in writing any Equi
ity Conditions (defined below). For purposes of this Section 8, "Non-Waivable Equity Conditions" refers to (A) the Equity Condition s
own more than the Maximum Percentage set forth in Section 3.4 of this Note), and (B) the Equity Condition set forth in Section 27.19(v
s of the Eligible Market). Any such waiver shall only be made for the purposes of permitting a Company Conversion to occur under this
erlying default or a continuing waiver of a future Equity Conditions Failure. Any such waiver shall not excuse the Company from the pe
er this Note.

Preparation of Installment Notices. Because of the complexity of the calculations contemplated under this Note, the Holder may, at its s
or the Installment Date Notice for the benefit of the Company, including the calculation of Pre-Installment Conversion Shares, Post-Ins
ificated Shares, Post-Installment Certificated Shares; provided, however, that no error or mistake in the preparation of such notices or in
t to enforce the terms of this Note, even if such error or mistake arises from the Holder's own calculation. Nothing in this Section shall l
notices or information, or a waiver of any of its rights and remedies under this Note.

Transfer Fees. The Company shall pay any and all transfer, stamp, issuance and similar taxes that may be payable with respect to the is
res, Post-Installment Conversion Shares, Pre-Installment Certificated Shares, and Post-Installment Certificated Shares.

ONCIRCUMVENTION. The Company hereby covenants and agrees that the Company will not, by amendment of its Certificate of Inc
ugh any reorganization, transfer of assets, consolidation, merger, scheme of arrangement, dissolution, issue or sale of securities, or any
ervance or performance of any of the terms of this Note, and will at all times in good faith carry out all of the provisions of this Note and
e Holder of this Note. Without limiting the generality of the foregoing, the Company (i) shall not increase the par value of any shares o
e above the Conversion Price then in effect, (ii) shall take all such actions as may be necessary or appropriate in order that the Company
-assessable shares of Common Stock upon the conversion of this Note, and (iii) shall, so long as this Note is outstanding, take all action
Agreement).

5

HOLDER'S REDEMPTIONS. If the Holder has submitted to the Company an Event of Default Redemption Notice in accordance with
within ten (10) Trading Days after the Company's receipt of such Event of Default Redemption Notice an amount equal to the Default
mium (the "Event of Default Redemption Price"); provided, however, that the Redemption Premium may only be applied in computing
two Events of Default under this Note, and not to any subsequent Events of Default. If the Holder has submitted to Company a Fundam
Section 5.2, then the Company shall pay to Holder in cash prior to the consummation of such Fundamental Transaction if such notice i
damental Transaction and within ten (10) Trading Days after the Company's receipt of such notice otherwise, an amount equal to the Fu
he Redemption Premium (the "Fundamental Transaction Redemption Price"). Notwithstanding anything in this Note to the contrary, su
er this Section 10 shall not be considered a separate Event of Default hereunder. In the event that the Company does not pay the applica
od required, at any time thereafter and until the Company pays such unpaid Redemption Price in full, the Holder shall have the option, i
emption Notice or the Fundamental Transaction Redemption Notice, as applicable, by written notice to the Company (the "Redemption
emption Cancellation Notice, (y) the Outstanding Balance of this Note as of the date of the Redemption Notice shall be increased by an
emption Price, or Fundamental Transaction Redemption Price (as the case may be), minus (2) the principal portion of the Outstanding B
version Price of this Note shall be automatically adjusted with respect to each conversion under this Note effected thereafter by the Hol
e of the Common Stock during the period beginning on and including the date on which the applicable Redemption Notice is delivered
he Redemption Cancellation Notice, (B) the Market Price as of the date of the Redemption Cancellation Notice, (C) the then current Ma
Holder's delivery of a Redemption Cancellation Notice and exercise of its rights following such notice shall not affect the Company's
e accrued prior to the date of such Redemption Cancellation Notice.

VOTING RIGHTS. The Holder shall have no voting rights as the holder of this Note, except as required by law and as expressly provid

AMENDING THE TERMS OF THIS NOTE. The prior written consent of the Holder shall be required for any change or amendment to

TRANSFER. This Note and any shares of Common Stock issued upon conversion of this Note may be offered, sold, assigned or transfe
npany.

REISSUANCE OF THIS NOTE.

. Transfer. If this Note is to be transferred, the Holder shall surrender this Note to the Company, whereupon the Company will forthwit
e (in accordance with Section 14.4), registered as the Holder may request, representing the Outstanding Balance being transferred by the
ance is being transferred, a new Note (in accordance with Section 14.4) to the Holder representing the Outstanding Balance not being tra

. Lost, Stolen or Mutilated Note. Upon receipt by the Company of evidence reasonably satisfactory to the Company of the loss, theft, de
ten certification and the indemnification contemplated below shall suffice as such evidence), and, in the case of loss, theft or destruction
Company in customary and reasonable form and, in the case of mutilation, upon surrender and cancellation of this Note, the Company s
rdance with Section 14.4) representing the Outstanding Balance.

6

. Note Exchangeable for Different Denominations. This Note is exchangeable, upon the surrender hereof by the Holder at the principal
ordance with Section 14.4 and in principal amounts of at least $1,000) representing in the aggregate the Outstanding Balance of this Not
uch Outstanding Balance as is designated by the Holder at the time of such surrender.

. Issuance of New Notes. Subject to Section 10, whenever the Company is required to issue a new Note pursuant to the terms of this No
e, (ii) shall represent, as indicated on the face of such new Note, the Outstanding Balance (or in the case of a new Note being issued pur
standing Balance designated by the Holder which, when added to the outstanding balance represented by the other new Notes issued in
standing Balance under this Note immediately prior to such issuance of new Notes), (iii) shall have an issuance date, as indicated on the
ance Date of this Note, (iv) shall have the same rights and conditions as this Note, and (v) shall represent accrued and unpaid Interest ar
nce as permitted hereunder from the Issuance Date.

REMEDIES, CHARACTERIZATIONS, OTHER OBLIGATIONS, BREACHES AND INJUNCTIVE RELIEF. The remedies, includin
ayment Premium, and all other charges, fees, and collection costs provided for in this Note, shall be cumulative and in addition to all ot
r Transaction Documents at law or in equity (including a decree of specific performance and/or other injunctive relief), and nothing her
sequential damages for any failure by the Company to comply with the terms of this Note. The Company covenants to the Holder that th
ument other than as expressly provided herein. Amounts set forth or provided for herein with respect to payments, conversion and the l
e received by the Holder and shall not, except as expressly provided herein, be subject to any other obligation of the Company (or the pe
each by it of its obligations hereunder will cause irreparable harm to the Holder and that the remedy at law for any such breach may be i
t of any such breach or threatened breach, the Holder shall be entitled, in addition to all other available remedies, to an injunction restra
out the necessity of showing economic loss and without any bond or other security being required. The Company shall provide all infor
ested by the Holder to enable the Holder to confirm the Company's compliance with the terms and conditions of this Note (including, v

PAYMENT OF COLLECTION, ENFORCEMENT AND OTHER COSTS. If (a) this Note is placed in the hands of an attorney for coll
ugh any legal proceeding or the Holder otherwise takes action to collect amounts due under this Note or to enforce the provisions of thi
ganization, receivership of the Company or other proceedings affecting Company creditors' rights and involving a claim under this Not
der for such collection, enforcement or action or in connection with such bankruptcy, reorganization, receivership or other proceeding, i
ursements. The Company expressly acknowledges and agrees that no amounts due under this Note shall be affected, or limited, by the f
the Original Principal Amount.

CONSTRUCTION; HEADINGS. This Note shall be deemed to be jointly drafted by the Company and the Holder and shall not be cons
lings of this Note are for convenience of reference and shall not form part of, or affect the interpretation of, this Note. Terms used in thi
l have the meanings ascribed to such terms on the Issuance Date in such other Transaction Documents unless otherwise consented to in

7

FAILURE OR INDULGENCE NOT WAIVER. No failure or delay on the part of the Holder in the exercise of any power, right or privi
l any single or partial exercise of any such power, right or privilege preclude other or further exercise thereof or of any other right, powe
riting and signed by an authorized representative of the waiving party.

DISPUTE RESOLUTION. In the case of a dispute as to the determination of the Conversion Price, Default Conversion Price, Pre-Instal
Price, the Closing Sale Price, VWAP or fair market value (as the case may be) or the arithmetic calculation of Conversion Shares or the
mpany or the Holder (as the case may be) shall submit the disputed determinations or arithmetic calculations (as the case may be) via fac
applicable notice giving rise to such dispute to the Company or the Holder (as the case may be) or (ii) if no notice gave rise to such disp
umstances giving rise to such dispute (including, without limitation, as to whether any issuance or sale or deemed issuance or sale was a
luded Securities). If the Holder and the Company are unable to agree upon such determination or calculation within two (2) Trading Da
ulation (as the case may be) being submitted to the Company or the Holder (as the case may be), then the Company shall, within two (2
rmination of the Conversion Price, Default Conversion Price, Pre-Installment Conversion Price, Conversion Rate, the Closing Bid Price
he case may be) to an independent, reputable investment bank selected by the Holder or (b) the disputed arithmetic calculation of the C
be) to the Company's independent, outside accountant. The Company shall cause at its expense the investment bank or the accountant
ulations (as the case may be) and notify the Company and the Holder of the results no later than ten (10) Trading Days from the time it
he case may be). Such investment bank's or accountant's determination or calculation with respect to the disputes set forth in this Secti
es absent demonstrable error.

NOTICES; PAYMENTS.

. Notices. Whenever notice is required to be given under this Note, unless otherwise provided herein, such notice shall be given in acco
tices." The Company shall provide the Holder with prompt written notice of all actions taken pursuant to this Note, including in reason
efore. Without limiting the generality of the foregoing, the Company will give written notice to the Holder (i) immediately upon any ad
onable detail, and certifying, the calculation of such adjustment and (ii) at least fifteen (15) Trading Days prior to the date on which the
ect to any dividend or distribution upon the Common Stock, (B) with respect to any grant, issuances, or sales of any Options, Convertib
rities or other property to all holders of shares of Common Stock, or (C) for determining rights to vote with respect to any Fundamental
case that such information shall be made known to the public prior to or in conjunction with such notice being provided to the Holder.

. Currency. All dollar amounts referred to in this Note are in United States Dollars ("U.S. Dollars"), and all amounts owing under this N
ominated in other currencies (if any) shall be converted into the U.S. Dollar equivalent amount in accordance with the Exchange Rate or
tion to any amount of currency to be converted into U.S. Dollars pursuant to this Note, the U.S. Dollar exchange rate as published in Th
eing understood and agreed that where an amount is calculated with reference to, or over, a period of time, the date of calculation shall

8

. Payments. Whenever any payment of cash is to be made by the Company to any Person pursuant to this Note, unless otherwise expres
ful money of the United States of America by wire transfer of immediately available funds pursuant to wire transfer instructions deliver
amount expressed to be due by the terms of this Note is due on any day which is not a Trading Day, the same shall instead be due on th
unt due under the Transaction Documents which is not paid when due shall result in a late charge being incurred and payable by the Co
e rate of eighteen percent (18%) per annum from the date such amount was due until the same is paid in full ("Late Charge").

CANCELLATION. After repayment or conversion of the entire Outstanding Balance, this Note shall automatically be deemed canceled
shall not be reissued.

WAIVER OF NOTICE. To the extent permitted by law, the Company hereby irrevocably waives demand, notice, presentment, protest a
delivery, acceptance, performance, default or enforcement of this Note and the Agreement.

GOVERNING LAW. This Note shall be construed and enforced in accordance with, and all questions concerning the construction, vali
overned by, the internal laws of the State of Utah, without giving effect to any choice of law or conflict of law provision or rule (whethe
ld cause the application of the laws of any jurisdictions other than the State of Utah. The Company hereby irrevocably submits to the ex
ng in Salt Lake City for the adjudication of any dispute hereunder or in connection herewith or with any transaction contemplated hereb
agrees not to assert in any suit, action or proceeding, any claim that it is not personally subject to the jurisdiction of any such court, that
nvenient forum or that the venue of such suit, action or proceeding is improper. Nothing contained herein shall be deemed to limit in an
nitted by law. In the event that any provision of this Note is invalid or unenforceable under any applicable statute or rule of law, then su
it may conflict therewith and shall be deemed modified to conform with such statute or rule of law. Any such provision which may pro
ct the validity or enforceability of any other provision of this Note. Nothing contained herein shall be deemed or operate to preclude the
nst the Company or any of its Subsidiaries in any other jurisdiction to collect on the Company's obligations to the Holder, to realize on
o enforce a judgment or other court ruling in favor of the Holder. THE COMPANY HEREBY IRREVOCABLY WAIVES ANY RIGHT
QUEST, A JURY TRIAL FOR THE ADJUDICATION OF ANY DISPUTE HEREUNDER OR IN CONNECTION WITH OR ARISIN
NTEMPLATED HEREBY.

SEVERABILITY. If any provision of this Note is prohibited by law or otherwise determined to be invalid or unenforceable by a court o
rwise be prohibited, invalid or unenforceable shall be deemed amended to apply to the broadest extent that it would be valid and enforc
vision shall not affect the validity of the remaining provisions of this Note so long as this Note as so modified continues to express, with
es as to the subject matter hereof and the prohibited nature, invalidity or unenforceability of the provision(s) in question does not substa
gations of the parties or the practical realization of the benefits that would otherwise be conferred upon the parties. The parties will end
ibited, invalid or unenforceable provision(s) with one or more valid provisions, the effect of which comes as close as possible to that of

9

FEES AND CHARGES. The parties acknowledge and agree that upon Company's failure to comply with the provisions of this Note, th
mate because of the parties' inability to predict future interest rates, the Holder's increased risk, and the uncertainty of the availability of
der. Accordingly, any fees, charges, and interest due under this Note, including without limitation the Prepayment Premium and the Rec
shall be deemed, a reasonable estimate of the Holder's actual loss of its investment opportunity and not a penalty, and shall not be deem
have hereunder, at law or in equity.

UNCONDITIONAL OBLIGATION. Subject to the terms of the Agreement, no provision of this Note shall alter or impair the obligatio
onditional, to pay the principal of, and interest on, this Note at the time, place, and rate, and in the coin or currency or where contemplat
erein prescribed. This Note is the direct obligation of the Company and not subject to offsets, counterclaims, defenses, credits or deduc

CERTAIN DEFINITIONS. For purposes of this Note, the following terms shall have the following meanings:

. "Affiliate" means, with respect to any Person, any other Person that directly or indirectly controls, is controlled by, or is under commo
poses of this definition that "control" of a Person means the power directly or indirectly either to vote 10% or more of the stock having o
on or direct or cause the direction of the management and policies of such Person whether by contract or otherwise.

. "Agreement" means that certain Securities Purchase Agreement, dated as of _____ __, 2012, as may be amended from time to time
hich the Company issued this Note.

. "Approved Stock Plan" means any stock option plan which has been approved by the Board of Directors of the Company, pursuant to
loyee, officer or director for services provided to the Company.

. "Black Scholes Consideration Value" means the value of the applicable Option or Convertible Security (as the case may be) as of the
oles Option Pricing Model obtained from the "OV" function on Bloomberg utilizing (i) an underlying price per share equal to the Closi
ediately preceding the public announcement of the execution of definitive documents with respect to the issuance of such Option or Co
rest rate corresponding to the U.S. Treasury rate for a period equal to the remaining term of such Option or Convertible Security (as the
onvertible Security (as the case may be), and (iii) an expected volatility equal to the greater of 100% and the 100 day volatility obtained
zing a 365 day annualization factor) as of the Trading Day immediately following the date of issuance of such Option or Convertible Se

. "Bloomberg" means Bloomberg, L.P.

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. "Closing Bid Price" and "Closing Sale Price" means, for any security as of any date, the last closing bid price and last closing trade pr
eported by Bloomberg, or, if the Principal Market begins to operate on an extended hours basis and does not designate the closing bid pr
ast bid price or last trade price, respectively, of such security prior to 4:00:00 p.m., New York time, as reported by Bloomberg, or, if the
hange or trading market for such security, the last closing bid price or last trade price, respectively, of such security on the principal secu
sted or traded as reported by Bloomberg, or if the foregoing do not apply, the last closing bid price or last trade price, respectively, of su
tronic bulletin board for such security as reported by Bloomberg, or, if no closing bid price or last trade price, respectively, is reported f
es, or the ask prices, respectively, of any market makers for such security as reported in "OTC Pink" by Pink OTC Markets Inc. (former
sing Bid Price or the Closing Sale Price cannot be calculated for a security on a particular date on any of the foregoing bases, the Closin
of such security on such date shall be the fair market value as mutually determined by the Company and the Holder. If the Company and
e of such security, then such dispute shall be resolved in accordance with the procedures in Section 19. All such determinations shall be
, stock combination or other similar transaction during such period.

. "Common Stock" means (i) the Company's shares of common stock, $0.01 par value per share, and (ii) any capital stock into which s
tal resulting from a reclassification of such common stock.

. "Contingent Obligation" means as to any Person, any direct or indirect liability, contingent or otherwise, of that Person with respect to
her Person if the primary purpose or intent of the Person incurring such liability, or the primary effect thereof, is to provide assurance to
or discharged, or that any agreements relating thereto will be complied with, or that the holders of such liability will be protected (in w

. "Conversion Shares" means shares of Common Stock issuable by the Company upon any conversion of this Note, including without l
version Shares, Post-Installment Conversion Shares, Pre-Installment Certificated Shares, and Post-Installment Certificated Shares.

0. "Convertible Securities" means any stock, preferred stock, stock appreciation rights, phantom stock, equity related rights, equity link
time and under any circumstances, directly or indirectly, convertible into, exercisable or exchangeable for, or which otherwise entitles t
k.

1. "Current Subsidiary" means any Person in which the Company on the Issuance Date, directly or indirectly, (i) owns any of the outsta
uch Person or (ii) controls or operates all or any part of the business, operations or administration of such Person, and all of the foregoin

2. "Deemed Issuance" means (i) a Deemed Conversion Issuance as defined in Section 3.3(b) hereof, (ii) a Deemed Installment Issuance
rant Issuance as defined in Section 7.1(e) hereof.

3. "Default Conversion Price" means, with respect to a particular date of determination, the lower of (i) the Conversion Price then in ef
Installment Notice Due Date or the Installment Date, as applicable. All such determinations to be appropriately adjusted for any stock s
saction during any applicable Measuring Period.

1

4. “DTC” means the Depository Trust Company.

5. “DTC/FAST Program” means the DTC’s Fast Automated Securities Transfer Program.

6. “DWAC” means Deposit Withdrawal at Custodian as defined by the DTC.

7. “DWAC Eligible Conditions” means that (i) the Common Stock is eligible at DTC for full services pursuant to DTC’s Operational A
C’s DWAC system, (ii) the Company has been approved (without revocation) by the DTC’s underwriting department, and (iii) the Trans
gram.

8. “Eligible Market” means The New York Stock Exchange, NYSE Amex, the Nasdaq Global Select Market, the Nasdaq Global Marke
OTCQX or the OTCQB, or the Principal Market. In no event shall quotations provided in OTC Pink by Pink OTC Markets Inc., or its su

9. “Equity Conditions” means: (i) with respect to the applicable date of determination all of the Conversion Shares are freely tradable u
applicable federal or state securities laws (in each case, disregarding any limitation on conversion of this Note); (ii) on each day during
of determination and ending on and including the applicable date of determination (the “Equity Conditions Measuring Period”), the Co
d or designated for quotation (as applicable) on an Eligible Market and shall not have been suspended from trading on an Eligible Mark
Trading Days and occurring prior to the applicable date of determination due to business announcements by the Company); (iii) on each
Company shall have delivered all shares of Common Stock issuable upon conversion of this Note on a timely basis as set forth in Sectio
e delivered by the Company on a timely basis as set forth in the other Transaction Documents; (iv) any shares of Common Stock to be i
rmination may be issued in full without violating Section 3.4 hereof (the Holder acknowledges that the Company shall be entitled to ass
under absent written notice from the Holder); (v) any shares of Common Stock to be issued in connection with the event requiring deter
s or regulations of the Eligible Market on which the Common Stock is then listed or designated for quotation (as applicable); (vi) on eac
ublic announcement of a pending, proposed or intended Fundamental Transaction shall have occurred which has not been abandoned, t
e no knowledge of any fact that would reasonably be expected to cause any of the Conversion Shares to not be freely tradable without th
rities laws (in each case, disregarding any limitation on conversion of this Note); (viii) on each day during the Equity Conditions Measu
erial compliance with each, and shall not have breached any, term, provision, covenant, representation or warranty of any Transaction D
day during the Equity Conditions Measuring Period, there shall not have occurred an Event of Default or an event that with the passag
Default; (x) all DWAC Eligible Conditions shall be satisfied as of each applicable Pre-Installment Notice Due Date and Installment Date
Installment Date, the average and median daily dollar volume of the Common Stock on its Principal Market for the previous twenty-th
000.00; (xii) the ten (10) day average VWAP of the Common Stock is greater than $0.005; and (xiii) Market Capitalization of the Com

2

0. “Equity Conditions Failure” means, with respect to a particular date of determination, that on any day during the period commencing
date of determination and ending on such date of determination, the Equity Conditions have not been satisfied (or waived in writing by
lt of an Event of Default, then the Equity Conditions Failure shall be deemed permanent and may not be cured by the Company.

1. “Excluded Securities” means any shares of Common Stock, options, or convertible securities issued or issuable (i) in connection with
, exercise price or similar provisions of any issuances pursuant to such Approved Stock Plan are not amended, modified or changed on
gers, acquisitions, strategic licensing arrangements, strategic business partnerships or joint ventures, in each case with non-affiliated thi
ose of which is not to raise additional capital; provided, that such third parties are not granted any registration rights. Notwithstanding
e capital for the Company or its Subsidiaries, directly or indirectly, in connection with any transaction contemplated by clause (ii) above
ore related transactions or that result in similar economic consequences, shall not be deemed to be Excluded Securities.

2. “Free Trading” means that (i) the certificate representing the applicable shares of Common Stock has been cleared and approved for
kerage firm and the clearing firm servicing such brokerage, and (ii) such shares are held in the name of the clearing firm servicing Holde
ring firm’s account for the benefit of Holder.

3. “Fundamental Transaction” means that (i) (1) the Company or any of its Subsidiaries shall, directly or indirectly, in one or more rela
ether or not the Company or any of its Subsidiaries is the surviving corporation) any other Person, or (2) the Company or any of its Sig
ore related transactions, sell, lease, license, assign, transfer, convey or otherwise dispose of all or substantially all of its respective prop
ny of its Subsidiaries shall, directly or indirectly, in one or more related transactions, allow any other Person to make a purchase, tender
e than 50% of the outstanding shares of Voting Stock of the Company (not including any shares of Voting Stock of the Company held b
ciated or affiliated with the Persons making or party to, such purchase, tender or exchange offer), or (4) the Company or any of its Subs
ted transactions, consummate a stock or share purchase agreement or other business combination (including, without limitation, a reorga
ngement) with any other Person whereby such other Person acquires more than 50% of the outstanding shares of Voting Stock of the Co
Company held by the other Person or other Persons making or party to, or associated or affiliated with the other Persons making or party
ness combination), or (5) the Company or any of its Subsidiaries shall, directly or indirectly, in one or more related transactions, reorga
r than an increase in the number of authorized shares of the Company’s Common Stock, or (ii) any “person” or “group” (as these terms
4 Act and the rules and regulations promulgated thereunder) is or shall become the “beneficial owner” (as defined in Rule 13d-3 under t
regate ordinary voting power represented by issued and outstanding Voting Stock of the Company.

4. “GAAP” means United States generally accepted accounting principles, consistently applied.

5. “Indebtedness” of any Person means, without duplication (i) all indebtedness for borrowed money, (ii) all obligations issued, underta
perty or services, including, without limitation, “capital leases” in accordance with GAAP (other than trade payables entered into in the
ment obligations with respect to letters of credit, surety bonds and other similar instruments, (iv) all obligations evidenced by notes, bon
gations so evidenced incurred in connection with the acquisition of property, assets or businesses, (v) all indebtedness created or arising
ement, or incurred as financing, in either case with respect to any property or assets acquired with the proceeds of such indebtedness (e
er such agreement in the event of default are limited to repossession or sale of such property), (vi) all monetary obligations under any le
AP, consistently applied for the periods covered thereby, is classified as a capital lease, (vii) all indebtedness referred to in clauses (i) th
Indebtedness has an existing right, contingent or otherwise, to be secured by) any mortgage, lien, pledge, charge, security interest or ot
luding accounts and contract rights) owned by any Person, even though the Person which owns such assets or property has not assumed
btedness, and (viii) all Contingent Obligations in respect of indebtedness or obligations of others of the kinds referred to in clauses (i) t

6. “Installment Amount” means the greater of (i) $62,500 (250,000.00 ÷ 4), plus the sum of any accrued and unpaid Interest as of the ap
rges, if any, under this Note as of the applicable Installment Date, and any other amounts accruing or owing to Holder under this Note a
standing Balance divided by the number of Installment Dates remaining prior to the Maturity Date. In the event the Holder shall sell or
sferee shall be allocated a pro rata portion (based on the portion of this Note transferred compared with the Outstanding Balance of this
ount hereunder.

7. “Installment Date” means the Initial Installment Date and the same day on each of the following calendar months following the Initia
nt of Default (or the issuance of any Redemption Cancellation Notice). If the Outstanding Balance is not paid on the Maturity Date, ther
nsaction Documents, the Installment Dates will continue on the same day of each calendar month until the Outstanding Balance is paid i
vide Pre-Installment Notices to the Holder pursuant to Section 8 hereof.

8. “Market Price” means 75% of the arithmetic average of the three (3) lowest VWAPs of the shares of Common Stock during the twen
eding the date of such determination (the “Measuring Period”). All such determinations are to be appropriately adjusted for any stock s
saction during such Measuring Period.

4

9. “Maturity Date” shall mean the date that is ten (10) months after the Issuance Date.

0. “New Subsidiary” means, as of any date of determination, any Person in which the Company after the Issuance Date, directly or indi
k or holds any equity or similar interest of such Person or (ii) controls or operates all or any part of the business, operations or administ
ectively, “New Subsidiaries.”

1. “Options” means any rights, warrants or options to subscribe for or purchase shares of Common Stock or Convertible Securities.

2. “Parent Entity” of a Person means an entity that, directly or indirectly, controls the applicable Person and whose common stock or eq
ket, or, if there is more than one such Person or Parent Entity, the Person or Parent Entity with the largest public market capitalization a
nsaction.

3. “Person” means an individual, a limited liability company, a partnership, a joint venture, a corporation, a trust, an unincorporated org
artment or agency thereof.

4. “Post-Installment Certificated Shares” means a number of shares of Common Stock equal to one (1) times the greater of (i) the Post-
icable Installment Date, and (ii) the Post-Installment Conversion Shares calculated using the Certificated Shares Installment Date (as if

5. “Post-Installment Conversion Price” means, with respect to a particular date of determination, the lower of (i) the Conversion Price t
allment Date. All such determinations to be appropriately adjusted for any stock split, stock dividend, stock combination or other simila

6. “Post-Installment Conversion Shares” means that number of shares of Common Stock that would be required to be delivered pursua
ng into account the delivery of any Pre-Installment Conversion Shares. The Post-Installment Conversion Shares are equal to the quotien
he Post-Installment Conversion Price as of the applicable Installment Date.

5

7. “Pre-Installment Certificated Shares” means the number of shares of Common Stock to be delivered pursuant to Section 8.4(a). The
s the number of Pre-Installment Conversion Shares that would otherwise be required to be delivered to the Holder pursuant to Section 8

8. “Pre-Installment Conversion Price” means, with respect to a particular date of determination, the lower of (i) the Conversion Price th
Installment Notice Due Date. All such determinations to be appropriately adjusted for any stock split, stock dividend, stock combinatio
suring Period.

9. “Pre-Installment Conversion Shares” means the number of shares of Common Stock to be delivered pursuant to Section 8.1. The Pre
) the Company Conversion Amount divided by (ii) the Pre-Installment Conversion Price as of the applicable Pre-Installment Notice Du

0. “Principal Market” means the Nasdaq Capital Market.

1. “Redemption Notices” means, collectively, Event of Default Redemption Notices and Fundamental Transaction Redemption Notices
ce.”

2. “Redemption Premium” means 135%.

3. “Redemption Price” means either the Event of Default Redemption Price or the Fundamental Transaction Redemption Price, as the c

4. “SEC” means the United States Securities and Exchange Commission or the successor thereto.

5. “Significant Subsidiaries” means, as of any date of determination, collectively, all Subsidiaries that would constitute a “significant su
he SEC, and each of the foregoing, individually, a “Significant Subsidiary.”

6. “Subsidiaries” means, as of any date of determination, collectively, all Current Subsidiaries and all New Subsidiaries, and each of the

6

7. “Successor Entity” means the Person, which may be the Company, formed by, resulting from or surviving any Fundamental Transac
nsaction shall have been made, provided that if such Person is not a publicly traded entity whose common stock or equivalent equity sec
ket, Successor Entity shall mean such Person's Parent Entity.

8. “Trading Day” means any day on which the Common Stock is traded on the Principal Market, or, if the Principal Market is not the p
principal securities exchange or securities market on which the Common Stock is then traded, provided that “Trading Day” shall not inc
ade on such exchange or market for less than 4.5 hours or any day that the Common Stock is suspended from trading during the final ho
hange or market does not designate in advance the closing time of trading on such exchange or market, then during the hour ending at 4:
rwise designated as a Trading Day in writing by the Holder.

9. “Voting Stock” of a Person means capital stock of such Person of the class or classes pursuant to which the holders thereof have the
oint, at least a majority of the board of directors, managers, trustees or other similar governing body of such Person (irrespective of whe
ses shall have or might have voting power by reason of the happening of any contingency).

0. “VWAP” means, for any security as of any date, the dollar volume-weighted average price for such security on the Principal Market
ket for such security, then on the principal securities exchange or securities market on which such security is then traded) during the per
ng at 4:00:00 p.m., New York time, as reported by Bloomberg through its “Volume at Price” function or, if the foregoing does not appl
rity in the over-the-counter market on the electronic bulletin board for such security during the period beginning at 9:30:01 a.m., New Y
eported by Bloomberg, or, if no dollar volume-weighted average price is reported for such security by Bloomberg for such hours, the av
ing ask price of any of the market makers for such security as reported in “OTC Pink” by Pink OTC Markets Inc. (formerly Pink Sheets
alculated for such security on such date on any of the foregoing bases, the VWAP of such security on such date shall be the fair market
der. If the Company and the Holder are unable to agree upon the fair market value of such security, then such dispute shall be resolved i
determinations shall be appropriately adjusted for any stock dividend, stock split, stock combination or other similar transaction during

7

DISCLOSURE. Upon receipt or delivery by the Company of any notice in accordance with the terms of this Note, unless the Company
notice do not constitute material, non-public information relating to the Company or any of its Subsidiaries, the Company shall within
icly disclose such material, non-public information on a Current Report on Form 8-K or otherwise. In the event that the Company belie
rmation relating to the Company or any of its Subsidiaries, the Company so shall indicate to such Holder contemporaneously with deliv
cation, the Holder shall be allowed to presume that all matters relating to such notice do not constitute material, non-public information

MAXIMUM PAYMENTS. Nothing contained in this Note shall, or shall be deemed to, establish or require the payment of a rate of inte
nitted by applicable law. In the event that the rate of interest required to be paid or other charges under this Note exceeds the maximum
imum shall be credited against amounts owed by the Company to the Holder and thus refunded to the Company.

[Remainder of page intentionally left blank]

8

WITNESS WHEREOF, the Company has caused this Note to be duly executed as of the Issuance Date set forth above.

THE COMPANY:

Seven Arts Entertainment In

By: _____
Name:_____
Title:_____

KNOWLEDGED, ACCEPTED AND AGREED:

aquint, Inc.

_____
John M. Fife, President

[Signature page to Convertible Promissory Note]

9

EXHIBIT A

Tonaquint, Inc.
303 East Wacker Drive, Suite 1200
Chicago, Illinois 60601

en Arts Entertainment Inc.
: _____
9 Sunset Boulevard 4th Floor
Angeles, California 90069

Date:_____

CONVERSION NOTICE

above-captioned Holder hereby gives notice to Seven Arts Entertainment Inc., a Nevada corporation (the "Company"), pursuant to that
npany in favor of the Holder on _____ __, 2012 (the "Note"), that the Holder elects to convert the portion of the Note balance set fort
mmon Stock of the Company as of the date of conversion specified below. Said conversion shall be based on the Conversion Price set fo
version Notice and the Note, the Note shall govern, or, in the alternative, at the election of the Holder in its sole discretion, the Holder m
form to the Note. Capitalized terms used in this notice without definition shall have the meanings given to them in the Note.

A. Date of conversion:
B. Conversion #:
C. Conversion Amount:
D. Conversion Price: _____
E. Section 3 Conversion Shares: _____ (C d
F. Remaining Outstanding Balance of Note: ____

_____ of the Conversion Amount converted hereunder shall be deducted from the Installment Amount(s) relating to the foll
_____.

se transfer the Section 3 Conversion Shares electronically (via DWAC) to the following account:

ker:_____
C#: _____
ount #: _____
ount Name: _____

Address: _____
_____
_____

he extent the Section 3 Conversion Shares are not able to be delivered to the Holder electronically via the DWAC system, please add ad
ent (5%) of the number of Section 3 Conversion Shares so converted (per Section 3.3(a) of the Note), and deliver all such certificated sh
ipt of this Conversion Notice (by facsimile transmission or otherwise) to:
_____
_____
_____

erely,

der: Tonaquint, Inc.

_____

John M. Fife, President

00

EXHIBIT B
ACKNOWLEDGMENT

Company hereby acknowledges this Conversion Notice and hereby directs _____ to issue the above indicated number of sh
vocable Instructions to Transfer Agent dated _____ __, 2012 from the Company and acknowledged and agreed to by _____

en Arts Entertainment Inc.

_____
ne: _____
e: _____

01

EXHIBIT C-1

Seven Arts Entertainment Inc.
8439 Sunset Boulevard, Suite 402
West Hollywood, California 90069

aquint, Inc.
: John Fife
E. Wacker Dr., Suite 1200
cago, IL 60657

Date: _____

PRE-INSTALLMENT NOTICE

above-captioned Company hereby gives notice to Tonaquint, Inc., a Utah corporation (the "Holder"), pursuant to that certain Convertil
Holder on _____, 2012 (the "Note"), of certain Company elections and certifications related to payment of the Installment Amo
"Installment Date"). In the event of a conflict between this Installment Notice and the Note, the Note shall govern, or, in the alternati
der may provide a new form of Installment Notice to conform to the Note. Capitalized terms used in this notice without definition shall

PRE-INSTALLMENT ELECTIONS AND CERTIFICATIONS
AS OF THE PRE-INSTALLMENT NOTICE DUE DATE

A. COMPANY ELECTIONS

Company elects to pay the Installment Amount as follows (check one):

___(i) Redeeming the Installment Amount in cash in accordance with Section 8 of the Note ("Company Redemption") (if selected, no c

___(ii) Converting the Installment Amount in accordance with Section 8 of the Note ("Company Conversion") (if selected, comple

___(iii) Combination of Company Redemption and Company Conversion (if selected, complete Section B(2) and

B. COMPANY CONVERSION (if applicable)

1. Company Conversion:

A. Pre-Installment Notice Due Date: _____
B. Company Conversion Amount:
C. Pre-Installment Conversion Price: _____ (lower of (i) Conversion Price in effect and (ii) Market Price
D. Pre-Installment Conversion Shares: _____ (E
E. Excess shares to be applied from previous installment (if any):
F. Installment shares to be delivered: _____
G. Remaining Note balance: _____

02

2. Combination of Company Redemption and Company Conversion (if elected above)

A. Pre-Installment Notice Due Date: _____

B. Installment Amount:

C. Company Redemption Amount: _____

D. Company Conversion Amount: _____ (

E. Pre-Installment Conversion Price: _____ (lower of (i) Conversion Price in effect and (ii) Market Price

F. Pre-Installment Conversion Shares: _____ (D

G. Excess shares to be applied from previous installment (if any):

H. Installment shares to be delivered: _____

I. Remaining Note balance: _____

C. EQUITY CONDITIONS CERTIFICATION (if applicable)

1. Market Capitalization of the Common Stock:_____

eck One)

2. _____The Company herby certifies that no Equity Conditions Failure exists as of the Pre-Installme

_____The Company hereby gives notice that an Equity Conditions Failure has occurred and requests a waiver from the Holder wi
ollows:

_____

_____

_____

erely,

npany: Seven Arts Entertainment Inc.

_____

ne: _____

e: _____

03

EXHIBIT C-2

Seven Arts Entertainment Inc.
8439 Sunset Boulevard, Suite 402
West Hollywood, California 90069

aquint, Inc.
: John Fife
E. Wacker Dr., Suite 1200
cago, IL 60657

Date: _____

INSTALLMENT DATE NOTICE

above-captioned Company hereby gives notice to Tonaquint, Inc., a Utah corporation (the "Holder"), pursuant to that certain Convertib
Holder on _____ __, 2012 (the "Note"), of Post-Installment Conversion Shares and Equity Conditions Certifications related to ____
flict between this Installment Notice and the Note, the Note shall govern, or, in the alternative, at the election of the Holder in its sole di
allment Notice to conform to the Note. Capitalized terms used in this notice without definition shall have the meanings given to them in

POST-INSTALLMENT CONVERSION SHARES AND CERTIFICATIONS
AS OF THE INSTALLMENT DATE

1. POST-INSTALLMENT CONVERSION SHARES

A. Pre-Installment Notice Due Date: _____, 201_

B. Company Conversion Amount: _____

C. Post-Installment Conversion Price: _____ (lower of (i) Conversion Price in effect and (ii) Market P

D. Post-Installment Conversion Shares: _____ (B divided by C)

E. Pre-Installment Conversion Shares delivered: _____

F. Post-Installment Conversion Shares to be delivered: _____ (only applicable if D minus E i

Pre-Installment Conversion Shares to be applied to next installment or returned:_____ (only applicable if D minus E is le

Pre-Installment Conversion Shares to be retained by the Holder because of a Payment Default: _____ (only applicable if
occurred)

04

2. EQUITY CONDITIONS CERTIFICATION

A. Market Capitalization of the Common Stock:_____

eck One)

B. _____The Company herby certifies that no Equity Conditions Failure exists as of the applicable

_____The Company hereby gives notice that an Equity Conditions Failure has occurred and requests a waiver from the Holder w
follows:

_____

_____

_____

erely,

npany: Seven Arts Entertainment Inc.

_____

ne: _____

e: _____

05

IRREVOCABLE LETTER OF INSTRUCTIONS TO TRANSFER AGENT

e: August 22, 2012

he transfer agent of SEVEN ARTS ENTERTAINMENT INC.

Instruction to Reserve and Transfer Shares

es and Gentlemen:

erence is made to that certain Convertible Promissory Note #1 dated as of August 22, 2012 (the "Note"), made by SEVEN ARTS ENTE
mpany"), pursuant to which the Company agreed to pay to TONAQUINT, INC., a Utah corporation, its successors and/or assigns (the "
, and collection costs. The Note was issued pursuant to that certain Securities Purchase Agreement dated August 22, 2012, by and betw
ther with the Note and all other documents entered into in conjunction therewith, including any amendments or waivers, the "Loan Doc
be converted into shares of the common stock, par value $0.01 per share, of the Company (the "Common Stock") (the shares of Comm
er the Note, the "Shares").

suant to the terms of the Agreement, until all of the Company's obligations under the Agreement and the Note are paid and performed in
sfer agent to establish a reserve of shares of authorized but unissued Common Stock equal to the amount calculated as follows (such cal
erve"): two times the higher of (1) the Outstanding Balance (as defined in and determined pursuant to the Note) divided by the Conversi
e), and (2) the Outstanding Balance divided by the Market Price (as defined in and determined pursuant to the Note).

irrevocable letter of instructions (this "Letter") shall serve as the authorization and direction of the Company to Interwest Transfer Co
t (hereinafter, "you" or "your"), to reserve shares of Common Stock and to issue (or where relevant, to reissue in the name of Holder) s
version of the Note, as follows:

rom and after the date hereof and until all of the Company's obligations under the Agreement and the Note are paid and performed in fu
orized but unissued Common Stock intended to cover the Share Reserve in an amount not less than 12,000,000 shares (the "Transfer A
nsfer Agent Reserve for the exclusive benefit of the Holder, (c) you shall issue the shares of Common Stock held in the Transfer Agent
ediately following clause (d)), (d) when you issue shares of Common Stock to the Holder or its broker under the Note pursuant to the o
shares from the Transfer Agent Reserve, unless the Holder delivers to you written pre-approval of such issuance, (e) you shall not redu
umstances, unless the Holder delivers to you written pre-approval of such reduction, and (f) you shall immediately add shares of Comm
ested by the Company in writing from time to time.

06

ou shall issue the Shares to the Holder or its broker in accordance with Paragraph 3 upon a conversion of all or any portion of the Note, version substantially in the form attached hereto as Exhibit A (the "Conversion Notice"), and (b) either (i) written confirmation from th ctive registration statement under the Securities Act of 1933, as amended (the "1933 Act"), or (ii) a legal opinion from either the Holder res to the Holder is exempt from registration under the 1933 Act or otherwise as to the free transferability of the Shares, dated within ni ever, that (assuming the Conversion shares are not registered for resale under the 1933 Act) unless such opinion of counsel indicates tha ("Rule 144") or any other available exemption under the 1933 Act, certificates may be issued or delivered without restrictive legend in ted States, then any certificates for such Conversion Shares shall bear the following restrictive legend:

ESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR THE SECUR LD OR OFFERED FOR SALE IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT FOR THE SECURITIES O BSTANCE AND SCOPE CUSTOMARY FOR OPINIONS OF COUNSEL IN COMPARABLE TRANSACTIONS OR OTHER EVID CH REGISTRATION IS NOT REQUIRED, OR UNLESS SOLD PURSUANT TO RULE 144 UNDER SAID ACT.

se note that a share issuance resolution is not required for each conversion since this Letter and the Loan Documents have been approve dance of doubt, this Letter is your authorization and instruction by the Company to issue the Shares pursuant to this Letter without any shall rely exclusively on the instructions in this Letter and shall have no liability for relying on any Conversion Notice provided by the l constitute an irrevocable instruction to you to process such notice or notices in accordance with the terms thereof, without any further smitted to you by fax, email, or any commercially reasonable method.

the case of a request for Shares pursuant to Paragraph 2 above, you shall, within three (3) Trading Days (as defined below) thereafter, t Company ("DTC") Fast Automated Securities Transfer Program, and the Common Stock is eligible to be transferred electronically w em ("DWAC Eligible"), credit such aggregate number of DWAC Eligible shares of the Common Stock to the Holder's or its designee's ank or broker (by providing its name and DTC participant number) and causes its bank or broker to initiate such DWAC Eligible transa ible, issue and deliver to the Holder or its broker (as specified in the applicable Conversion Notice), via reputable overnight courier, to t ficate, registered in the name of the Holder or its designee, representing such aggregate number of shares of Common Stock as have be version Notice. For purposes hereof, "Trading Day" shall mean any day on which the New York Stock Exchange is open for customar pany and the Holder understand that you shall not be required to perform any issuance or transfer of Shares if (y) such an issuance or t rities laws or regulations, or (z) the issuance or transfer of Shares is prohibited or stopped as required or directed by a court order.

ou understand that a delay in the delivery of Shares hereunder could result in economic loss to the Holder and that time is of the essenc

07

o the extent the applicable Shares being issued or reissued will be certificated, the certificates representing the Shares to be issued or rei
e of the Holder, (b) not bear any legend restricting transfer, (c) not be subject to any stop-transfer restrictions, and (d) shall otherwise be
npany, if:

the Conversion Notice is accompanied by the opinion of counsel described in Paragraph 2 opining that, pursuant to Rule 144 or any oth
ficates may be issued or delivered without restrictive legend in accordance with the applicable securities laws of the United States;

the Conversion Notice is accompanied by a shareholder representation letter providing that (a) the date on which the Conversion Notice
ths following the date the Note was issued or (ii) more than six (6) months (but not more than twelve (12) months) following the date th
liate", as defined in Rule 144 (a)(i) under the 1933 Act, of the Company; and

only to the extent Paragraph 5.2(a)(ii) immediately above is applicable, the Company is subject to the reporting requirements of Section
mended, and is current in its reporting obligations thereunder.

he Company hereby confirms to you and to the Holder that no instruction other than as contemplated herein (including instructions to in
uant to Paragraph 1(f) above) will be given to you by the Company with respect to the matters referenced herein. The Company hereby
egard any contrary instruction received by or on behalf of the Company or any other person purporting to represent the Company.

he Company hereby agrees to notify the Holder in the event of any replacement of Interwest Transfer Company, Inc. as the Company's

he Company acknowledges that the Holder is relying on the representations and covenants made by the Company in this Letter and that
er constitute a material inducement to the Holder to make the loan evidenced by the Note. The Company further acknowledges that wit
npany, the Holder would not have made the loan to the Company evidenced by the Note.

08

he Company shall indemnify you and your officers, directors, principals, partners, agents and representatives, and hold each of them ha age, claim or expense (including the reasonable fees and disbursements of its attorneys) incurred by or asserted against you or any of th orth herein, the performance of your duties hereunder and otherwise in respect hereof, including the costs and expenses of defending yo under, except that the Company shall not be liable hereunder as to matters in respect of which it is determined that you have acted with

The Holder is an intended third-party beneficiary of this Letter. The parties hereto specifically acknowledge and agree that in the event provision hereof, the Holder will be irreparably damaged, and that damages at law would be an inadequate remedy if this Letter were n ch or threatened breach of this Letter, the Holder shall be entitled, in addition to all other rights or remedies, to an injunction restraining al damage or to post any bond or other security, and/or to a decree for a specific performance of the provisions of this Letter.

This Letter shall be fully binding and enforceable against the Company even if it is not signed by the Company's transfer agent. If the C Letter, then such action or inaction will constitute a default under the Loan Documents. Although no additional direction is required by mediately confirm this Letter and the instructions contemplated herein to the Company's transfer agent will constitute a default under the

By signing below, each individual executing this Letter on behalf of an entity represents and warrants that he or she has authority to so e such entity to the terms and conditions hereof.

[SIGNATURE PAGE FOLLOWS]

09

Very truly yours,

Seven Arts Entert

By:_____
Name:_____
Title:_____

KNOWLEDGED AND AGREED:

E HOLDER:

aquint, Inc.

_____
n M. Fife, President

E TRANSFER AGENT:

rwest Transfer Company, Inc.

_____
ne:_____
e:_____

chments:

ibit A – Form of Conversion Notice

nature page to Irrevocable Letter of Instructions to Transfer Agent]

10

HIBIT A

FORM OF CONVERSION NOTICE

[attached]

11

IRREVOCABLE LETTER OF INSTRUCTIONS TO TRANSFER AGENT

e: _____ __, 2012

he transfer agent of SEVEN ARTS ENTERTAINMENT INC.

Instruction to Reserve and Transfer Shares

es and Gentlemen:

erence is made to that certain Convertible Promissory Note #2 dated as of _____ __, 2012 (the "Note"), made by SEVEN ARTS ENTE
mpany"), pursuant to which the Company agreed to pay to TONAQUINT, INC., a Utah corporation, its successors and/or assigns (the "
, and collection costs. The Note was issued pursuant to that certain Securities Purchase Agreement dated August 22, 2012, by and betw
ther with the Note and all other documents entered into in conjunction therewith, including any amendments or waivers, the "Loan Doc
be converted into shares of the common stock, par value $0.01 per share, of the Company (the "Common Stock") (the shares of Comm
er the Note, the "Shares").

suant to the terms of the Agreement, until all of the Company's obligations under the Agreement and the Note are paid and performed in
sfer agent to establish a reserve of shares of authorized but unissued Common Stock equal to the amount calculated as follows (such cal
erve"): two times the higher of (1) the Outstanding Balance (as defined in and determined pursuant to the Note) divided by the Conversi
e), and (2) the Outstanding Balance divided by the Market Price (as defined in and determined pursuant to the Note).

irrevocable letter of instructions (this "Letter") shall serve as the authorization and direction of the Company to Interwest Transfer Co
t (hereinafter, "you" or "your"), to reserve shares of Common Stock and to issue (or where relevant, to reissue in the name of Holder) s
version of the Note, as follows:

rom and after the date hereof and until all of the Company's obligations under the Agreement and the Note are paid and performed in fu
orized but unissued Common Stock intended to cover the Share Reserve in an amount not less than _____ shares (the "Transfer
nsfer Agent Reserve for the exclusive benefit of the Holder, (c) you shall issue the shares of Common Stock held in the Transfer Agent
mediately following clause (d)), (d) when you issue shares of Common Stock to the Holder or its broker under the Note pursuant to the o
shares from the Transfer Agent Reserve, unless the Holder delivers to you written pre-approval of such issuance, (e) you shall not redu
umstances, unless the Holder delivers to you written pre-approval of such reduction, and (f) you shall immediately add shares of Comm
ested by the Company in writing from time to time.

12

ou shall issue the Shares to the Holder or its broker in accordance with Paragraph 3 upon a conversion of all or any portion of the Note, version substantially in the form attached hereto as Exhibit A (the "Conversion Notice"), and (b) either (i) written confirmation from th ctive registration statement under the Securities Act of 1933, as amended (the "1933 Act"), or (ii) a legal opinion from either the Holder res to the Holder is exempt from registration under the 1933 Act or otherwise as to the free transferability of the Shares, dated within ni ever, that (assuming the Conversion shares are not registered for resale under the 1933 Act) unless such opinion of counsel indicates tha ("Rule 144") or any other available exemption under the 1933 Act, certificates may be issued or delivered without restrictive legend in ted States, then any certificates for such Conversion Shares shall bear the following restrictive legend:

ESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR THE SECUR LD OR OFFERED FOR SALE IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT FOR THE SECURITIES O BSTANCE AND SCOPE CUSTOMARY FOR OPINIONS OF COUNSEL IN COMPARABLE TRANSACTIONS OR OTHER EVID CH REGISTRATION IS NOT REQUIRED, OR UNLESS SOLD PURSUANT TO RULE 144 UNDER SAID ACT.

se note that a share issuance resolution is not required for each conversion since this Letter and the Loan Documents have been approve dance of doubt, this Letter is your authorization and instruction by the Company to issue the Shares pursuant to this Letter without any shall rely exclusively on the instructions in this Letter and shall have no liability for relying on any Conversion Notice provided by the l constitute an irrevocable instruction to you to process such notice or notices in accordance with the terms thereof, without any further smitted to you by fax, email, or any commercially reasonable method.

the case of a request for Shares pursuant to Paragraph 2 above, you shall, within three (3) Trading Days (as defined below) thereafter, st Company ("DTC") Fast Automated Securities Transfer Program, and the Common Stock is eligible to be transferred electronically w em ("DWAC Eligible"), credit such aggregate number of DWAC Eligible shares of the Common Stock to the Holder's or its designee's ank or broker (by providing its name and DTC participant number) and causes its bank or broker to initiate such DWAC Eligible transa ible, issue and deliver to the Holder or its broker (as specified in the applicable Conversion Notice), via reputable overnight courier, to t ficate, registered in the name of the Holder or its designee, representing such aggregate number of shares of Common Stock as have be version Notice. For purposes hereof, "Trading Day" shall mean any day on which the New York Stock Exchange is open for customar pany and the Holder understand that you shall not be required to perform any issuance or transfer of Shares if (y) such an issuance or t rities laws or regulations, or (z) the issuance or transfer of Shares is prohibited or stopped as required or directed by a court order.

13

ou understand that a delay in the delivery of Shares hereunder could result in economic loss to the Holder and that time is of the essenc

o the extent the applicable Shares being issued or reissued will be certificated, the certificates representing the Shares to be issued or rei
e of the Holder, (b) not bear any legend restricting transfer, (c) not be subject to any stop-transfer restrictions, and (d) shall otherwise be
npany, if:

the Conversion Notice is accompanied by the opinion of counsel described in Paragraph 2 opining that, pursuant to Rule 144 or any oth
ificates may be issued or delivered without restrictive legend in accordance with the applicable securities laws of the United States;

the Conversion Notice is accompanied by a shareholder representation letter providing that (a) the date on which the Conversion Notice
ths following the date the Note was issued or (ii) more than six (6) months (but not more than twelve (12) months) following the date th
liate", as defined in Rule 144 (a)(i) under the 1933 Act, of the Company; and

only to the extent Paragraph 5.2(a)(ii) immediately above is applicable, the Company is subject to the reporting requirements of Section
mended, and is current in its reporting obligations thereunder.

he Company hereby confirms to you and to the Holder that no instruction other than as contemplated herein (including instructions to in
uant to Paragraph 1(f) above) will be given to you by the Company with respect to the matters referenced herein. The Company hereby
egard any contrary instruction received by or on behalf of the Company or any other person purporting to represent the Company.

he Company hereby agrees to notify the Holder in the event of any replacement of Interwest Transfer Company, Inc. as the Company's

he Company acknowledges that the Holder is relying on the representations and covenants made by the Company in this Letter and that
er constitute a material inducement to the Holder to make the loan evidenced by the Note. The Company further acknowledges that wit
npany, the Holder would not have made the loan to the Company evidenced by the Note.

14

he Company shall indemnify you and your officers, directors, principals, partners, agents and representatives, and hold each of them ha age, claim or expense (including the reasonable fees and disbursements of its attorneys) incurred by or asserted against you or any of th orth herein, the performance of your duties hereunder and otherwise in respect hereof, including the costs and expenses of defending yo under, except that the Company shall not be liable hereunder as to matters in respect of which it is determined that you have acted with

The Holder is an intended third-party beneficiary of this Letter. The parties hereto specifically acknowledge and agree that in the event provision hereof, the Holder will be irreparably damaged, and that damages at law would be an inadequate remedy if this Letter were n ch or threatened breach of this Letter, the Holder shall be entitled, in addition to all other rights or remedies, to an injunction restraining al damage or to post any bond or other security, and/or to a decree for a specific performance of the provisions of this Letter.

This Letter shall be fully binding and enforceable against the Company even if it is not signed by the Company's transfer agent. If the C Letter, then such action or inaction will constitute a default under the Loan Documents. Although no additional direction is required by mediately confirm this Letter and the instructions contemplated herein to the Company's transfer agent will constitute a default under the

By signing below, each individual executing this Letter on behalf of an entity represents and warrants that he or she has authority to so e such entity to the terms and conditions hereof.

[SIGNATURE PAGE FOLLOWS]

15

Very truly yours,

Seven Arts Entertainment Inc.

By:_____
Name:_____
Title:_____

KNOWLEDGED AND AGREED:

E HOLDER:

aquint, Inc.

_____
n M. Fife, President

E TRANSFER AGENT:

rwest Transfer Company, Inc.

_____
ne:_____
e:_____

chments:

ibit A – Form of Conversion Notice

nature page to Irrevocable Letter of Instructions to Transfer Agent]

16

HIBIT A

FORM OF CONVERSION NOTICE

[attached]

SEVEN ARTS ENTERTAINMENT INC.
SECRETARY'S CERTIFICATE

_____, hereby certify that I am the duly elected, qualified and acting Secretary of SEVEN ARTS ENTERTAINMENT
orized to execute this Secretary's Certificate (this "Certificate") on behalf of the Company. This Certificate is delivered in connection
ust 22, 2012 (the "Purchase Agreement"), by and between the Company and Tonaquint, Inc., a Utah corporation. All capitalized terms
nings set forth in the Purchase Agreement.

ly in my capacity as Secretary, I certify that Schedule 1 attached hereto is a true, accurate and complete copy of all of the resolutions ad
solutions") approving and authorizing the execution, delivery and performance of the Purchase Agreement and related documents to wh
sactions contemplated thereby. Such Resolutions have not been amended, rescinded or modified since their adoption and remain in effe

WITNESS WHEREOF, I have executed this Secretary's Certificate as of August 22, 2012.

Seven Arts Entertainment Inc.

Printed Name:
Title: Secretary

18

Schedule 1

BOARD RESOLUTIONS

[attached]

19

VEN ARTS ENTERTAINMENT INC.

RESOLUTIONS ADOPTED BY THE BOARD OF DIRECTORS

Effective August 22, 2012

APPROVAL OF SECURITIES PURCHASE AGREEMENT

EREAS, the Board of Directors (the "Board") of Seven Arts Entertainment Inc., a Nevada corporation (the "Company"), has determine
ncing in the amount of $500,000.00 through the issuance and sale to Tonaquint, Inc., a Utah corporation (the "Investor"), of two conver

EREAS, the terms of the Financing are reflected in a Securities Purchase Agreement substantially in the form attached hereto as Exhibi
missory Note issued by the Company in the original principal amount of $310,000.00 substantially in the form attached hereto as Exhib
ed by the Company in the original principal amount of $250,000 substantially in the form attached hereto as Exhibit C ("Company Note
stantially in the form attached hereto as Exhibits D and E, a share issuance resolution substantially in the form attached hereto as Exhibi
documents being or to be executed and delivered under or in connection with the Financing (collectively, the "Financing Documents");

EREAS, the Board, having received and reviewed the Financing Documents, believes that it is in the best interests of the Company and
ncing Documents and authorize the officers of the Company to execute such documents.

W THEREFORE BE IT:

OLVED: that the Financing is hereby approved and determined to be in the best interests of the Company and its stockholders;

OLVED: that the form, terms and provisions of the Financing Documents are hereby ratified, confirmed and approved (including all ex

OLVED: that upon the issuance and delivery thereof in accordance with the Purchase Agreement, Company Note 1 and Company Note

OLVED: that the Company shall take all action reasonably necessary to at all times have authorized, and reserved for the purpose of iss
he Company's Common Stock required under the Purchase Agreement and the Company Note (the "Reserved Shares");

OLVED: that upon the issuance and delivery thereof in accordance with the Purchase Agreement and Company Note 1, Company Note
ective Company Note) shall be duly and validly issued;

20

SOLVED, that each of the officers of the Company be, and each of them hereby is, authorized to execute and deliver in the name of uments and any other related agreements (with such additions to, modifications to, or deletions from such documents as the officer ap execution and delivery), to conform the Company's minute books and other records to the matters set forth in these resolutions, and t hem deem necessary, required, or advisable with respect to the matters set forth in these resolutions;

SOLVED, that the Board hereby determines that all acts and deeds previously performed by the Board and other officers of the Compan e resolutions are ratified, confirmed and approved in all respects as the authorized acts and deeds of the Company; and

SOLVED, that all prior actions or resolutions of the directors that are inconsistent with the foregoing are hereby amended, corrected and with.

****

HIBITS ATTACHED TO BOARD RESOLUTIONS:

ibit A	PURCHASE AGREEMENT
ibit B	COMPANY NOTE 1
ibit C	COMPANY NOTE 2
ibit D	TRANSFER AGENT LETTER 1
ibit E	TRANSFER AGENT LETTER 2
ibit F	SHARE ISSUANCE RESOLUTION

[Remainder of page intentionally left blank]

Share Issuance Resolution
Authorizing The Issuance Of New Shares Of Common Stock In

Seven Arts Entertainment Inc.

Effective August 22, 2012

undersigned, as a qualified officer of Seven Arts Entertainment Inc., a Nevada corporation (the "Company"), hereby certifies that this S
the resolution of the Company's board of directors regarding that certain Convertible Promissory Note 1 in the face amount of $310,00
"Note"), made by the Company in favor of Tonaquint, Inc., its successor and/or assigns ("Tonaquint"), pursuant to that certain Securiti
mpany and Tonaquint (the "Agreement").

OLVED, that Interwest Transfer Company, Inc., as the Company's common stock transfer agent ("Transfer Agent"), is authorized to re
ibit A attached hereto (the "Conversion Notice") without any further inquiry, to be delivered to the Transfer Agent from time to time by

OLVED FURTHER, that Transfer Agent is authorized to issue the number of "Conversion Shares" set forth in each Conversion Notice
es to be issued in the name of Tonaquint, or its successors, transferees, or designees, with such shares to be issued free of any restricted

OLVED FURTHER, that the Transfer Agent is authorized and directed to immediately create a share reserve equal to 40,000,000 share
aquint (the "Share Reserve"); provided that the Share Reserve may be increased from time to time by a written certification provided to
eement.

OLVED FURTHER, that Tonaquint must consent in writing to any reduction in the Share Reserve; provided, however, that upon full c
erve will terminate.

OLVED FURTHER, that the Company shall indemnify the Transfer Agent and its employees against any and all actions taken by Tran
olution.

undersigned officer of the Company hereby certifies that this is a true copy of the Company's Share Issuance Resolution, effective as o
been in any way rescinded, annulled, or revoked but the same is still in full force, and effect.

cer's Signature Date

ted Name and Title

22

HIBIT A

CONVERSION NOTICE

[attached]

23

SEVEN ARTS ENTERTAINMENT INC.
8439 Sunset Boulevard 4th Floor
Los Angeles, California 90069

e: _____

aquint, Inc.
East Wacker Drive, Suite 1200
cago, Illinois 60601

VIA FAX: _____

erence is hereby made to a certain Securities Purchase Agreement (the "Purchase Agreement") dated August 22, 2012 between Se
mpany"), and Tonaquint, Inc., a Utah corporation ("Purchaser"). Pursuant to Section 5.2(q) of the Purchase Agreement, the Company
th ending _____, 201_ (the "Applicable Month"):

_____ No Anti-Dilution Event (as defined in the Purchase Agreement) occurred duri

_____ The following Anti-Dilution Event(s) occurred during the A

A. Date of Anti-Dilution Event: _____
B. Purchaser(s): _____
C. Anti-Dilution Price: _____
D. Description of Anti-Dilution Event: _____
_____
_____
_____
_____
_____
_____

KNOWLEDGED AND CERTIFIED:

VEN ARTS ENTERTAINMENT INC.

_____
ne: _____
e: _____

24

en Arts Entertainment, Inc.

(Formerly Seven Arts Pictures, Plc)
Consolidated Balance Sheets
Aa of March 31, 2012 and June 30, 2011

	M (U
ASSETS	
RRENT ASSETS:	
n and cash equivalents	$
ounts receivable, net of allowance for doubtful accounts of $78,661 and $195,623	
from related parties, net	
er receivables and prepayments	
l current assets	
costs, less accumulated amortization of $3,830,952 and $2,843,734	
ic assets	
perty and equipment, net of accumulated depreciation of $111,232 and $106,671	
TAL ASSETS	$
LIABILITIES AND SHAREHOLDERS' EQUITY	
RRENT LIABILITIES:	
k overdraft	$
ounts payable	
rued liabilities	
es to be issued	
icipation and residuals	
er loans	
& production loans	
erred income	
vision for earnout	
l Current Liabilities	
TAL LIABILITIES	$
CKHOLDERS' EQUITY	
vertible redeemable Series A preferred shares, $10 par value, 125,125 issued and outstanding	$
vertible redeemable Series B preferred shares, $100 par value, 180,000 issued and outstanding	
es held in escrow	
mon stock; $0.01 par value; 250,000,000 shares authorized;	
68,972 and 2,643,131 issued and outstanding, respectively	
mon stock; £0.25 par value; 20,527,360 shares authorized;	
3,131 shares issued and outstanding	
erred stock; £0.45 par value; 13,184,000 shares authorized;	
13,184,000 shares issued and outstanding	
erred stock; £1.00 par value; 2,268,120	
es issued and outstanding	
itional paid in capital	

vertible debentures	
umulated deficit	
nprehensive income	
eholders' equity	
TAL LIABILITIES AND SHAREHOLDERS' EQUITY	$

accompanying notes are an integral part of these consolidated financial statements.

merly Seven Arts Pictures, Plc)
solidated Statements of Operations
the Three and Nine Months Ended March 31, 2012 and 2011

	3 Months Ended March 31, 2012	3 Month Ended March 31,
enue:		
revenue	$ 187,793	$ 272,703
related revenue - related party	-	-
l revenue	187,793	272,703
of revenue		
ortization and impairment of film costs	186,890	523,998
er cost of revenue	262,041	18,208
of revenue	448,931	542,206
ss profit	(261,138)	(269,503
rating expenses:		
eral and administrative expenses	500,897	591,285
debt expense	109,481	71,800
l operating expenses	610,378	663,085
me from operations	(871,516)	(932,588
-operating income(expense)		
er income	30,196	-
rest expenses	(744,469)	(40,448
rest income	-	2
l non-operating income (expense)	(714,273)	(40,446
me/(loss) before taxes	(1,585,789)	(973,034
nge in debt derivative	-	-
	(1,585,789)	(973,034
vision for income tax (benefit)	-	-
income (loss)	$ (1,585,789)	$ (973,034
nprehensive income (loss):		
income (loss)	(1,585,789)	(973,034
ign exchange translation gain (loss)	-	-
nprehensive income (loss)	(1,585,789)	(973,034
ghted average number of ordinary shares used in the profit (loss) per share calculation:		
c	30,421,315	1,717,451
ted	30,421,315	1,717,451
c profit/ (loss) per share	(0.05)	(0.57
ted profit/ (loss) per share	(0.05)	(0.57

accompanying notes are an integral part of these consolidated financial statements.

Seven Arts Entertainment, Inc.
(Formerly Seven Arts Pictures, Plc.)
Consolidated Statements of Cash Flows
Nine Months Ended March 31, 2012 and 2011
(Unaudited)

	Nine Mar
SH FLOWS FROM OPERATING ACTIVITIES:	
loss	$
ustments to reconcile net loss to net cash provided by (used in) operating activities:	
reciation	
ortization of film cost	
version of debt to equity	
k for services	
debt	
giveness of interest by lender	
eign currency impact of movement of consolidated entity to related party	
ance of share options	
nges in operating assets and liabilities:	
le receivables	
to and due from related parties, net	
italized film assets	
eivables and prepayments	
k overdraft	
ounts payable	
erred income	
k to be issued	
icipation and residuals	
rued liabilities	
cash provided /(used in) operating activities	
SH FLOWS FROM INVESTING ACTIVITIES:	
chase of property and equipment	
cash used in investing activities	
SH FLOWS FROM FINANCING ACTIVITES:	
version of convertible notes payable	
ance of common stock	
res of common stock issued in safisfaction of debt	
eeds from notes payable	
ments on notes payable `	
res held in escrow	
ance of Preferred Stock	
ance of stock for cash	
uisition of music assets	
uisition of Big Jake Music	
value of earnout	

res of common stock issued to PLC for assets	
k issued in share exchange	
ilities retained in PLC in share exchange	
cash provided by financing activities	
ct of exchange rate changes on cash	
T CHANGE IN CASH	
SH AT BEGINNING OF PERIOD	
SH AT END OF PERIOD	$
plemental cash flow information:	
n paid for interest	$
res of common stock issued to PLC for assets	
mmon and preferred stock to be issued	
k issued in share exchange	
ilities retained in PLC in share exchange	
ounts receivable applied against loan set-off	
k issued for services	
mmon stock issued in satisfaction of debt	
eign currency impact of movement of consolidated entity to related party	

en Arts Entertainment, Inc.

(Formerly Seven Arts Pictures, Plc.)
Notes to Consolidated Financial Statements
March 31, 2012
(Unaudited)

TE 1 – NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES

ure of Activities, History and Organization

en Arts Entertainment, Inc. (herein referred to as “the Company”, “Seven Arts” or “SAE,”), a Nevada Corporation, is the continuation o
en Arts Pictures Plc., (“PLC”) which was founded in 2002 as an independent motion picture production and distribution company engag
duction, and licensing of theatrical motion pictures for exhibition in domestic (i.e., the United States and Canada) and foreign theatrical
ns of media, including home video and pay and free television. The Company currently owns interests in 33 completed motion pictures,
rests of other parties. As discussed herein, in early March 2012, the Company launched Seven Arts Music (“SAM”) and acquired 52 co
ms.

June 11, 2010, Seven Arts Entertainment, Inc. (“SAE”), a Nevada Corporation, was formed and became a wholly owned subsidiary of S
mpany entered into an Asset Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer all of the a
assumption by SAE of certain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have beer
es of SAE were issued to PLC in order to satisfy any remaining obligations. This transfer was approved by the PLC shareholders at an
pose of this transfer was to eliminate our status as a foreign private issuer and to assume compliance with all obligations of a domestic is
s. Our intention in executing this transaction was to redomicile our business with no change in the economic interests of our shareholder

August 31, 2011, NASDAQ approved the substitution of one share of SAE, Inc. stock for the Company's NASDAQ listing, effective at
, each of the Company's ordinary shares were exchanged for one share of common stock of SAE, and commenced trading on NASDAQ
s transaction was approved by the Company’s shareholders at the Company’s Extraordinary General Meeting on June 11, 2010.

E’s authorized capital consists of 250,000,000 shares of common stock, $.01 par value per share.. As of March 31, 2012, there were 41,9
ch are fully paid and non-assessable. (including the 2,000,000 shares issued to SAP Plc as part of the asset transfer agreement approved
ommon stock entitles the holder thereof to one vote per share on matters submitted to a vote of stockholders.

125 Series A preferred shares with a $10.00 par value per share, were issued to one shareholder in November 2011for a transaction co
version price to common stock of $0.15/share. Two further tranches of 11,500 and 10,859 shares of Series A preferred have been subs
n issued.

000 Series B preferred shares $100.00 par value per share have been issued to two shareholders and 120,000 of such shares are held in

E is now a United States issuer and commenced regular quarterly reporting from the first quarter ended September 30, 2011.

November 8, 2011, the Company's listing predecessor, PLC, was placed into involuntary creditors liquidation under English law (See N
btedness of PLC remained with PLC and will be subject to administration or payment in those administration proceedings. In accorda
ed 2,000,000 shares of common stock of SAE in order to satisfy these obligations.

March 2012, the Company acquired the music assets of David Michery and 100% of the stock of Big Jake Music, although the deals we
Company is now also an independent distributor and producer of sound recordings.

material assets that were acquired comprise 52 completed sound recordings including two completed albums with “DMX”, up to two a
ne Thugs-N-Harmony”. The commitments and liabilities assumed were a promissory note dated June 15, 2010 in the amount of $200,0
MX in amounts to be approved by us but not to exceed $140,000.

onnection with the acquisition of the music assets of David Michery, the Company issued 50,000 shares of our Series B convertible pre
roximately $1.10 per share subject to amendment and adjustment, as defined in the agreement, as of September 30, 2012) to David Mic
00 shares of our Series B convertible preferred stock to Mr. Michery and his assigns if two DMX albums and two Bone Thugs-N-Harm
re interest and taxes of $5,000,000 during the next five fiscal years. The second 50,000 shares are currently held in escrow. Mr. Micher
a wholly-owned subsidiary of the Company.

onnection with the acquisition of the stock of Big Jake Music, the Company issued 10,000 shares of our Series B convertible preferred s
0 per share subject to amendment and adjustment, as defined in the agreement, as of September 30, 2012) to Jake Shapiro and his assig
Series B convertible preferred stock to Mr. Shapiro and his assigns if certain specific terms are met 40,000 shares are subject to proving
es are subject to an earnout over a two year period. The 70,000 shares are currently held in escrow. Mr. Shapiro is the Chief Executive
idiary of the Company.

udited Interim Financial Statements:

accompanying unaudited interim consolidated financial statements of the Company have been prepared in accordance with accounting
erica and the rules of the Securities and Exchange Commission. These financial statements are unaudited and, in the opinion of manage
rring accruals) necessary to present fairly the balance sheet, statement of operations, statement of stockholders’ equity and statement of
unting principles generally accepted in the United States. Certain information and footnote disclosures normally included in financial s
ciples generally accepted in the United States have been condensed or omitted pursuant to SEC rules and regulations. It is presumed tha
ave access to the audited financial statements and. footnote disclosure for the preceding fiscal year contained in the Company’s Annual
e and nine months ended March 31, 2012 are not necessarily indicative of the results of operations for the full year or any other interim
ld be read in conjunction with Management's Discussion and Analysis and Financial Statements and notes thereto included in the Com
filed in December 2011. The Company’s predecessor, PLC, was considered a foreign filer as of its June 30, 2011 year-end, and therefo
1. The 2011 comparatives for the nine months to March 31, 2011 have been derived from the June 30, 2011 20-F filing which was pre
rterly reports.

ificant Accounting Policies:

Company's management selects accounting principles generally accepted in the United States of America and adopts methods for their
ires the estimating, matching and timing of revenue and expense. It is also necessary for management to determine, measure and alloca
ess according to those principles. The accounting policies used conform to generally accepted accounting principles which have been c
ements.

financial statements and notes are representations of the Company's management which is responsible for their integrity and objectivity
onsible for adopting sound accounting practices, establishing and maintaining a system of internal accounting control and preventing ar
unting control is designed to assure, among other items, that 1) recorded transactions are valid; 2) valid transactions are recorded; and 3
ly manner to produce financial statements which present fairly the financial condition, results of operations and cash flows of the Comp

s of Presentation

accompanying consolidated financial statements include the accounts of Seven Arts Entertainment, Inc. ("SAE"), and its wholly owned
AFE, Ltd."), Seven Arts Music, Inc. ("SAM") and Big Jake Music, Inc. ("BJM").

Company consolidates its subsidiaries in accordance with Accounting Standards Codification ("ASC") 810, "Business Combinations",
dition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one re
tanding voting shares of another entity is a condition pointing toward consolidation." The Company does not have any variable interest

Company prepares its financial statements on the accrual basis of accounting and in accordance with Generally Accepted Accounting P
ntercompany balances and transactions are eliminated. Management believes that all adjustments necessary for a fair presentation of th
2 and 2011, respectively, have been made.

of Estimates:

preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimate
disclosures. The most significant estimates made by management in the preparation of the financial statements relate to ultimate revenu
rtization and impairment of film costs, estimates for allowances and income taxes. Accordingly, actual results could differ from those e

ently Issued Accounting Pronouncements:

Company does not expect the adoption of recently issued accounting pronouncements to have a significant impact on the Company's re

enue Recognition:

M

Company recognizes revenue from the sale (minimum guarantee or non-refundable advances) or licensing arrangement (royalty agreen
venue Recognition". Revenue will be recognized only when all of the following criteria have been met:

Persuasive evidence of a sale or licensing arrangement with a customer exists.
The film is complete and, in accordance with the terms of the arrangement, has been delivered or is available for immediate ar
unconditional delivery. (i.e. the "notice of delivery" ("NOD") has been sent and there is a master negative available for the cu
The license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale.
The arrangement fee is fixed or determinable.
Collection of the arrangement fee is reasonably assured.

ritten agreement with clients (purchase order, letter, contract, etc.), indicating the film name, territory and period is required for the reco
ormance criteria in the contracts have been met. The customer generally confirms agreement by their signature on the contract.

imum guarantee revenue (i.e., non-refundable advances) is recognized as and when the film is available for delivery to the respective te
racts are recorded as deferred revenue until the film is available for delivery (as described above) at which point the deferred revenue is
nues relating to minimum guarantee on any motion picture or amortization expenses on that picture until United States theatrical releas
ment of minimum guarantee will be delayed for any material period of time to permit such a theatrical release.

alty revenue, which equates to an agreed share of gross receipts of films, is recognized as income as and when the Company is notified
rts. Revenue is recorded net any of sales or value added taxes charged to customers.

SIC

enue, which equates to an agreed share of gross receipts, is recognized as income as and when the Company is notified of the amounts b
rts.
enue is recorded

a) net of any sales or value added taxes charged to customers and
b) net of discounts agreed with customers and
c) net of returns provision agreed with the distributor and
d) grossed up for the distribution fee charged by the distribution agent.

enue from digital distribution will be reported by the various digital platforms such as iTunes in their periodic reports and posted as rec

related revenues

y countries make tax credits available to encourage film production in the territory. Seven Arts benefits from tax credits in:

- the UK and several other European territories for their European productions
- Canada for their Canadian productions
- Louisiana for their US productions
- Tax preferred financing deals

e majority of circumstances these tax credits are treated as a reduction in the capitalized costs of the film assets they are financing.

ign Currency Transactions and Comprehensive Income

Company's functional currency, as well as the Company's subsidiary, SAFE, Ltd. is the US Dollar. The functional currency of the Com
e transactions which are generated in the United Kingdom are denominated in GBP.

ts and liabilities generated in a currency other than the functional currency are translated at exchange rates as of the balance sheet date.
ffect for the periods presented. The cumulative translation adjustment is included in the accumulated other comprehensive gain (loss) w
saction gains and losses arising from exchange rate fluctuations on transactions denominated in a currency other than the functional cur
rations.

ere possible, the Company seeks to match GBP income with GBP expenditures. To date, the Company has not hedged any transactional
ew and where appropriate may enter into such transactions in future.

me Taxes:

Company has adopted ASC 740-10 "Income Taxes", which requires the use of the liability method in the computation of income tax ex

n and Cash Equivalents:

n and cash equivalents includes cash in banks with original maturities of three months or less and are stated at cost which approximates
ect to an insignificant risk of loss in value. The cash and cash equivalents of the Company consisted of cash balances held on deposit w
Dollars, Pounds Sterling and Euros.

ounts Receivable:

ounts Receivable are carried at their face amount, less an allowance for doubtful accounts. On a periodic basis, the Company evaluates
btful accounts based on a combination of specific customer circumstances and credit conditions, and on a history of write offs and colle
rest on trade receivables after the invoice becomes past due. A receivable is considered past due if payments have not been received wit
time when a customer receivable is deemed uncollectible. The Company's allowance for doubtful accounts was $78,661 and $195,623
stantially all of the trade receivables in the consolidated financial statements are pledged as security for borrowings by the Company.

perty & Equipment:

ipment is carried at the cost of acquisition or construction and depreciated over the estimated useful lives of the assets. Costs associated
ts associated with improvements which extend the life, increase the capacity or improve the efficiency of our property and equipment ar
related asset. Gains and losses on dispositions of equipment are reflected in operations. Depreciation and amortization are provided usin
s of the assets, which are 3 to 5 years.

er Receivables and Prepayments:

Company has entered into contracts for investor relations and consulting services to assist in future fundraising activities. A portion of
k that vested immediately and will be amortized over the period the services are to be provided.

Costs:

costs include the unamortized costs of completed films which have been produced by the Company or for which the Company has acq
uisitions of companies and films in progress and in development. For films produced by the Company, capitalized costs include all direc
production overhead.

ts of acquiring and producing films are amortized using the individual-film-forecast method, whereby these costs are amortized and part
portion that current year's revenue bears to management's estimate of ultimate revenue at the beginning of the current year expected to b
films. The majority of a film's costs (approximately 80% or more) are generally amortized within three years of the picture's initial relea

mate revenue includes estimates over a period not to exceed ten years following the date of initial release. Film costs are stated at the lo
vidual film costs are reviewed on a title-by-title basis, when an event or change in circumstances indicates that the fair value of a film is
is determined using management's future revenue and cost estimates and a discounted cash flow approach. Impairment is recorded in t
mated fair value of the film. Estimates of future revenue involve measurement uncertainty, and it is therefore possible that reductions in
ired as a consequence of changes in management's future revenue estimates.

s are included in the general "library" category when initial release dates are at least three years prior to the acquisition date.

s in progress include the accumulated costs of productions which have not yet been completed. Films in development include costs of a
enplays and costs to adapt such projects. Such costs are capitalized and, upon commencement of production, are transferred to productio
er of the date they are determined not to be recoverable or when abandoned.

ic Costs/Assets

initial material assets that were acquired comprise 52 completed sound recordings including two completed albums with “DMX”, up to
“Bone Thugs-N-Harmony”.

ic assets include the unamortized costs of completed albums, singles and videos which have been produced by the Company or for wh
ries acquired as part of acquisitions and albums in progress and in development. For albums produced by the Company, capitalized c
talized interest and production overhead.

s of acquiring and producing music assets will be amortized using the individual-album-forecast method, whereby these costs are amo
s to management’s estimate of ultimate revenue at the beginning of the current year expected to be recognized from the exploitation or

airment of Long Lived Assets:

Company evaluates, on a periodic basis, long-lived assets to be held and used for impairment in accordance with the reporting requirem
isposal of Long-Lived Assets”. The evaluation is based on certain impairment indicators, such as the nature of the assets, the future ec
itability measurements, as well as other external market conditions or factors that may be present. If these impairment indicators are pre
unt of the asset may not be recoverable, then an estimate of the discounted value of expected future operating cash flows is used to dete
ny impairment is measured as the difference between the carrying amount of the asset and its estimated fair value. The fair value is esti
imilar assets or discounted future operating cash flows.

ings Per Share:

c earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common shares outstanding
effects of any outstanding options, warrants and other potentially dilutive securities. For the periods presented, there were no potentially
ings per share equals diluted earnings per share. Basic and diluted earnings per share (“EPS”) are based on weighted-average common
ct. In accordance with ASC 260-10-45-19, the Company did not consider any potential common shares in the computation of diluted EP
inuing operations, as they would have an anti-dilutive effect on EPS.

e Based Payments:

Company accounts for share based payments using a fair value based method whereby compensation cost is measured at the grant date
gnized over the service period. The Company uses the Black-Scholes pricing model to calculate the fair value of options and warrants i
mptions used such as the expected life of the option, risk-free interest rate, dividend yield, volatility and forfeiture rate. The use of a dif
a material impact on the amount of calculated compensation expense.

)

ment Reporting:

Company now operates in two business segments as a motion picture producer and distributor and as a music label managing the asse
nesses should be reported as two business segments. (See Note 2 - Segment Reporting)

Value Measurements:

C Topic 820, “Fair Value Measurements and Disclosures”, defines fair value, establishes a framework for measuring fair value in genera
losures about fair value measurements. In general, fair value of financial instruments are based upon quoted market prices, where availa
e is based upon internally developed models that primarily use, as inputs, observable market based parameters. Valuation adjustments m
rded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Corporation’s credit worthiness
meters. Any such valuation adjustments are applied consistently over time.

ivative Instruments:

Company’s policy is not to use derivative or hedging financial instruments for trading or speculative purposes, except certain embedde
t provisions attached to the convertible debentures, as described in Note 9.

TE 2 - SEGMENT INFORMATION

ccordance with ASC 280 Segment Reporting, operating segments are identified as components of an enterprise about which separate dis
he chief operating decision maker, or decision-making group, in making decisions how to allocate resources and assess performance. Ou
ance, is a combination of the Chief Executive Officer and the Chief Financial Officer.

he quarter ended March 31, 2012, the Company formed a new subsidiary, Seven Arts Music, and acquired music assets from David Mic
new line of business for the Company, and therefore, will now have two reportable operating segments.

table below presents the financial information for the two reportable segments for the nine months ended March 31, 2012. Comparable
mpany only had one segment during that time.

	Nine Months Film	
enues	$	9
of revenues		(1,54
ss profit (loss)		(56
rating expenses		(1,37
s from operations	$	(1,9

of March 31, 2012, the Company had film and music assets of $24,111,370 and $9,540,859, respectively. As of December 31, 2011, a

TE 3 – FILM COSTS

costs as March 31, 2012 and June 30, 2011 are as follows:

	Mar 2012
Costs, beginning of period	$
itions to film costs during the period	
l film costs	
: Accumulated amortization	
l film costs, net of accumulated amortization	$

ortization of film costs was $987,221 and $689,618 for the nine months ended March 31, 2012 and 2011. The Company reviews cap
nges in circumstances indicate that the carrying amounts of such assets may not be recoverable or at least once per year. Determination
s resulting from the use of the asset, and its eventual disposition. Measurement of an impairment loss for the assets is based on the fair
model.

TE 4 – MUSIC ASSETS

ic assets at March 31, 2012 and June 30, 2011 are as follows:

	M 20
ic assets, beginning of period	$
itions to music assets during the period	
l film costs	
: Accumulated amortization	
l film costs, net of accumulated amortization	$

2

initial material assets that were acquired comprise 52 completed sound recordings including two completed albums with “DMX”, up to
n “Bone Thugs-N-Harmony”.

music assets were valued at the value of the preferred stock issued, the fair value of Mr. Michery’s earnout and capitalized costs incur

rently no earnout provision has been recorded for the acquisition of Big Jake Music, as the Company does not yet believe it has any basi

ortization of music assets was $0 and $0 for the nine months ended March 31, 2012 and 2011 as the assets were acquired in March 2012
airment whenever events or changes in circumstances indicate that the carrying amounts of such assets may not be recoverable or at leas
d on an estimate of future cash flows resulting from the use of the asset, and its eventual disposition. Measurement of an impairment lo
mated using a discounted cash flow model.

TE 5 – RELATED PARTY DUE TO/DUE FROM

en Arts Pictures, Inc. (“SAP, Inc.”) directly or through related various Louisiana limited liability companies, have from time-to-time ma
idiaries or have received advances back from the Company. The balances of these combined accounts due to the Company as of March
25,974, respectively. SAP, Inc. has pledged an interest in its shares of the Company’s stock to secure certain indebtedness for which SA
llo and Armadillo debts. The stock of SAP, Inc. was transferred to the listing predecessor of SAE on September 10, 2011.

TE 6 – INCOME TAXES

Company has adopted ASC 740-10, “Income Taxes”, which requires the use of the liability method in the computation of income tax e
erred tax liability) or benefit (deferred tax asset). Valuation allowances are established when necessary to reduce deferred tax assets to t

ng the nine months ended March 31, 2012 the Company had a net loss of $3,664,072 increasing the deferred tax asset approximately $
ts at March 31, 2012 consisted of the following:

erred tax asset related to:

	M 20
r Year	$
Benefit (Expense) for Current Period	
erred Tax Asset	$
: Valuation Allowance	
Deferred Tax Asset	$

3

net deferred tax asset generated by the loss carry forward has been fully reserved and will expire in 2019 through 2030. The realization
ings and therefore, is fully reserved at March 31, 2012.

TE 7 – EARNINGS PER SHARE

c and diluted earnings per share (“EPS”) are based on weighted-average common shares and generally exclude shares that would have
-10-45-19, the Company did not consider any potential common shares in the computation of diluted EPS as of March 31, 2012, due to
ld have an anti-dilutive effect on EPS.

TE 8 – COMMITMENTS AND CONTINGENCIES

ditors Liquidation of SAP Plc.
Company’s listing predecessor Seven Arts Pictures Plc. (‘PLC’) was placed by the English Companies Court into compulsory liquidati
fman, as a director of PLC had sought an administration order but this request was denied by the Courts as a result of inter alia the oppo
cipal creditors have appointed a liquidator for the orderly winding up of its remaining assets not transferred to us pursuant to the Asset

Hoffman expects that the liquidator and PLC will pursue its substantial claims against Parallel and its defenses to Parallel’s claims. Para
ted States that the Asset Transfer Agreement between the Company and PLC was ‘fraudulent’ and may seek additional compensation or
Asset Transfer Agreement is a valid agreement for value and not subject to attack and that Parallel will not prevail in its claims. Manage
e claims by Parallel which are disputed by the Company and as a result Parallel will not obtain any relief from the courts on this issue.

ed on discussions with the liquidator, our management believes this liquidation proceeding will have no material effect on the cost, busi

her Share Issue to SAE Inc
June 11, 2010, Seven Arts Entertainment, Inc. (“SAE”), a Nevada Corporation, was formed and became a 100% owned subsidiary of Se
red into an Asset Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer all of the assets with
mption by SAE of certain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have been dis
es of SAE were issued to PLC in order to satisfy any remaining obligations. There are several outstanding lawsuits which the liquidator
dation proceedings . Any proceeds from these legal matters will also be used to pay off outstanding obligations within the PLC. If there
in PLC. then SAE Inc. may well have to issue more stock to cover this shortfall .

4

Esplanade Guarantee

en Arts Pictures Louisiana LLC, a related party and/or an affiliate of the Company, entered into a Credit Agreement with Advantage Ca
ober 11, 2007, for the acquisition and improvement of a production and post production facility located at 807 Esplanade Avenue in Ne
cipal advances of up to $3,700,000. This agreement was guaranteed by the Company's predecessor. Approximately $3,700,000 plus
eement, as of March 31, 2012. The Company has also guaranteed this amount. A construction loan of $1,800,000 has also been guarant

adillo

re is a guarantee of a $1,000,000 note plus interest due to Armadillo by the Employee Benefit Trust of the Company's listing predecesso
es from Armadillo.

works Litigation

Company prevailed in a motion for summary adjudication on February 10, 2011 in an action against CanWest Entertainment and two o
ership of five motion pictures "Rules of Engagement", "An American Rhapsody," "Who Is Cletis Tout," "Onegin," and "The Believer"
nst Content Media Corporation ("Content") and Paramount Picture Corp. ("Paramount") to recover the Copyrights and substantial dam
orted acquisition from CanWest. The Company may incur up to $200,000 in legal expenses to pursue this claim but expects to recover

owhead Target Fund

en Arts Future Flow I ("SFF"), a limited liability Company owned by SAP Inc., a Company previously controlled by Mr. Hoffman, obt
rrowhead") of approximately $8,300,000 (the "Arrowhead Loan"). SFF secured the Arrowhead Loan with liens on 12 motion pictures t
e 30, 2009, $2,739,800 in the fiscal year ended March 31, 2008 and $544,478 in the three month period ended June 30, 2009. The Comp
n the proceeds of the film assets pledged against the Arrowhead Loan. The Company is not required to repay the Arrowhead Loan from
idiary, SAFE, Ltd. was the collateral agent of the film assets.

Arrowhead Loan became due in February 2009 and SFF has not paid the outstanding principle and interest due thereon. Arrowhead has
not done so at the present time. SFF has received a default notice to this effect and as a result Arrowhead is now collecting directly all s
ion pictures, and has appointed a new servicing agent for these motion pictures with the result that the Company no longer controls the
nance the Arrowhead Loan could result in a material disposition of assets through the loss of the Company's rights to the twelve motion
difficult to predict.

result of the foregoing, the Company has removed all assets accounts relating to the twelve motion pictures pledged to Arrowhead and
btedness from the Company's consolidated balance sheet at fiscal year ended June 30, 2009, due to the fact that the loan was a limited
gations to Arrowhead beyond the pledged film assets.

5

owhead filed an action on September 22, 2010, which seeks recovery from the Company of the monies which the Company has retained Arrowhead. In addition, Arrowhead makes substantial additional claims against the Company, Mr. Hoffman and SAP Inc. regarding cl ements, including failure to properly account, failure to turn over materials, failure to remit monies collected, and similar matters. The d ranties for damages are $8,300,000 although Arrowhead states no basis for this amount.

Company had moved to dismiss the action against all defendants other than Seven Arts Future Flows I LLC, which is not part of the Co rt granted the Company's motion and dismissed all defendants except Seven Arts Filmed Entertainment Limited in its capacity as a coll owhead claim.

owhead has purported to refile its claim against the Company and the other defendants. The Company will seek dismissal of these claim eve that Arrowhead's claims against the Company are without substantial merit.

owhead Capital Partners – AGC Loan

Company's predecessor and several affiliates were named as defendants in an action by Arrowhead Capital Partners Ltd filed in the Su portedly served on May 24, 2010, seeking to collect $1,000,000 plus interest (the "ACG Loan") due to Arrowhead Consulting Group LL art of the Cheyne Loan . The ACG Loan is fully subordinated to repayment of the Cheyne Loan, which has not been repaid, and a subsi ts under the subordination provision of the Cheyne Loan. As a result Management does not believe that ACG has the right to maintain t ateral pursuant to the Cheyne Loan. The Company intends to vigorously defend against this action and has filed for summary judgemen

stigation into Claim for Tax Credits (SAPLA)

US Attorney in New Orleans is investigating claims for Louisiana film infrastructure tax credits including such tax credits to be claime isiana LLC and has issued subpoenas for discovery of documents in the possession of the Company related to their tax credits. This inv ther certain expenses claimed by this affiliate were improper or fraudulent. All such claimed expenses were audited by independent aud e expenses or credits has been included in the Company's financial statements for any period. Management believes that this investigati npany's operations or the total tax credits to be received by the Company's affiliates, but could result in charges against current or forme uding Mr. Hoffman.

llel Action

June 28, 2011, Seven Arts Pictures Plc. ("PLC") filed an action in the High Court of England against Parallel Media LLC ("Parallel") to ribution rights in Russia to four motion pictures and to confirm Parallel's obligations under both a signed and unsigned investment agree en. On the same day Parallel filed a petition to wind up and liquidate PLC in the Companies Courts of England based on its claim of rep Winter Queen. PLC is no longer part of the Company.

September 19, 2011, Parallel filed a new action against PLC and SAE in the Superior Court of California, asserting the same claims as i posed administration proceedings in England. A request for a preliminary injunction was denied by the Superior Court.

6

RC Investigation

July 19, 2011 Officers of Her Majesty's Revenue & Customs ("HMRC") attended the offices of Seven Arts Pictures Plc. (the "Company ngements involving the subscription for shares in a number of companies which had lost value, resulting in subscribers making claims t

Company's participation in these transactions was limited to the Company's predecessor's transfer of rights to certain motion pictures t duction and release costs of those pictures and making available the provision of loans to fund a portion of those investments. The Comp ch were made on arms-length terms. The Company believes that it is not a subject of the HMRC investigation.

onnection with the transactions, the Company did not make any representations or warranties to any party, including the investors, regar sactions. Prior to the closing of the transactions the investors obtained and made available to the Company, an opinion of prominent Qu the transactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws. The Company remains eptable under the terms of the applicable United Kingdom revenue laws.

RC has requested interviews with three officers of the Company to discuss whether those officers were involved in the arrangements fo npany is fully cooperating with the investigation. The Company believes there is no basis for any claim of responsibility of any of its of Company, there is no need for it to record a contingent liability in its financial statements in connection with the investigation or the rela

nout for David Michery

Company's Asset Purchase Agreement with David Michery provided for 50,000 of the Company's $100 par, Convertible Redeemable EBIT (as defined in the agreement) from distribution of the DMX Albums and two albums embodying the performance of Bone Thugs- npany's independent auditor. At the end of five years, should the Net EBIT be less than $5,000,000, the shares will be released on a frac determined the fair value of the earnout as of the acquisition date to be $2,837,134 and has reflected it as a liability as of March 31, 201

TE 9 – CONVERTIBLE NOTES PAYABLE

sting Notes:

January 27, 2012, the Company converted $132,645 of the Runway debt and relevant interest into 1,211,219 shares of the Company's 000 of debt was converted to 333,333 shares and the final $50,000 was converted into 333,333 shares on February 15, 2012.

7

y Notes:

following table presents convertible notes payable entered into during this fiscal year. Each of these notes is convertible into shares of t
version rate.

vertibles	Principal		Fixe conv price
Rock	$	300,000	$
SM	$	150,000	$
over	$	62,660	$
over	$	150,000	$
over	$	445,000	$
od/CMS etc	$	100,000	$
od	$	50,000	$
od	$	150,000	$
hael Briskin	$	100,000	$
uvoir	$	50,000	$
uvoir	$	100,000	$
ufort	$	350,000	$
vett Capital	$	200,000	$
way	$	190,000	$
dero	$	250,000	$
	$	2,647,660	
nce of S144/3a9 Debt Conversions			
over/Magna –Blue Rider	$	900,000	$
gna – Palm	$	80,000	$
na/Olsen –Mark Betor	$	100,000	$
	$	1,080,000	
TAL	$	3,727,660	

Company has evaluated these convertible notes for embedded derivative features and has determined that no derivative liability exists.
ber of shares to be issued to satisfy approximately $3,727,660 of debt plus accrued interest is approximately 17,653,000 shares of the

3

TE 10 – LOANS PAYABLE

Company has the following indebtedness as of March 31, 2012:

der	Start Date	Due date	Amount Outstanding
and Production Loans			
n Finance			$ 3,588,435
n Finance			$ 1,101,986
db Film Finance LLC			$ 4,425
l Fusion Media Group LLC			$ 610,360
ged shares			$ (384,000
l Film and Production Loans			$ 4,921,206
algar Capital (in liquidation)	10/15/2008	08/31/2009	$ 531,987
- loan interest	03/31/2011	09/30/2011	$ 75,770
way - Loan - $190k	01/11/2012	09/30/2012	$ 194,997
dero - $250k	01/24/2012	09/30/2012	$ 255,507
c Organisation	01/20/2012	07/20/2012	$ 255,836
od Group - $150k loan	02/01/2012	02/01/2013	$ 152,811
over Holding Loans	11/16/2011	02/16/2012	$ 63,989
voir Capital Ltd	11/22/2011	03/31/2012	$ 106,411
Rock	12/12/2011	06/12/2012	$ 310,849
rwood Investment Inc-Eastside Holdings	10/25/2011	04/30/2012	$ 208,658
is - Tripod	12/15/2011	06/30/2012	$ 34,507
is – CMS	12/15/2011	06/30/2012	$ 34,506
is - Rachel	15/12/2011	06/30/2012	$ 34,506

uvoir Capital - $50k	04/14/2011	10/14/2011	$	54,822
over Holding Loan $150k	10/19/2011	05/18/2012	$	156,740
od Group - $50k loan	01/16/2012	06/30/2012	$	51,233
hael Briskin - Loan $100k	02/03/2012	02/03/2013	$	101,874
over Loan $445k	10/19/2011	10/19/2012	$	464,995
ufort Loan $350k	02/29/2012	08/26/2012	$	353,567
vett Capital Loan $200k	02/28/2012	09/30/2012	$	202,104
l Corporate Loans			$	3,645,669
TAL LOANS			$	8,566,875

Company converted $2,963,028 of the film and production loans into 5,989,349 shares of common stock during the three months ende
s for 3,490,385 shares of common stock in the 2nd quarter ended December 31, 2011 and $943,580 of film and production loans for 6,
ch 31, 2012.

9

TE 11 – EQUITY TRANSACTIONS

t quarter 2011/12

August 31, 2011, NASDAQ approved the substitution of one share of SAE, Inc. stock for the Company's NASDAQ listing, effective at , each of the Company's ordinary shares were exchanged for one share of common stock of SAE, and commenced trading on NASDAQ s transaction was approved by the Company’s shareholders at the Company’s Extraordinary General Meeting on June 11, 2010.

Company is authorized to issue 250,000,000 common shares at a par value of $0.01 per share. These shares have full voting rights. At 49,480 and 2,643,131 respectively, common shares outstanding. The Company’s predecessor, PLC, had a 1:5 reverse stock split on Ma orized shares to 250,000,000 from 50,000,000 at the Company’s shareholder meeting in February 2012.

ng the three months ending September 30, 2011, Company issued 6,496,349 shares in satisfaction of $3,188,028 of outstanding loans p vertible notes payable and $2,963,028 of film and production loans. The conversions were done at contractual share prices ranging from

uly 2011, the Company also issued 10,000 shares for investor relations services valued at approximately $10,000.

Company did not assume the deferred stock of the listing predecessor which was outstanding at June 30, 2011. Deferred stock is subord

f September 30, 2011, $1,986,722 of stock was fully paid but still to be issued, consisting of $1,251,250 of Series A preferred stock and ty. There were 11,149,480 shares were outstanding as of September 30, 2011.

ond Quarter 2011/12

ween October 1, 2011 and December 31, 2011 the Company issued 11,470,808 shares. The total number of shares outstanding on Dece

9,049	common shares were issued in satisfaction of the $612,336 of convertible debt shares at an average conversion price of
	common shares were issued on the conversion of the Agua Alta, Sendero and Isaac convertible notes totalling $427,706
1,374	conversion price of $0.15/ share.
0,385	common shares were issued in satisfaction of $906,000 of corporate loans at an average conversion price of $0.26/share
000	common shares were issued as restricted stock for cash, $250,000 to Fletcher and $150,000 to Goldstrand at $1.00/share
00	common restricted shares were issued for investor relations services at $0.36/share
00	common restricted shares were issued to a director in lieu of compensation at $0.50/share
70,808	

0

d Quarter 2011/12

ween January 1, 2012 and March 31, 2012, the Company issued 19,348,684 shares at an average price of $0.19 per share. The total nu
68,972. (See Subsequent Events Note 13 for stock issuances subsequent to March 31, 2011).

	common shares were issued in satisfaction of the $943,580 of newly converted film debt at an average conversion price
9,658	of $0.14/share .
6,589	common shares were issued in satisfaction of $929,596 of overhead at an average conversion price of $0.20/share
2,255	common shares were issued on the conversion of old notes including the final conversion of the Runway convertible n
	of $516,568 was converted at at an average
	conversion price of $0.15/ share.
	common shares were issued in satisfaction of $698,736 of film loans previously converted at an average conversion pri
4,962	$0.23/share.
0,000	common shares were issued as restricted stock for cash, to Blue Rider at $0.50/share
220	common restricted shares were issued for consultancy services provided under the S-8 authority at $0.28/share
48,684	

ng the nine months ended March 31, 2012, the Company issued 100,000 options to the seven members of the board of directors. These
e closing price of the Company's stock at the date of issue. Each director was issued 50,000 options with a strike price of $0.44 on Oc
9 on December 6, 2011. Half of the options vested on December 31, 2011 and the remaining half will vest on December 31, 2012.

ng the quarter ended March 31, 2012, the Company issued 2,000,000 options to David Michery in conjunction with his employment ag
e price of $0.18 and vest and shall be exercisable in equal monthly installments over the term of his employment agreement, which is F

ing the quarter ended March 31, 2012, the Company has agreed to issue 50,000 options per year to Jake Shapiro in conjunction with
ons have a strike price equal to the closing price of the Companys stock at the date of issue, with the exception of the first year, which t
sures compensation expense related to stock options with the Black Scholes option pricing model, and recognizes expense over the vest

anuary 2012, the Company filed a registration statement on Form S-8 in connection with the registration under the Securities Act of 1
mon stock under the Company's 2012 Stock Incentive Plan.

vertible Preferred Shares

125 shares of Series A Cumulative Convertible $10.00 Preferred Stock with a dividend rate of 8% (payable quarterly) were issued in N
k of the Company is $0.15/share.

additional $115,000 was invested for another 11,500 Series A preferred stock which has not yet been issued. This amount is included in
nce sheet as of March 31, 2011.

rther 10,859 Series A shares have been subscribed for but not yet issued, as of March 31, 2012. This amount is included in the shares

000 Series B convertible preferred shares, $100.00 par value have been issued to two shareholders although 120,000 of such shares are
ed to acquire music assets for the Company. These shares in escrow are shown on the balance sheet as a contra to equity.

earnout provision on David Michery's $5,000,000 or 50,000 Series B preferred shares has been calculated using the fair value of the $ per year. No earn-out provision has been applied to Big Jake Music assets as the Company does not yet believe it has any basis for this

TE 12 – RELATED PARTY TRANSACTIONS

Company's Chief Executive Officer, Peter Hoffman, controls several companies, including Seven Arts Pictures, Inc. ("SAP, Inc.") that sfers distribution rights or other assets related to the business and which control production of the motion pictures. The agreements with vide that all revenues related to the Company's business payable to Mr. Hoffman or any of these related party companies is due to the C ership. None of these affiliates are variable interest or special purpose entities.

suant to a related party agreement, SAP, Inc. holds ownership of limited liability corporations in the United States, with all distribution r tion, they have also provided other services for Seven Arts Pictures Plc. and SAFE, Ltd. And SAE, Inc. at no fee other than Mr. Hoffma eles office, all of which are reflected in the financial statements of SAFE, Ltd. These other services are any reasonable requests of the m ices, audits of distribution statements, collection of accounts receivable, supervision of production of motion pictures and similar day-to uary 1, 2012 no further such transactions are intended.

Company has made and received advances from and to SAP Inc.and various Louisiana limited liability companies referred to above, w bear interest. The balances of these combined accounts were $3,552,137 and $2,725,974 as of March 31, 2012 and June 30, 2011, respe

February 28, 2012 the Company took out a convertible loan of $200,000 from Rowett Capital Ltd. This was then loaned to 807 Esplana struction loan.

TE 13 – FAIR VALUE MEASUREMENTS

n, accounts receivable, accounts payable and other accrued expenses and other current assets and liabilities are carried at amounts which relatively short maturity of those instruments.

C 820, "Fair Value Measurements and Disclosures", establishes a framework for measuring fair value. That framework provides a fair v niques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical as est priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described as

Level 1 - Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that Company has the ability to access.

Level 2 - Inputs to the valuation methodology include:

quoted prices for similar assets or liabilities in activ
quoted prices for identical or similar assets or liabil
inputs other than quoted prices that are observable
inputs that are derived principally from or corrobor
means.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the a

Level 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

2

asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significa
l need to maximize the use of observable inputs and minimize the use of unobservable inputs.

preceding method described may produce a fair value calculation that may not be indicative of net realizable value or reflective of futu
eves its valuation method is appropriate and consistent with other market participants, the use of different methodologies or assumption
ruments could result in a different fair value measurement at the reporting date. As of March 31, 2012 and June 30, 2011, all of the Com
due to the short maturity the carrying amounts are considered to approximate fair value.

TE 14 – RECENT ACCOUNTING PRONOUNCEMENTS

May 2011, the FASB issued guidance intended to achieve common fair value measurements and related disclosures between U.S. GAAP
ndments primarily clarify existing fair value guidance and are not intended to change the application of existing fair value measurement
ances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has c
nning after December 15, 2011, and early application is prohibited. The Company adopted these amendments on January 1, 2012; and t

une 2011, the FASB issued Accounting Standards Update ("ASU") No. 2011-05, "Comprehensive Income — Presentation of Compreh
ent the components of other comprehensive income as part of the statement of stockholders' equity. It requires an entity to present the t
me, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two sep
FASB issued ASU 2011-12, "Comprehensive Income — Deferral of the Effective Date for Amendments to the Presentation of Reclassi
nprehensive Income in ASU 2011-05," to defer the effective date of the specific requirement to present items that are reclassified out of
gside their respective components of net income and other comprehensive income. All other provisions of this update, which are to be a
interim periods within those years, beginning after December 15, 2011. The Company adopted these amendments on January 1, 2012; a

December 2011, the FASB issued ASU No. 2011-11, "Balance Sheet — Disclosures about Offsetting Assets and Liabilities." ASU 2011
related arrangements of financial instruments and derivative instruments and will be applied retrospectively for all comparative periods
rting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The Company currently believes t
solidated financial statements.

TE 15 – SUBSEQUENT EVENTS

Company issued the following shares of common stock subsequent to March 31, 2012:

Stock Issances through May 10, 2012

	common shares were issued in satisfaction of $1,120,000 of film loans previously converted at an average conversion p
42,472	$0.09/share. (high of $.10 and low of $.06)
	common shares were issued in satisfaction of the $625,000 of newly converted debt at an average conversion price of $
8,890	(high of $.09 and low of $.06)
7,789	common shares were issued for consultancy services provided under the S-8 authority at $0.14/share (high of $.20 and l
2,051	common shares were issued in satisfaction of $100,000 of existing overhead liabilities at an average conversion price o
21,202	

l shares outstanding as of May 10, 2012 was 68,090,174. (including 2 million shares issued to SAP Plc.)

itionally, the Company had the following new convertible debt acquired, which will be converted to equity, subsequent to March 31, 20

$50,000 loan was issued on April 4, 2012 by Michael Briskin for conversion at $0.09
$60,000 loan was issued on April 17, 2012 by Michael Briskin for conversion at $0.09
$50,000 loan was issued on April 24 2012 by Michael Briskin for conversion at $0.06

ditors Liquidation of SAP Plc.

Company's listing predecessor Seven Arts Pictures Plc. ('PLC') was placed by the English Companies Court into compulsory liquidati
fman, as a director of PLC had sought an administration order but this request was denied by the Courts as a result of inter alia the oppo
cipal creditors have appointed a liquidator for the orderly winding up of its remaining assets not transferred to the Company pursuant to
1.

Hoffman expects that the liquidator and PLC will pursue its substantial claims against Parallel and its defenses to Parallel's claims. Para
ted States that the Asset Transfer Agreement between the Company and PLC was 'fraudulent' and may seek additional compensation or
Asset Transfer Agreement is a valid agreement for value and not subject to attack and that Parallel will not prevail in its claims. Manage
e claims by Parallel which are disputed by the Company and as a result Parallel will not obtain any relief from the courts on this issue.

ed on discussions with the liquidator, our management believes this liquidation proceeding will have no material effect on the cost, busi

ng of S-8

anuary 2012, the Company filed a registration statement on Form S-8 in connection with the registration under the Securities Act of 1
mon stock under the Company's 2012 Stock Incentive Plan.

4

VEN ARTS PICTURES PLC.

CONSOLIDATED BALANCE SHEETS
AS OF JUNE 30, 2011 AND 2010

	2011
ETS	
RRENT ASSETS:	
n and cash equivalents	$ 8,785
le receivables, net of allowance of $669,396 and $532,996	431,891
from related parties, net	2,725,974
er receivables and prepayments	1,620,895
l Current Assets	4,787,545
M COSTS, net of accumulated amortization of $8,497,211 and 53,477, respectively	23,133,560
OPERTY AND EQUIPMENT, net of accumulated depreciation of 910 and $90,968, respectively	24,540
TAL ASSETS	$ 27,945,645
BILITIES AND SHAREHOLDERS' EQUITY	
RRENT LIABILITIES:	
k overdraft	$ 987
ounts payable	2,569,275
rued liabilities	2,382,916
icipation and residuals	503,187
er loans	1,755,250
n and production loans	10,890,430
erred income	407,763
T payable	1,477,584
l current liabilities	19,987,392
TAL LIABILITIES	19,987,392
AREHOLDERS' EQUITY	
vertible redeemable preference shares, £1.00 par value, 6,000,000 shares authorized; no es issued and outstanding	
nary stock, £0.25 par value, 20,527,360 shares authorized; 3,131 and 1,495,460 shares issued and outstanding	1,121,208
erred stock, £0.45 par value, 13,184,000 shares authorized; 84,000 and 13,184,000 shares issued and outstanding	11,636,594
erred stock, £1.00 par value, 2,268,120 and 1,495,460 es issued and outstanding	3,876,745
itional paid in capital	11,118,198
vertible debentures	3,432,450
eivable from Employee Benefit Trust	(1,237,417)
umulated deficit	(19,952,188)
nslation reserve	(2,037,337)

reholders' equity		7,958,253
TAL LIABILITIES AND SHAREHOLDERS' EQUITY	$	27,945,645

The accompanying notes are an integral part of these consolidated financial statement

5

VEN ARTS PICTURES PLC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND
OTHER COMPREHENSIVE INCOME
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

enue	
n revenue	$ 2
related revenue - related party	5
l revenue	3
t of sales	
ortization and impairment of film costs	2
er cost of sales	(
t of sales	3
ss profit/(loss)	(
rating expenses	
eral and administrative expenses	1
debt expense	2
l operating expenses	2
me (loss) from operations	(
-operating income (expense)	
er income	4
rest expense	(
rest income	1
l non-operating income (expense)	3
it (loss) before taxes	1
nge in debt derivative	(
vision for income tax (benefit)	-
income (loss)	$ 1
nprehensive income (loss):	
income (loss)	1
eign exchange translation gain (loss)	(
nprehensive income (loss)	$ 1

ghted average number of ordinary shares used in the profit (loss) per share calculation:	
c	
ted	
c profit (loss) per share	$
ted profit (loss) per share	$

The accompanying notes are an integral part of these consolidated financial statement

6

VEN ARTS PICTURES PLC.

CONSOLIDATED STATEMENTS OF DEFICIENCY IN STOCKHOLDERS' EQUI
FOR THE YEARS ENDED MARCH 31, 2008, JUNE 30, 2008, JUNE 30, 2009, JUNE 30, 2010 an

	£1 Conv, Redeem Pref Shares		Non Red Conv Loans		Common Stock		Deferred Stock 2		Deferred Stock 1	
	Shares	GBP	Shares	USD	Shares	USD	Shares	USD	Shares	US
nce, June 2009	500,000	£1,539,800	1,750,000	$3,432,450	1,385,460	$599,684	1,385,460	$2,398,736	13,184,000	$1
s Bialek ons-Oct 27,					2,000	807	2,000	3,230		
ust payable AP Inc on ve @ par e					8,000	3,230	8,000	12,918		
eiveable n SAP Inc bove saction										
nslation Adj c 09										
Share ons M stin to loan ec 08 pd 0,000										
n loan 000 shres 5p Dec 09					20,000	7,481	20,000	29,924		
Share version - (£0.25 per e)	(500,000)	(748,100)			80,000	29,924	80,000	119,696		
/10 EBT - 00 @ 85 exc 793/£1 es to Eden										
10 EBT - 000 @ exc										

57/£1 es to Inc										
rest charged BT										
rest rsed to										
nsfer nce of eem to Sh n		(791,700)								
it & Loss - e 30, 2010										
nslation stment										
nce, June 2010	-	£-	1,750,000	$3,432,450	1,495,460	641,126	1,495,460	$2,564,504	$13,184,000	$11
er & algar es Dec 10					267,522	126,850	267,522	507,400		
shares										
nslation stment										
algar, Isaac ew Moon es Feb 1					355,138	142,497	355,138	569,988		
rection to erTrafalgar 0								(5,987)		
n Finance es Mar 1					150,000	60,210	150,000	240,840		
& Eden es May 1					275,011	110,385				
apiro es June 1					100,000	40,140				
shares										
loss										
nslation stment										
nce, June 2011	-	£-	1,750,000	$3,432,450	2,643,131	$1,121,208	2,268,120	$3,876,745	13,184,000	$11

The accompanying notes are an integral part of these consolidated financial statement

VEN ARTS PICTURES PLC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

SH FLOWS FROM OPERATING ACTIVITIES:	$
income/ (loss)	
ustments to reconcile net income (loss)	
et cash provided by (used in) operating activities:	
reciation of property and equipment	
ortization of film cost	2
airment of film cost	8
te off of previously capitalized film assets	-
giveness of debt	(
giveness of interest by lender	(
rease)/reduction of EBT interest receivable	(
te-off of other receivables and prepayments	-
nary shares issuance in exchange for I/R fees and to repay loans	2
debt expense and provision for doubtful accounts	2
te-off of previously accrued participations	-
nge in operating assets and liabilities	
le receivables	8
to and due from related parties, net	9
italized film assets	(
er receivables and prepayments	(
ounts payable	2
er current liabilities	3
erred income	(
cash provided by operating activities	4
SH FLOWS FROM INVESTING ACTIVITIES:	
chase of property and equipment	(
cash (used in) investing activities	(
SH FLOWS FROM FINANCING ACTIVITIES:	
ceeds from/(repayment of) participation equity/investment	
notes payable	(
ance of common stock for cash	-
cash (used in) financing activities	(
ct of exchange rate changes on cash and cash equivalents	(
T (DECREASE) IN CASH & CASH EQUIVALENTS	(
SH & CASH EQUIVALENTS, BEGINNING OF YEAR	2
SH & CASH EQUIVALENTS, END OF YEAR	$

PPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION	
n paid during the year or period for:	
rest	$
me taxes	$ -
N CASH INVESTING AND FINANCING TRANSACTIONS:	
ounts receivable applied against loan set off	$ -
duction loan settled by shares owned by EBT	$ -
assification of share premium to accrued liabilities	$ -
ated party advances settled by shares owned by EBT	$
rest of loan payable capitalized on film assets	$
rued interest included in loan payable amount	$
re based compensation expense	$

The accompanying notes are an integral part of these consolidated financial statement

8

VEN ARTS PICTURES, PLC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

TE 1 - NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES

ure of Activities, History and Organization

en Arts Pictures, Plc. (herein referred to as “PLC” or collectively as “the Group”, “the Company”, or “Seven Arts”), was founded in 20
pany engaged in the development, acquisition, financing, production, and licensing of theatrical motion pictures for exhibition in do
trical markets, and for subsequent worldwide release in other forms of media, including home video and pay and free television. T
ion pictures, subject in certain instances to the prior financial interests of other parties.

consolidated financial statements include the financial statements of Seven Arts Pictures Plc. (“PLC”), and its wholly owned subsid
”), Seven Arts Filmed Entertainment (UK) Limited, Cinematic Finance Limited and Cinematic Finance (Equicap) Ltd, herein referre
w for detail on consolidated entities.

June 11, 2010, Seven Arts Entertainment, Inc. (“SAE”), a Nevada Corporation, was formed and became a 100% owned subsidiary o
et Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer all of the assets with a cost basis fro
ain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have been distributed to shareholde
LC in order to satisfy any remaining obligations. This transfer was approved by the PLC shareholders at an Extraordinary General M
to eliminate our status as a foreign private issuer and to assume compliance with all obligations of a domestic issuer under all applic
cuting this transaction was to redomicile our business in the United States of America with no change in the economic interests of our sh

of January 27, 2011, net assets with a book value totaling approximately $7,200,000 plus convertible debentures with no redemption d
AE in accordance with the asset transfer agreement.

August 31, 2011, NASDAQ approved the substitution of one share of SAE stock for the Company's NASDAQ listing, effective at the o
of the Company's ordinary shares were exchanged for one share of common stock of SAE, and commenced trading on NASDAQ as
saction was approved by the Company’s shareholders at the Company’s Extraordinary General Meeting on June 11, 2010.

E’s authorized capital consists of 50,000,000 shares of stock, $.01 par value per share, of which the board of directors has approved 2
1, there were 6,476,344 shares of common stock outstanding, all of which are fully paid and non-assessable. Each outstanding share
share on matters submitted to a vote of stockholders.

E is now a United States issuer and commenced regular quarterly reporting for the first quarter ended September 30, 2011.

November 8, 2011, PLC, was placed into involuntary creditors liquidation under English law (See NOTE 16 – Commitments and Con
E and will be subject to administration or payment in those administration proceedings. In accordance with the asset transfer agreem
k of SAE in order to satisfy these obligations.

9

s of Consolidation

Company consolidates its subsidiaries in accordance with Accounting Standards Codification (“ASC”) 810, “Business Combinations”,
dition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule, ownership by one re
tanding voting shares of another entity is a condition pointing toward consolidation." The Company does not have any variable intere

consolidated financial statements include the financial statements of Seven Arts Pictures Plc (“PLC”), and its wholly owned subsid
”), Seven Arts Filmed Entertainment (UK) Limited, Cinematic Finance Limited and Cinematic Finance (Equicap) Ltd, herein referred to

accompanying consolidated financial statements include the accounts of Seven Arts Pictures Plc. (“SAP Plc.”) and its wholly owned su

en Arts Pictures Plc.
en Arts Filmed Entertainment Limited
en Arts Filmed Entertainment (UK) Limited
ematic Finance Limited
ematic Finance (Equicap) Ltd

Group acquired SAFCO’s in May 2009. SAFCO’s refers to 17 companies formed by investors in the Zeus transaction (as described in
er the applicable laws of the United Kingdom upon obtaining full control of the books, records and operation of the SAFCO’s. The Gr
ted to the SAFCO’s except the contingent liability for VAT on the Zeus transaction. The SAFCO’s results have not been and will not be

significant intercompany balances and transactions have been eliminated on consolidation.

ificant Accounting Policies

Company’s management selects accounting principles generally accepted in the United States of America and adopts methods for the
ires the estimating, matching and timing of revenue and expense. The accounting policies used conform to generally accepted accoun
preparation of these financial statements.

financial statements and notes are representations of the Company’s management which is responsible for their integrity and objectiv
onsible for adopting sound accounting practices, establishing and maintaining a system of internal accounting control and preve
rnal accounting control is designed to assure, among other items, that 1) recorded transactions are valid; 2) valid transactions a
per period in a timely manner to produce financial statements which present fairly the financial condition, results of
respective periods being presented.

0

s of Accounting

Company prepares its financial statements on the accrual basis of accounting and in accordance with Generally Accepted Accounting P material intercompany balances and transactions are eliminated. Management believes that all adjustments necessary for a fair pres 2010, respectively, have been made.

Group has also engaged in various transactions under which it has received cash proceeds from the transfer of tax credits or luctions. Any such proceeds are generally treated as a reduction in the production costs of the applicable motion picture.

To the extent such tax benefit proceeds would exceed the capitalized cost of the film or represent fee income not applied to product cost, such proceeds are accounted for as producers' fees income where relevant producers contracts are in place.

To the extent that the Group were to receive benefits from tax advantaged investments relating to:

a picture that has not commenced production by a particular date a no further obligations to the investor or

third party productions taken on by the Group as sales agent/distrib fees income.

enue Recognition

enue earned by the Group can be classified into two categories:

1. Film revenue: Revenue is earned from the exploitation of new productions, back catalogue and third party produc

Fee-related revenue: Producer's fees income earned by the Group on productions controlled by the Group is earned when the Group i um irrespective of the distribution revenue from that picture.

n Revenue

Group recognizes revenue from the sale (minimum guarantee or non-refundable advances) or licensing arrangement (Royalty agreem
ognition". Revenue will be recognized only when all of the following criteria have been met:

a) Persuasive evidence of a sale or licensing arrangement with a customer exists.
The film is complete and, in accordance with the terms of the arrangement, has been delivered or is available for immediate and uncon
been sent and there is a master negative available for the customer)
c) The license period of the arrangement has begun and the customer can begin its exploitation, exhib
d) The arrangement fee is fixed or determinable.
e) Collection of the arrangement fee is reasonably assured.

ritten agreement with clients (purchase order, letter, contract, etc.) indicating the film name, territory and period is required for the re
ormance criteria in the contracts have been met. The customer generally confirms agreement by their signature on the contract.

imum guarantee revenue (i.e. non-refundable advances) is recognized as and when the film is available for delivery to the respective te
tracts are recorded as deferred income until the film is available for delivery (as described above) at which point the deposit rever
nues relating to minimum guarantee on any motion picture as well as amortization expense on that picture until United States theatrica
ayment of minimum guarantee will be delayed for any material period of time to permit such a theatrical release.

alty revenue which equates to an agreed share of gross receipts of films is recognized as income as and when the Group is notified
rts.

related Revenues

y countries make tax credits available to encourage film production in their territory. Seven Arts benefits from tax credits in:

a) the UK and several other European territories for their European productions
b) Canada for their Canadian productions
c) Louisiana for their US productions
d) Tax preferred financing deals

2

he majority of circumstances, these tax credits are treated as a reduction in the capitalized costs of the film assets they are financing. Ho

a) exceed the capitalized cost of the film or

b) represent fee income not applied to production cost, such proceeds are accounted for as producers' fees income where rele

ddition, to the extent that the Group was to receive benefits from tax advantaged investments relating to:

) a picture that has not commenced production by the investment agreement closing date, that investment is forfeited such that the Gro

b) third party productions taken on by the Group as sales agent/distributor, then such benefits are also recorded

of the risks for the investor associated with these tax advantaged investments is that a particular picture will not start production with t value to their slate of investments. The contract with the Group will generally state that there is no recourse to the Group and associate ustry that the investors are made aware of on signing the investment agreements. Therefore, when a picture has not commenced pro stment is forfeited and the Group has no further obligations to the investors. These financing schemes are part of the general operatio ended June 30, 2011 however did not include fee income derived from a structured film and distribution cost financing with UK inves ciated with films produced in Louisiana. In 2010, the Group recognized $2,650,794 of fee income as described and, in addition, produ

stments

stments are held at the lower of cost or net realizable value, and reviewed annually for any impairment charges. As of June 30, 2011 the

Costs

costs include the unamortized costs of completed films which have been produced by the Group or for which the Group has acq uisitions of companies and films in progress and in development. For films produced by the Group, capitalized costs include all direct duction overhead.

ts of acquiring and producing films are amortized using the individual-film-forecast method, whereby these costs are amortized an portion that current year's revenue bears to management's estimate of ultimate revenue at the beginning of the current year expected to films. Generally, 80% or more of a film's costs are amortized within three years of the picture's initial release.

mate revenue includes estimates of revenue to be earned over a period not to exceed ten years following the date of initial release. mated fair value. Individual film costs are reviewed on a title-by-title basis, when an event or change in circumstances indicates that t fair value of the film is determined using management's future revenue and cost estimates and a discounted cash flow approach mortized costs exceed the estimated fair value of the film. Estimates of future revenue involve measurement uncertainty and it is therefo s may be required as a consequence of changes in management's future revenue estimates.

ns are included in the general “library” category when initial release dates are at least three years prior to the acquisition date.

ns in progress include the accumulated costs of productions which have not yet been completed. Films in development include costs o
enplays and costs to adapt such projects. Such costs are capitalized and, upon commencement of production, are transferred to product
er of the date they are determined not to be recoverable or when abandoned.

perty & Equipment

ipment is carried at the cost of acquisition or construction and depreciated over the estimated useful lives of the assets. Costs associated
ts associated with improvements which extend the life, increase the capacity or improve the efficiency of our property and equipment ar
related asset. Gains and losses on dispositions of equipment are reflected in operations. Depreciation and amortization are provided u
s of the assets, which are two to five years.

me Taxes

Company has adopted ASC 740-10 “Income Taxes”, which requires the use of the liability method in the computation of income tax ex

Group is not part of any consolidated return filed in the United States.

eign Currency Transactions and Comprehensive Income

accounts are presented in United States Dollars (“USD”), the functional currency of the main operating company, SAFE Ltd. The fu
r entities located in the UK is in Pounds Sterling (“GBP”). The books of the foreign entities are converted to USD at each reporting per

Group translates the foreign currency transactions and balances into USD using the year or reporting period end or average exchang
slated at exchange rates as of the balance sheet date. Revenues and expenses are translated at average rates in effect for the period
uded in the translation reserve within shareholders’ equity (deficit). Foreign currency transaction gains and losses arising from exch
ency other than the functional currency are included in the consolidated results of operations.

ere possible, the Group seeks to match USD income with USD expenditures. To date the Group has not hedged any transactional c
ew and where appropriate may enter into such transactions in future.

4

evant exchange rates used in the preparation of the financial statements are as follows for the years ended June 30, 2011 and 2010 (GBP

	June 30, 2011
nce sheet period end exchange rate:	GBP
rage exchange rate for the year ended:	GBP
nce sheet period end exchange rate:	GBP
rage exchange rate for the year ended:	GBP

vative Instruments and Hedging Activities

Group's policy is not to use derivative or hedging financial instruments for trading or speculative purposes, except certain embedded t provision attached to the convertible debentures as described in NOTE 12.

ings Per Share

c earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common shares outstan ude the effects of any outstanding options, warrants and other potentially dilutive securities. For the periods presented, there were no po ings per share equals diluted earnings per share. Basic and diluted earnings per share ("EPS") are based on weighted-average -dilutive effect. In accordance with ASC 260-10-45-19, the Company did not consider any potential common shares in the computati oss from continuing operations, as they would have an anti-dilutive effect on EPS.

of Estimates

preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimat disclosures. The most significant estimates made by management in the preparation of the financial statements relate to ultimat rtization and impairment of film costs, estimates for allowances, option pricing for options and warrants issued and income taxes mates.

ently Issued Accounting Pronouncements

Company does not expect the adoption of recently issued accounting pronouncements to have a significant impact on the Company's re

5

ounts Receivable

eivables are recognized at the initial amount of the invoice. As a result of the nature of the Group's activities, accounts receivabl ivable whose recovery date was is beyond one year would be measured at its present value. The Group does not charge interest on late

erve for doubtful accounts represent a provision charged to reflect management's best estimate of the likelihood that certain of th ected. This provision is based on historical experience and relevant facts and information regarding collectability at the time and wi al results.

receivable outstanding is only written off after management has deemed the receivable to be uncollectible, under the terms of the ag omers at each reporting period. As of June 30, 2011 and 2010 the Group had an allowance for bad debts and doubtful accounts of $3 ollectible receivables. The Group determines its allowance by considering a number of factors, including the length of time receival omer's current ability to pay its obligation to the Group, and the condition of the general economy and the industry as a whole.

stantially all of the trade receivables at face value as reflected in the consolidated financial statements are pledged as security for borrow

ounts Payable

operating trade payables (including notes payable and accrued supplier invoices) relate to the purchase of goods and services. The vever any payable whose due date was more than one year would be measured at its present value. The Group did not have any such lon

Value of Financial Instruments

carrying amount of cash, trade accounts receivable, other accounts receivable, receivables due from and payable to related parties, trad enses, as well as short-term debt, approximate their corresponding estimated fair values due to the short-term maturity and revolving n equivalents are recognized at fair value considering quoted market prices if available for the same or similar instruments. Long-ter ruments, considering interest rates currently available in connection with bank loans with similar terms and due dates.

re Based Payments

Company accounts for share based payments using a fair value based method whereby compensation cost is measured at the grant gnized over the service period. The Company uses the Black-Scholes pricing model to calculate the fair value of options and warrants mptions used such as the expected life of the option, risk-free interest rate, dividend yield, volatility and forfeiture rate. The use of a di e a material impact on the amount of calculated compensation expense.

6

n and Cash Equivalents

cash and cash equivalents of the Group consisted of cash balances held on deposit with banks, of which $8,767 is denominated in USD
se deposits earn interest at the relevant bank interest rates, which are all floating rates of interest. These annual interest rates ranged
1, and 3.1% to 8.8% for the fiscal year ended June 30, 2010.

TE 2 - REVENUE

enue earned by the Group can be classified into two categories: film revenues and fee-related revenues (see NOTE 1).

revenues consist of minimum guarantees from distributors, royalties earned either collected or receivable, and other fees or income ass

revenue by geographical areas is as follows:

	Ju
ope	$ 9
th America	
th America	3
ca and Middle East	3
	2
tralia	4
l	$ 2

fee-related revenues for the years ended June 30, 2011 and 2010 were generated in North America, and through a related party (as descr

related revenues in the period ended June 30, 2011 consisted of:

Producer's fees of $70,097 resulting from excess tax credits received on Night of the Demons. This item was collected by Seven Arts Pi
under the agreement between the Group and SAPLA.

b) $500,000 of fees relating to Esplanade Pictures based in Louisiana.

related revenues in the period ended June 30, 2010 consisted of:

$2,650,794 of fee income derived from the Equicap transactions, a structured finance transaction with UK investors who invested in
Group. The fee items related to the Equicap transactions were contractually entered with Seven Arts Pictures Louisiana LLC (“SAPL
but collected and recorded by the Group under the Group’s agreement with SAPLA as fee income.

Producer's fees of $637,397 resulting from excess tax credits received on Night of the Demons. This item was collected by SAPLA a
between the Group and SAPLA.

Producer’s fees income of $1,154,728 resulting from excess tax credits received on American Summer (Pool Boys) and Autopsy. This
Group under the Group’s agreement with SAPLA.

of the Group's revenues and profits before taxes in each year are derived from the financing, production and distribution of films.

TE 3 – NET INTEREST EXPENSE

following presents the Group's interest expense and interest income for the years ended June 30, 2011 and 2010:

	Ju
rest expense	
duction loans interest paid	$ (
porate loans interest paid	(
k interest paid	(
l interest paid	$ (
rest income	
rest received	$
k interest received	
l interest received	$
interest (expense)/income	$ (

TE 4 – OTHER INCOME RELATED TO CANCELATION OF INDEBTEDNESS

Group recorded of $4,458,621 of other income for the year ended June 30, 2011 related to the cancellation of indebtedness arising fro

The release of a loan of $1,788,904 from Arrowhead (See NOTE 11) which is subordinated to the Cheyne debt of $6,500,000 which w
ot believe that forecast income will be sufficient to repay the primary loan; therefore the subordinated loan will also not be repaid.

b) Forgiveness of accrued interest of $2,669,717, which was accrued through June 30, 2010, on the Pal

ing the year ended June 30, 2010, the Company recorded a $150,000 gain on the cancellation of indebtedness arising from a settlem
ng 2010, 120dB agreed to a cash settlement of $323,000 in full and final settlement of the outstanding loan for Knife Edge. The C
btedness related to this settlement. Total other income related to cancellation of indebtedness was $533,874 for the year ended June 30

3

TE 5 – INCOME TAXES

Company has adopted ASC 740-10, “Income Taxes”, which requires the use of the liability method in the computation of income tax e
erred tax liability) or benefit (deferred tax asset). Valuation allowances are established when necessary to reduce deferred tax assets to

ing the year ended June 30, 2011 the Company had a net income of $1,461,554 decreasing the deferred tax asset approximately $496,9
une 30, 2011 and 2010 consisted of the following:

operating loss carry forwards	$
ital loss carry forwards	
Total carry forwards	
rate of 34%	
l long-term deferred tax assets	
: valuation allowance	
long-term deferred tax assets	$

net deferred tax asset generated by the loss carry forward has been fully reserved and will expire in 2019 through 2030. The realiza
ings and, therefore, is fully reserved at June 30, 2011 and 2010.

9

following represents the effect of timing differences on the Group's tax expense or benefit for the years ended June 30, 2011 and 2010:

ent tax charge/(benefit)	$
ors affecting the tax charge for the year:	
me/(loss) before taxes	
me/(loss) before taxes multiplied by the standard rate of UK corporation tax of June 30 2011 at 27.5% (June 2010 at 28%)	
cts of:	
deductible expenses	
ess of amortization over tax deductions	
-qualifying depreciation	
ess of capital allowances over depreciation	
vement in tax losses	
tax profit adjustment	
ent tax expense/(benefit)	$

f June 30, 2011, the Group had operating losses of approximately $10,422,664 to carry forward against future operating profits.

f June 30, 2011, the Group had capital losses of approximately $5,398,529 to carry forward against future capital profits.

net deferred tax asset generated by the loss carry forwards has been fully reserved and will expire in 2019 through 2030. The realiz
ings and is fully reserved at June 30, 2011 and 2010.

)

TE 6 – EARNINGS PER SHARE

ic net income/(loss) per share is based upon the weighted average number of common shares outstanding for the period presented a up's two separate 5:1 reverse stock splits. Diluted earnings per share is based on the assumption that all dilutive convertible shares an assumed to be exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used ng the period. At June 30, 2011, the Company had a total of 2,217,872 common stock equivalents outstanding, including options, wa valents for the year ended June 30, 2010 are anti-dilutive due to the net loss incurred.

ic and diluted earnings per share ("EPS") are based on weighted-average common shares and generally exclude shares that woul -10-45-19, the Group did not consider any potential common shares in the computation of diluted EPS as of June 30, 2011 or for June 3 year ended June 30, 2011, 329,160 anti-dilutive shares were excluded from the EPS calculation, which would have been conside rations.

following is a reconciliation of the number of shares (denominator) used in the basic and diluted earnings per share computations for th

	2011	
	Weighted Average Shares Outstanding	Per Sha Amoun
ic earnings per share	1,888,712	$ 0.77
ted earnings per share	1,888,712	$ 0.77

ic and diluted net income (loss) per share is calculated based on the weighted average common shares outstanding for the period presen rse stock splits which occurred on December 31, 2008 and May 12, 2011.

TE 7- EMPLOYEE BENEFIT TRUST

Group established the Seven Arts Employee Benefit Trust ("EBT") for the purpose, among others, of acquiring 3,000,000 of the G rmadillo"). EBT is governed by a Trust Deed that the Group entered into with the trustees. Under the Trust Deed, the Trustees have mmend options to the trustees. The Group has the right after approval of the audit committee to restrict the Trust's right to vote its shar ne Group and the right to remove the Trustees under certain circumstances for the same purpose.

Group has no interest in the profits or losses of the Trust on the Group's shares and does not control the actions of the Trustees in the ificant influence on the EBT. All cash and ordinary shares owned by EBT are held by EBT for the benefit of the Group's United Kingd

October 30, 2008, EBT reached an agreement to acquire these preference shares for £1,500,000 plus the return of 1,600,000 of Armad
0,000 as the first of three equal installments together with 1,600,000 shares of Armadillo Investments Plc. The EBT acquired 3,000
adillo. Seven Arts has guaranteed the remaining two payments due to Armadillo aggregating £1,000,000, but has not yet advanced
ments due to Armadillo. On November 20, 2008, EBT converted 2,500,000 of these preferred shares into 2,000,000 of the Group's or
aining 500,000 preferred shares to 400,000 ordinary shares.

EBT originally pledged 266,667 ordinary shares to Armadillo to secure the sum due to Armadillo, which the pledge will be terminate
ebruary 9, 2011, 150,000 shares of the Group were issued to New Moon Pictures LLC who then pledged the shares to Armadillo Invest

xtended the terms of the repayment of the £1,000,000 due from the EBT to June 30, 2011; and
educed their lien over the 266,667 shares currently held by the EBT to 200,000 shares.

une 30, 2011, the loan receivable from EBT amounted to £643,084 ($1,107,134) and the EBT owned 200,000 shares (or approximatel
e 30, 2011) all of which are pledged to Armadillo Investments Ltd.

TE 8 - FILM COSTS

following presents the Group's film costs as of June 30, 2011 and 2010:

	Ju
costs - beginning balance	$
itional costs incurred	
d party investments/ tax credits	
ortization of film costs during period	
costs as of June 30, 2011	$

net book value of all films as of June 30, 2011 includes $17,917,287 relating to films released since April, 2007 and $5,216,272 relatin

r 98% of the Group's pictures released before April 2007 have been fully amortized and therefore have a net book value of zero as of Ju

italized film costs are reviewed for impairment at least twice a year and whenever events or changes in circumstances indicate that the c
ermination of recoverability is based on an estimate of future cash flows resulting from the use of the asset, and its eventual dispositio
ed on the fair value of the asset as estimated using a discounted cash flow model. An impairment charge of $ 820,951 was recognized
year ended June 30, 2010.

2

TE 9 – PROPERTY AND EQUIPMENT

Group's property and equipment as of June 30, 2011 and 2010:

book value as of June 30, 2009	$ 4
itions	2
reciation charge for the period	(
nange differences	(
book value as of June 30, 2010	2
itions	1
reciation charge for the period	(
nange differences	-
book value as of June 30, 2011	$ 2

TE 10 – FILM AND PRODUCTION AND CORPORATE LOANS

following presents that Company's film and production and corporate loans as of June 30, 2011 and 2010:

rent	Ju (U
& production loans	$ 1
porate loans	1
rent	$ 1

3

n and Production Loans

n and production loans arose from the financing of motion pictures and are secured with an interest in the associated motion pictures.

an of $8,300,000 was advanced to Seven Arts Future Flows I LLC ("SFF"), a subsidiary of Seven Arts Pictures Inc., (“SAP, Inc.) a r
rowhead") and was secured by a pledge of Seven Arts Filmed Entertainment Limited’s distribution rights in twelve designated pictu
od ended June 30, 2009, Arrowhead made the decision to take control over the distribution rights to these pictures. Since the Group no
removed all investment in the cost of these pictures as well as receivables from its assets and has removed the non-recourse indebtedne
9. This resulted in the recognition of $5,601,683 of “Other income” in the period ended June 30, 2009 relating to the cancellation of ind

owhead filed an action on September 22, 2010, which seeks recovery from the Group of the monies which the Group has retained u
owhead. In addition, Arrowhead makes substantial additional claims against the Group, Mr. Hoffman and Seven Arts Pictures Inc. re
ements, including failure to properly account, failure to turn over materials, failure to remit monies collected, and similar matter
ranties for damages are $8,300,000 although Arrowhead states no basis for this amount.

Group had moved to dismiss the action against all defendants other than Seven Arts Future Flows I LLC, which is not part of the Gro
ted the Group’s motion and dismissed all defendants except SAFE Ltd. in its capacity as a collateral agent, which is not a material
eve that Arrowhead’s claims against the Group are without substantial merit.

agement has accounted for the monies collected and not remitted from the Arrowhead titles as accrued liabilities in the Group’s books

original loan of $7,500,000 was taken from Cheyne Specialty Finance Fund LLP ($6,500,000) senior debt and Arrowhead Consultin
yne portion of the loan was acquired by SAFE Ltd for payment of $6,500,000 in April 2008, leaving a balance owed by the Group of $
subordinated to the collection of $6,500,000 plus interest from certain pictures after June 30, 2008. The $1,000,000 balance of the lo
00,000 plus interest from six films (Deal, Noise, Pool Hall Prophets, A Broken Life, Mirror Wars and Boo) as well as with a seconda
owhead) and a first security interest in 321,400 shares of the Group owned by Seven Arts Pictures Inc. The Group is in litigation with th
$1,000,000 plus accrued interest and it believes this debt will never be paid due to its subordination to the senior loan.

ecurity interest in favor of Palm Finance Corporation ("Palm") was lodged at Companies House (the United Kingdom’s registrar of co
e by Palm to finance the films Nine Miles Down, The Pool Boys and Autopsy. The Group entered into two senior financing loan and
nce the production costs of The Pool Boys, Autopsy and Nine Miles Down dated May 7, 2007 and December 17, 2007. These loans
ion pictures. The revenues so far collected have been insufficient to repay the majority of these loans, primarily as result of manage
inal principal amount of the Palm loan for The Pool Boys and Autopsy are $5,500,000 including $700,000 of accrued interest, and for
ccrued interest. In November 2010, the Group entered into a new financing agreement with Palm extending the due date of these loans t

lender agreed to write-off the accrued interest as of June 30, 2011, giving rise to forgiveness of debt income of $2,669,717. The outsta
10,052 (Pool Boys/Autopsy) and $ 3,176,018 (Nine Miles Down).

sequent to June 30, 2011, the lender sold $2,750,000 of its debt and converted 50% of the monies received to Series A preference shares

4

August 27, 2007, the Group borrowed $1,650,000 from Blue Rider Financial ("Blue Rider") to pay for the domestic prints and adverti arranged that the revenues due from Metro-Goldwyn-Mayer Studios Inc. ("MGM") to the Group for the distribution of that motion pict hat loan. To date the revenues paid to the Group from MGM have not yet been sufficient to repay the Blue Rider Loan. The Group h Blue Rider to redeem the loan due for $2,200,000, less approximately $812,000 of collections that have been received by Blue Rider t id from proceeds due from MGM on or before December 31, 2011.

porate loans

algar Loan

October 15, 2008 the Group borrowed £1,000,000 from Trafalgar Capital Special Investment Fund ("Trafalgar"). A portion of this loa allment for the acquisition of all the Preferred Shares owned by Armadillo. On September 2, 2009 the Group repaid Trafalgar $1,0 nst this loan, with the remaining balance subject to repayment in cash or convertible to the ordinary shares of the Group at the conver June 22, 2010 an amended agreement was entered into with Trafalgar for an extension of the due date of the convertible debentures ,000 ordinary shares to settle a portion of the debt. Trafalgar agreed to reduce the loan amount from the proceeds it receives from se es were sold in the market before December 31, 2010. A further amended agreement was entered into with Trafalgar for an extension 2011, and the Group issued 425,000 ordinary shares to settle a portion of the debt. Trafalgar agreed to reduce the loan amount from th es. The per-share value is determined as the amount recovered by Trafalgar on sale thereof in the market and Trafalgar may "put" these ot previously sold. This put option was not exercised by Trafalgar.

er Loan

May, June and September 2010, the Group issued an aggregate of $200,000 Convertible Promissory Notes to Asher Enterprises, Inc. ch 17, 2011 and June 24, 2011, respectively. The Asher Notes bore interest at a rate of 8% per annum and were convertible into the Gro dred twenty (120) days following the issuance of the Asher Notes, at the holder's option, at the conversion rate of 60% of the marke nary shares during the ten-day period ending one trading day prior to the date of the conversion notice is sent by the note holders via fac

Group has identified the embedded derivatives related to the Asher Notes. These embedded derivatives included certain conversion fe vative financial instruments requires that the Group record fair value of the derivatives as of the inception date of Asher Notes and to ption of the Asher Notes, the Group determined a fair value of $178,187 on the embedded derivative. The fair value of the embedd ion Pricing Model based on the following assumptions:

Assumption	Amount
Dividend yield:	0.0%
Volatility	133% ~ 142%
Risk free rate:	0.25% ~ 0.37%

ing the year ended June 30, 2011, the Company issued an aggregate of 53,668 shares of common stock in full settlement of the $100, ed interest. In addition, the Company paid remaining two Convertible Promissory Notes an aggregate of $120,000 in cash. As such, th ount for the year ended June 30, 2011 and $32,530 loss on change in fair value of debt derivative.

5

vertible Notes issued August 30, 2010

August 30, 2010, the Group issued an aggregate of $470,000 Convertible Debt to qualified investors that matures on February 28, 2011 annum and could be converted into the Group's ordinary shares beginning on the date which is one hundred twenty (120) days f version rate of $3.75 per share, subject to certain changes, and are convertible at the option of the Group.

On March 22, 2011 an additional $300,000 of convertible notes were issued to Runway Investments Ltd on the same terms as above. A 31, 2011.

b) All $770,000 of these notes were extended on May 24, 2011 to September 30, 2011, and the conversion terms

Scarborough note's principal and interest will convert into common stock at $0.50 per share.

extending the maturity date until December 31, 2011, Sendero and Runway will reduce their conversion price to $0.60 per share.

extending the maturity date until September 30, 2011, Agua Alta will reduce its conversion price to $0.75 per share.

average conversion price of the three remaining notes is $0.64 per share.

c) $225,000 of the Scarborough notes were converted to 507,000 shares on July 29, 2011, subsequen

d) $170,000 of the Agua Alta and $75,000 of the Sendero notes were converted into 1,786,374 shares on

6

c Capital Group

June 10, 2011, the Group borrowed $150,000 from Isaac Capital Group ("ICG") in the form of a convertible note. The loan is for 6 m
t to convert the Loan at any time into shares at a conversion price of 60% of the volume weighted average sale price on NASDAQ of t
oan. There is also a closing fee of 15,000 shares on closing of the Loan. (These shares have not yet been issued).

maturity dates and interest rates applicable to the Group's funded indebtedness and third party guarantees are as follows:

	Amount outstanding		
der	June 30, 2011	June 30, 2010	Applicable interest rate
n and Production Loans			
owhead Consulting Group	$ -	$ 1,788,904	19-23% Variable
n Finance Corporation	4,910,052	6,575,881	18% Fixed
n Finance Corporation	3,176,018	4,243,835	18% Fixed
e Rider Finance Inc.	813,742	1,599,813	22.5% per annum plus 4% indebtedness for each 30 d indebtedness remains outs December 15, 2008
dB Film Finance LLC	323,000	219,000	No stated interest rate
l Fusion Media Group LLC	582,510	920,410	10% Fixed
llel Media	1,469,108	1,418,846	No stated interest rate
ged Shares	(384,000)	-	
n and Production Loans	$ 10,890,430	$ 16,766,689	
porate Loans			
algar Capital Specialized Investment Fund	$ 490,412	$ 1,176,608	9% Fixed
er Enterprise, Inc.	-	150,000	8% Fixed
n House	263,234	207,983	30% Fixed
rborough/Runway	853,384	-	15% fixed
c Capital Group	148,220	-	15% fixed
porate Loans	$ 1,755,250	$ 1,534,591	
l Loans	$ 12,645,680	$ 18,301,280	

loan amounts as of June 30, 2011 and 2010, includes accrued interest of $2,233,994 and $5,238,407, respectively.

7

TE 11 - SHAREHOLDERS' EQUITY

following presents the Company's authorized, issued and outstanding shares, by class as of June 30, 2011 and 2010:

horized	
0,000, £1 convertible, redeemable preference shares for all periods.	
27,360 ordinary shares at £ 0.25 par value each for all periods.	
27,360 deferred shares at £1.00 par value each for all periods	
84,000 deferred shares at £0.45 par value each for all periods	
ed and outstanding	
0 convertible, redeemable preference shares	
3,131 ordinary shares at £.25 par value as of June 30, 2011, 1,495,460 as of June 30, 2010;	$
8,120 deferred shares of £1 as of June 30, 2011,	
5,460 as of June 30, 2010;	
84,000 deferred shares of £0.45 each for all periods.	
	$

vertible Redeemable Preferred Shares

ing the year ended March 31, 2005, Seven Arts issued approximately £3,000,000 of convertible redeemable preferred shares to Armadi
nary shares from Armadillo, valued at $5,668,800.

The convertible redeemable preferred shares held by Armadillo were acquired by the Seven Arts Employee Benefit Trust ('EBT") on
were converted into 2,000,000 of the Seven Arts Pictures Plc ordinary shares on November 20, 2008.

The remaining 500,000 convertible preferred shares owned by the EBT were converted into 400,000 ordinary shares of Seven Arts P
2010, there were no convertible redeemable preferred shares outstanding.

3

terms attached to the convertible redeemable preferred shares include:

a. no dividends,
b. a liquidation preferred,
c. conversion rights into ordinary shares, and
d. redemption rights only in the event of certain defaults by Group

nary Shares

May 9, 2011, the shareholders approved a 5:1 reverse split and then the division of the new share into £0.25 ordinary share and £1.00
ements have been retroactively adjusted to the earliest period presented for the effect of this reverse split.

ne year ended June 30, 2011, the Group issued an aggregate of 1,147,671 shares of ordinary stock comprised of:

a) 342,000 shares issued to consultants in exchange for services rendered
153,000 shares issued to Trafalgar Capital Specialized Investment Fund pursuant to an amended loan agreement and 100,000 issued to E
c) 53,668 shares issued to Asher Enterprises in exchange for conversion of notes payable in the aggregate a
Pledges of stock issued to SAP Inc (23,800 shares) for an insurance policy, New Moon LLC (150,000 shares) pledged against Arm
175,000 shares) pledged against a loan of $125,000 given to the Company in March 2011 (See NOTE 12)

NOTE 20 – Subsequent Events, for details of shares issued subsequent to June 30, 2011.

ne year ended June 30, 2010, the Group issued an aggregate of 110,000 shares of ordinary stock comprised of:

a) 80,000 shares issued to the EBT on conversion of 500,000 convertible preferred shares. The EBT conversion resulted in an
$1,390,180 to the additional paid in capital account and a reduction of $1,539,800 in the carrying value of the preferred shares in t
2,000 share options were converted to 10,000 ordinary shares by a former employee. As the excess 8,000 ordinary shares were issu
advance and pledge 8,000 of its shares of Seven Arts Pictures Plc to the Group until it can arrange for the cancellation of these shares a
o the former employee. As of June 30, 2010, the Group had not received these cancelled shares.
c) 20,000 shares were issued to Eden Finance to cover loan, interest and fees in April 201

9

erred Shares

Group's deferred shares issued prior to March 31, 2007 have essentially no rights for participation with income or assets of the Gro
ership. The Group has the right to purchase back and cancel the deferred shares. These shares were issued when the ordinary stock pa
very £0.50 per share held the shareholder received one £0.05 ordinary share and one £0.45 deferred share.). The Group has no curren
art of the nominal share capital valued at £0.45 per share.

second category of deferred shares was issued on May 12, 2011 after the 5:1 reverse split when five ordinary shares with £0.25 par v
e and then the resulting share subdivided into one ordinary share of £0.25 and one deferred share of £1.00. These shares have essenti
Group other than their existing rights under ordinary share ownership. The Group has the right to purchase back and cancel the defer
e capital valued at £1.00 per share.

TE 12 - CONVERTIBLE DEBENTURES WITH NO REDEMPTION DATE

	As Ju
vertible debentures	$

ing the year ended March 31, 2005, Seven Arts issued £3,000,000, of convertible debt to Langley Park Investment Trust Plc ("Lang
ed at approximately $5,204,000. Langley converted £1,250,000 of its convertible debenture into 1,000,000 ordinary shares in Seven
50,000 ($3,432,450) of convertible debentures are convertible into a maximum of 1,400,000 ordinary shares at 4:1 conversion.

original Langley agreement stated that the debentures were convertible at 2:1 when the original share price was £0.5 and above, increa
r the 5:1 reverse split the conversion parameters became 2:1 at £2.5 and above and 4:1 at £1.25 and below. The Group also agreed to g
es as is equal to the difference, if a positive amount, between (a) the number of ordinary shares into which the original amount of deb
, less (b) the aggregate number of the ordinary shares into which the original amount of debt has actually been converted at the date of
d conversion price of £0.5. As of June 30, 2011, there were no such options granted.

Convertible debentures bear no interest, are entitled to a liquidation preferred ahead of ordinary and preferred shareholders, are co
ired due date on the Group's Debentures. The Debentures rank junior to all the Group's indebtedness and senior only to its ordinary
unted for as equity transactions.

0

TE 13 - DERIVATIVES AND OTHER FINANCIAL INSTRUMENTS

ncial instruments

Group's financial instruments comprise cash balances, items such as trade receivables and trade payables that arise directly from its op erence shares and loans taken out from banks and other third parties. Financial instruments such as investments in, and advances to, su payables have been offset in the consolidation.

Group relies on loans taken out from banks and other third parties to fund its investment in the production of motion pictures and to ion to these loans is to minimize the interest rate and to maximize the flexibility of repayment terms. The reliance on loans to provide in loans payables at the period end and the extent to which favorable terms have been achieved on these loans is indicated in the disclos

main risks arising from the Group's financial instruments are foreign currency risk, interest rate risk, liquidity risk, credit risk and price

ign currency risk

Group receives distribution income from overseas, normally in US Dollars. Consequently, its trade receivables are largely denominat ash in US Dollars. The Group's exposure to exchange rate fluctuations is currently deemed to be low, since the majority of its liabili up does not hedge against this risk.

nsactions in GB Pounds are in the opinion of Management either immaterial or outside the ordinary course of business and therefore t version of GBP to USD.

analysis of the monetary assets of the Group as of June 30, 2011, showing the amount denominated in each currency, is as follows:

		GBP
le receivables	$	
ayments		1,3
ets	$	1,3
le payables	$	1,9
rued liabilities		3
icipation and residuals		
porate loans		1,7
and production loans		
erred income		
es payable		3
ilities	$	4,4

uidity risk

nagement monitors liquidity risk regularly by way of preparing cash flow forecasts and ensuring that adequate loan facilities are in plac
ny film.

dit risk

Group has a large number of customers, primarily sub-distributors who are located all over the world. Certain of these customers a
erally regarded as presenting a credit risk. However, certain of the smaller customers are considered to be a potential credit risk, and
ntaining regular contact with those customers who owe the Group money.

nomic dependence

ing the year ended June 30, 2011, revenue from two major customers approximated $714,681 and $149,000, or 26% and 5%, respect
e two customers approximated $0 and $0, respectively, of the total accounts receivable at June 30, 2011.

ing the year ended June 30, 2010, revenue from two major customers approximated $1,020,000 and $518,000, or 52% and 26%, respec
e two customers approximated $212,000 and $518,000, or 14% and 35%, respectively, of the total accounts receivable at June 30, 2010

ng the year ended June 30, 2011, 100% of fee related revenue in the amount of $570,029 was generated through SAPLA, all of which

ing the year ended June 30, 2010, 100% of fee related revenues in the amount of $4,442,919 was generated through SAPLA, $3,28
Overall receivable due from SAPLA (including SAPLOU Equicap) through the related parties accounts was approximately $2,473,00
ies.

re was no supplier in any of the periods reported who accounted for more than 10% of the Company’s expenditures during the years enc

2

e risk

Group manages the risk of goods and services being obtained at a higher than necessary price by ensuring that all purchases above a
hase order being placed.

duction and corporate loans are included in the Group's balance sheet as financial liabilities. Production loans of $10,890,430 as of June
s of $1,755,250 are denominated in both USD and GBP. The bank overdraft in June 30, 2011 was denominated in Pounds Sterling.

analysis of notes payable is as follows:

d and variable rate - production and corporate loans	$
stated interest - production loans	
l financial liabilities	$

fixed rate financial liabilities have fixed interest rates for the entire term of each loan. The weighted average interest rate of these fixe
year ended June 30, 2011 and 12.2% for the year ended June 30, 2010.

se loans where no interest was payable were all loans made to fund the production of motion pictures that were repayable from the
ned payment schedule. The period over which these loans are repayable, therefore, depends on the performance of each motion picture

financial assets of the Group are cash balances held on deposit with banks. As of June 30, 2011, the Group had only nominal cash ba
rest rates, which are generally fixed.

fair value of all the financial assets and liabilities of the Group are considered to be equal to their stated value due to the short-term natu

Group has recorded the fair value of the derivative liabilities at fair value with changes in the value of the derivatives accounted for as
e 12, as of June 30, 2011, the Group measured fair value of its derivative liabilities at approximately $0, using unobservable, Level 3 in

TE 14 – SHARE BASED PAYMENTS

Group accounts for share based payments in accordance with ASC 718 ("Accounting for Stock Compensation") using a fair value bas
t date based on the value of the services received and is recognized over the service period. The Company uses the Black-Scholes
rants issued. In calculating this fair value, there are certain assumptions used such as the expected life of the option, risk-free interest
of a different estimate for any one of these components could have a material impact on the amount of calculated compensation expense

numbers of stock options granted by the Group, by period, are as follows:

standing at beginning of period	4
nted	1
rcised	
celled or expired	(
standing at end of period	1

000 and 0 options were issued during the years ended June 30, 2011 and 2010, respectively.

following presents the inputs used by the Group in the Black Scholes valuation model for the new options issued in the periods presente

-free interest rate	5
ected option lives (in years)	3 y
ected volatility for options	2
ected dividend yield	(
eiture rate	(

shares are vested upon the grant date the Group recognized share-based compensation expense of $ 87,026 and $0 in the years ended
efit recognized in the statements of operations for share-based compensation arrangements during any periods presented herein. Un
tled to any tax benefit for such share-based compensation arrangements.

weighted average exercise price of the share options outstanding at June 30, 2011 is $1.97 per share. The weighted average remainin
ths.

4

loyee options

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares Outstanding	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price of Outstanding Options	Number of Shares Exercisable	Weighted Average Exercise Price of Exercisable Options
30	4,000	0.17	7.30	4,000	7.30
70	12,000	0.35	7.70	12,000	7.70

-employee options

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares Outstanding	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price of Outstanding Options	Number of Shares Exercisable	Weighted Average Exercise Price of Exercisable Options
00	20,000	1.6	$ 2.00	20,000	$ 2.00
00	100,000	2.3	$ 1.00	100,000	$ 1.00

TE 15 – RELATED PARTY TRANSACTIONS

loyment Agreement

Group engaged Kate Hoffman as an employee and director, who is the daughter of Peter Hoffman, the Chief Executive Officer. The G suant to which she will act as Chief Operating Officer ad infinitum at a current salary of £52,000 ($85,000) per year plus bonu -compete clause whereby she is excluded from competing against the Group for 6 months following the date of her termination. She cu up.

5

liated and Related Party Agreements

n acquisition of control of the Group by Seven Arts Pictures Inc. ("SAP Inc.") in September 2004, Seven Arts Pictures Plc. entered into
en Arts Pictures Inc. provided the services of Peter Hoffman for the amount of his contracted salary as well as the direct costs of th
SAP Inc. is a related party by virtue of it being majority owned by Peter Hoffman, the Group's Chief Executive Officer and Director,

ain affiliates controlled by Mr. Hoffman are entitled to be reimbursed by the Group for general overhead incurred by each to conduct
up and then to be reimbursed for certain third party costs on motion pictures controlled by the Group and to be indemnified for loss co
ness if approved by the Group. The Group has the right to control through management all material decisions of all affiliates controlled
erial effect on the Group's business or results of operations.

r Hoffman controls several companies that are not part of the Group but from which it obtains or transfers distribution rights or
duction of the motion pictures. The agreements with Mr. Hoffman, and the companies controlled by him; provide that all revenues rel
of these related party companies is due to the Group, except Mr. Hoffman's salary, bonus and stock ownership.

suant to an inter Group agreement, SAP Inc. also, from time to time, holds ownership of limited liability corporations in the United Sta
to SAFE Ltd. In addition, they also provide other services for PLC and SAFE Ltd. At no fee other than Mr. Hoffman's salar
ce. These other services are any reasonable requests of the management of the Group including accounting services, audits of dist
ervision of production of motion pictures and similar day-to-day aspects of the Group's business.

Inc. has, from time to time, made non-interest bearing advances to the Group and SAFE Ltd, when the Group has not been able to col
t payments required to creditors. Any such advances that have been made by SAP. Inc. have been made solely for working capital purp

suant to the inter Group agreements, the Group earned $551,672 from distribution of the Group's motion pictures during the year en
ls to SAPLA which is a Louisiana limited liability company controlled by SAP Inc. SAP Inc. would then be obligated to return the fu
Group's books of account and the Group has recorded the amounts earned as described above.

Group has from time to time made and received advances from and to Seven Arts Pictures Inc., Seven Arts Future Flow I LLC and v
ve, where the advances from and to these related parties do not bear interest. The balances of these combined accounts as of June 30, 20

6

llo Media

ether with SAP Inc, the Group entered into a settlement agreement, dated September 30, 2006, with ApolloMedia GmbH & Co. Fi
rding amounts ultimately payable to ApolloMedia from distribution of the motion picture Stander and one of our subsidiaries' assumpt
tander. The Settlement Agreement fully releases the Group from any liability to ApolloMedia in exchange for a payment of $1,800,0
). In connection with the SAP Inc's payment obligation of the settlement amount to ApolloMedia, the Group issued 700,000 ordinary
polloMedia to secure SAP Inc's obligations under the settlement agreement. SAP Inc has agreed that it will (1) return to the Group a
sfy SAP Inc's obligations to ApolloMedia and (2) deliver to the Group from SAP Inc's ordinary shares, any ordinary shares in e
btedness to ApolloMedia under the settlement agreement. The shares pledged to ApolloMedia will be sold by Apollo as necessary f
800,000 less $175,000) and any pledged shares remaining after such sale will be returned to the Group.

tionship with Seven Arts Pictures Louisiana LLC ("SAPLA")

Group license distribution rights to pictures controlled by them to its affiliate, SAPLA which perform distribution services for their mo
agreements with Mr. Hoffman and his affiliates described above.

Company entered into a distribution agreement with SAPLA (subsequently assigned by SAPLA to Seven Arts Pictures Louisiana (E
up granted SAPLA the right to distribute motion pictures in return for a distribution fee of 20% of the revenues generated from these f
related party agreements described above to pay and has permitted the Group to retain 100% of all such distribution fees.

PLA entered into a Credit Agreement with Advantage Capital Community Development Fund LLC dated October 11, 2007 for t
-production facility located at 807 Esplanade Avenue in New Orleans, Louisiana for aggregate principal advances of up to $3,70
roximately $3,700,000 has been drawn under the terms of this Credit Agreement, as of June 30, 2011 and 2010.

Group has entered into a new financing agreement with Palm Finance in November 2010 to refinance the existing indebtedness secured
eans, Louisiana under which Palm has acquired the existing credit facility of $3,700,000 plus accrued interest of our affiliate SAPL
00,000 to complete renovation and construction of this facility. Palm's advance and interest at the rate of 15% per annum are due and p
07 Esplanade Avenue in New Orleans ("Property") and Louisiana film infrastructure and historical rehabilitation credits, as well as Fe
the Property. As part of this agreement the Group has entered into an agreement with Palm extending the due date of the loans on
ember 31, 2011.

n commencement of business of SAPLA's production and post-production facility in New Orleans, Louisiana, SAPLA and an affiliate,
he lessee of those facilities and under the related party agreement all profits of SAFE LA if any will be returned to the Group under the

stigation into Claim for Tax Credits (SAPLA)

US Attorney in New Orleans is investigating claims for Louisiana film infrastructure tax credits including such tax credits to be cla
isiana LLC. This investigation appears to include investigation as to whether certain expenses claimed by this affiliate were improper
ndependent auditors and reviewed by counsel. None of these expenses or credits have been included in the Group's financial stat
stigation will have no material adverse effect on the Group's operations or the total tax credits to be received by the Group's affiliat
loyees of this affiliate based on prior audits, including Mr. Hoffman.

n to Gone to Hell from Palm Finance

ether with SAP Inc, the Group guaranteed a $4,000,000 loan on December 17, 2007 between Palm Finance Corporation ("Palm") an
rating Officer and Director Kate Hoffman, in exchange for the distribution rights to the movie, Nine Miles Down. The loan was mad
vn and is secured by the distribution rights to that motion picture. The loan carries an annual rate of interest of 15% and became
earance agreement with Palm in extending the due date of this loan to December 31, 2011.

n from Cold Fusion

Group entered into a loan and security agreement dated January 15, 2009 for $750,000, together with SAP Inc. and certain limited lia
the production of the motion picture Night of the Demons ("NOTD"). The Group guaranteed the loan in exchange for the distributio
nce NOTD and is secured by the distribution rights to NOTD. The loan bears interest of ten percent (10%) per annum. The loan bec
ribution revenues of NOTD. At June 30, 2011, the balance due to Cold Fusion amounted to $582,510 including unpaid accrued interest.

loyee Benefit Trust

Group engaged Smith and Williams Trustees (Jersey) Limited to set up an Employee Benefit Trust ("EBT") in December, 2008. T
rolled by the Trustees. The EBT entered into an agreement to purchase the 3,000,000 convertible preferred shares held by Armadillo
in three equal installments of £500,000, and the return of the 1,600,000 ordinary shares in Armadillo owned by the Group, valued at £
agreed upon purchase price was to be loaned to the EBT by the Group at a nominal interest rate and, to date, the Group has advanced £
the 1,600,000 ordinary shares of Armadillo, valued at £800,000 in the Group's books, to the EBT which has paid them over to Armadi
1,000,000 representing the second and third installments, but has not yet advanced these amounts. The EBT has repaid £582,604 ($1
1 by selling ordinary shares owned by the EBT to creditors of the Group. The Group charged interest of $44,822 to the EBT during the
EBT to the Group as at June 30, 2011 was $1,237,417.

3

TE 16 – COMMITMENTS AND CONTINGENCIES

uisition of Big Jake Music

September 29, 2011, the Company entered into a definitive agreement to acquire of all of the capital stock of Big Jake Music ("BJM"),
pany, for $5,000,000 of convertible preferred stock, convertible into common stock at a premium to the market price at closing, and w
release soundtracks of Seven Arts films, including Night of the Demons (a film released in October 2010) and The Pool Boys (a film re

ditors Liquidation of SAP Plc.

was placed into compulsory liquidation on November 8, 2011 by the English Companies Court. The Company's CEO, Mr. Peter Hof
r but this request was denied by the Courts as a result of inter alia the opposition of Parallel Pictures LLC ('Parallel'). The creditors
titioner as liquidator. The role of a liquidator is to realize a company's assets for the benefit of the creditors and shareholders. Mr. Hof
tantial claims against Parallel and its defenses to Parallel's claims. Parallel has claimed in the proceedings in England and the Unite
npany and PLC was 'fraudulent' and may seek additional compensation or guarantees from Company. Management believes that the
not subject to attack and that Parallel will not prevail in its claims. Management believes it has the support of its creditors to res
npany and as a result Parallel will not obtain any relief from the courts on this issue.

Esplanade Guarantee

en Arts Pictures Louisiana LLC, a related party of the Company, entered into a Credit Agreement with Advantage Capital Communit
acquisition and improvement of a production and post-production facility located at 807 Esplanade Avenue in New Orleans,
00,000. This agreement was guaranteed by the Company's predecessor. Approximately $3,700,000 has been drawn under the ter
npany has also guaranteed this amount.

re is a $1,000,000 guarantee of a note due to Armadillo by the Employee Benefit Trust resulting from the purchase back of the Seven A

works Litigation

Group prevailed in a motion for summary adjudication on February 10, 2011 in an action against CanWest Entertainment and t
ership of five motion pictures "Rules of Engagement ", "An American Rhapsody," "Who Is Cletis Tout," "Onegin," and "The Believ
nst Content Media Corporation ("Content") and Paramount Picture Corp.("Paramount") to recover the Copyrights and substantial
orted acquisition from CanWest.The Group has also filed suits against Content and Paramount in the Unites States for collateral dam
of copywright. The Group may incur up to $200,000 in legal expenses to pursue this claim but expects to recover those fees from Conte

9

es Film

Group, its subsidiary Seven Arts Filmed Entertainment Limited, and a related party, SAP Inc, were the subject of an arbitration award interest thereon relating to an ongoing dispute regarding a participation in the motion picture entitled 9 ½ Weeks II, even thoug plaining party, and potential loss of further distribution rights in this motion picture. The Federal District Court enforced this arbitr sion. The Group has accrued for the liability in the amount of $800,000 including approximately $100,000 of accrued interest as of Jun guaranteed by SAP Inc., a related party.

owhead Target Fund

en Arts Future Flow I ("SFF"), a limited liability Group owned by SAP Inc., one of the Group's controlling shareholders and a Group owhead Target Fund, Ltd. ("Arrowhead") of approximately $8,300,000 (the "Arrowhead Loan"). The Group secured the Arrowhead Lo 820,026 in the year ended June 30, 2009, $2,739,800 in the year ended March 31, 2008. The Group's only liability is to repay the ged against the Arrowhead Loan. The Group is not required to repay the Arrowhead Loan from any of its other assets or revenues.

Arrowhead Loan became due in February 2009 and SFF has not paid the outstanding principle and interest due. Arrowhead has the r e so at the present time. SFF has received a default notice to this effect and as a result Arrowhead is now collecting directly all sums ures, and has appointed a new servicing agent for these motion pictures with the result that the Group no longer controls the licensing Arrowhead Loan could result in a material disposition of assets through the loss of the Group's rights to the twelve motion pictures and ict.

a result of the foregoing, the Group has removed all assets accounts relating to the twelve motion pictures pledged to Arrowhead btedness from the Group's consolidated balance sheet at fiscal year ended June 30, 2009, due to the fact that the loan was a limited re owhead beyond the pledged film assets.

owhead filed an action on September 22, 2010 which seeks recovery from the Group of the monies which the Group has retained u owhead. In addition, Arrowhead makes substantial additional claims against the Group, Mr. Hoffman and Seven Arts Pictures Inc. re ements, including failure to properly account, failure to turn over materials, failure to remit monies collected, and similar matter ranties for damages are $8,300,000 although Arrowhead states no basis for this amount.

Group had moved to dismiss the action against all defendants other than Seven Arts Future Flows I LLC, which is not part of the Gro ted the Group's motion and dismissed all defendants except Seven Arts Filmed Entertainment Limited in its capacity as a collatera m. The Group continues to believe that Arrowhead's claims against the Group are without substantial merit.

owhead Capital Partners – AGC Loan

Group and several affiliates were named as defendants in an action by Arrowhead Capital Partners Ltd filed in the Supreme Court of N May 24, 2010, seeking to collect $1,000,000 plus interest (the "ACG Loan") due to Arrowhead Consulting group LLC ("ACG") as yne Loan described above in NOTE 12 under "Production Loans". The ACG Loan is fully subordinated to repayment of the Cheyne up has been assigned all Cheyne's rights under the subordination provision of the Cheyne Loan. As a result Management does not b ect any monies or to foreclose on any collateral pursuant to the Cheyne Loan. The Group intends to vigorously defend against this ac niss this action.

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erback – Hungarian co-producer

Group has obtained a final judgment from the Queen's Bench in England for approximately $300,000 erroneously converted to fees
es Down. The Group is seeking to collect these fees back through enforcement by Hungarian courts and currently a bailiff has beer
rrectly appropriated fees have been included in the film asset in prior years. Capitalized film costs will be reduced upon collection of th

ewood/Nine Miles Down

ttlement agreement for $250,000 has been reached with the liquidators of Gone to Hell ("GTH") the production company for Nine Mi
Stonewood; owned by the director of GTH and SAP INC for an action it took against the liquidator for interfering in the free distributio
only to the amount that is not payable back to SAP INC and Stonewood as they are the insured parties. The Group has guaranteed th
ribution rights to the movie. The Group has accounted for the legal expenses incurred related to this litigation by capitalizing them i
1, due to the fact that these are direct expenditures to this particular film.

s VAT

Group believes that the accrual of the VAT input refund or output VAT tax with respect to the Zeus transaction is highly uncertain.
es regarding the Zeus transaction as early as May, 2008, and has made no determination regarding any of the inputs or outputs of VAT
ation is still unresolved in that HMRC has not made a VAT refund to the 17 companies formed by investors in the Zeus transaction ("
ne supplies made for the SAFCO's and declared on the Group's VAT return filed in 2008 and in that HMRC has taken no steps to enf
Group, as an internal "hold" has been placed on collection by HMRC. Until and unless this interest is lifted, HMRC will take no actio
ne Group. The amount of VAT at issue is approximately £23,000,000 ($35,000,000) which would be both the amount owed by the Gro
FCO's as their refund from HMRC. The collection department of HMRC has stopped the collection of the VAT due from the Group, ar
up does not expect any penalties or fees will result from the VAT related to the Zeus transaction, accordingly no accrual of interest or p

Group acquired the SAFCO's as part of the Zeus transaction described above in May, 2009. The SAFCO's are not consolidated into
k accounts and the accounting records. The Group has instructed counsel to liquidate the SAFCO's under the applicable laws of the Uni

of the Group's affiliates filed an action against Zeus Partners Limited and two of its executives for indemnity in relation to Value Ad
pose of this action is to protect the Group's rights with respect to any potential liability to the Group with respect to Value Added Tax ar

stigation into Claim for Tax Credits (SAPLA)

US Attorney in New Orleans is investigating claims for Louisiana film infrastructure tax credits including such tax credits to be cla
isiana LLC. This investigation appears to include investigation as to whether certain expenses claimed by this affiliate were improper
ndependent auditors in Louisiana and reviewed by counsel. None of these expenses or credits have been included in the Group's financ
investigation will have no material adverse effect on the Group's operations or the total tax credits to be received by the Group's affili
loyees of this affiliate based on prior audits, including Mr. Hoffman.

ctor's Service Contracts

P Inc. has an employment agreement with Peter Hoffman pursuant to which he will act as the Group's Chief Executive Officer ("CEO" up, it entered into a contract with SAP Inc. to secure Mr. Hoffman's services solely to the Group as CEO. In connection with that emplo

- the right to sole responsibility for creative and business decisions regarding motion pictures we devel

right of first refusal to produce remakes, sequels or prequels of motion pictures produced by Mr. Hoffman and acquired by the Group mployment,

- an annual salary of $500,000 per year plus bonuses, expenses and a signing option an

right upon termination without cause to a lump sum payment of approximately $1,500,000, an assignment of all projects in developme ue upon such compensation as an excise tax.

Group has an employment agreement with Kate Hoffman pursuant to which she will act as Chief Operating Officer ad infinitum at a enses. Ms. Hoffman's contract contains a "non-compete' clause pursuant to which she will be excluded from competing against the Gro

Group has an employment agreement with Elaine New pursuant to which she will act as an executive director and Chief Financial Off plus bonuses and expenses. Ms. New's contract contains a "non-compete' clause pursuant to which she will be excluded from compe termination.

of the employment agreements grant us a right to injunctive relief if the respective employee breaches the agreement. With the exce loyment agreements do not contain "non-compete" clauses.

llel Action

June 28, 2011, PLC filed an action in the High Court of England against Parallel Media LLC ("Parallel") to collect sums due to PLC wi motion pictures and to confirm Parallel's obligations under both a signed and unsigned investment agreement with respect to the llel filed a petition to wind up and liquidate PLC in the Companies Courts of England based on its claim of repayment of $1,000,000 tember 19, 2011, Parallel filed a new action against PLC and SAE in the Superior Court of California, asserting the same claims a posed administration proceedings in England. A request for a preliminary injunction was denied by the Superior Court.

2

RC Investigation

July 19, 2011 Officers of Her Majesty's Revenue & Customs ("HMRC") attended the offices of PLC in London. Documents w
scription for shares in a number of companies which had lost value, resulting in subscribers making claims to tax relief.

C's participation in these transactions was limited to the transfer of rights to certain motion pictures to the investors in return for their
ures and making available the provision of loans to fund a portion of those investments. PLC received no tax benefits from the tran
eves that it is not a subject of the HMRC investigation.

onnection with the transactions, PLC did not make any representations or warranties to any party, including the investors, regarding an
he closing of the transactions the investors obtained and made available to the Company, an opinion of prominent Queen's coun
sactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws. PLC remains confident that th
ns of the applicable United Kingdom revenue laws.

et Transfer Agreement

June 11, 2010, Seven Arts Entertainment, Inc. ("SAE"), a Nevada Corporation, was formed and became a 100% owned subsidiary o
et Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer all of the assets with a cost basis fro
ain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have been distributed to shareholde
LC in order to satisfy any remaining obligations. This transfer was approved by the PLC shareholders at an Extraordinary General M
to eliminate our status as a foreign private issuer and to assume compliance with all obligations of a domestic issuer under all appli
ntion in executing this transaction was to redomicile the business with no change in the economic interests of the shareholders.

ctive at the opening of trading on September 1, 2011, Seven Arts Entertainment Inc. ("Seven Arts" or "SAE") was substituted for
mpany"). On that date, each of the Company's ordinary shares was exchanged for one share of common stock of SAE, which co
mpany's NASDAQ listing. SAE's new CUSIP number is 81783N102 and its trading symbol will remain SAPX.

rantees and Pledges

rantee of the Advantage Capital Loan

PLA, a related party of the Group, entered into a Credit Agreement with Advantage Capital Community Development Fund LLC dated
production and post-production facility located at 807 Esplanade Avenue in New Orleans, Louisiana for aggregate principal advances o
Group. Approximately $3,700,000 has been drawn under the terms of this Credit Agreement, as of June 30, 2011. The Group has guara

3

rantee of the £1,000,000 due to Armadillo by the EBT

iscussed in NOTE 1, PLC is a guarantor on the £1,000,000 due to Armadillo by the EBT.

TE 17 – OPERATING LEASE COMMITMENTS

ing the years ended June 30, 2011 and 2010, the Group had no operating lease commitments. Both office facilities are operating
roximately $4,500 a month for the Los Angeles office and $6,500 a month in London.

TE 18 – FAIR VALUE OF FINANCIAL INSTRUMENTS

n, accounts receivable, accounts payable and other accrued expenses and other current assets and liabilities are carried at amounts whi
relatively short maturity of those instruments.

C 820, “Fair Value Measurements and Disclosures”, establishes a framework for measuring fair value. That framework provides a fa
niques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identic
est priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described as

Leve l 1 - Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access.

Leve l 2 - Inputs to the valuation methodology include:

- quoted prices for similar assets or liabilities in active markets;
- quoted prices for identical or similar assets or liabilities in inactive m
- inputs other than quoted prices that are observable for the asset or lia
- inputs that are derived principally from or corroborated by observab

e asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or l

Leve l 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

asset or liability’s fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is signific
l need to maximize the use of observable inputs and minimize the use of unobservable inputs.

preceding method described may produce a fair value calculation that may not be indicative of net realizable value or reflective of f
eves its valuation method is appropriate and consistent with other market participants, the use of different methodologies or assum
ruments could result in a different fair value measurement at the reporting date. As of June 30, 2011 and 2010, all of the Company’s
short maturity the carrying amounts are considered to approximate fair value.

4

TE 19 – RECENT ACCOUNTING PRONOUNCEMENTS

May 2011, the FASB issued guidance intended to achieve common fair value measurements and related disclosures between U.S
ndments primarily clarify existing fair value guidance and are not intended to change the application of existing fair value measureme
ances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements
nning after December 15, 2011, and early application is prohibited. The Company will adopt these amendments on January 1, 2012
erial effect.

TE 20 – SUBSEQUENT EVENTS

June 11, 2010, Seven Arts Entertainment, Inc. ("SAE"), a Nevada Corporation, was formed and became a 100% owned subsidiary o
et Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer all of the assets with a cost basis fro
ain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have been distributed to shareholde
LC in order to satisfy any remaining obligations. This transfer was approved by the PLC shareholders at an Extraordinary General M
to eliminate our status as a foreign private issuer and to assume compliance with all obligations of a domestic issuer under all appli
ntion in executing this transaction was to redomicile the business with no change in the economic interests of the shareholders.

of January 27, 2011, net assets with a book value totaling approximately $7,200,000 plus convertible debentures with no redemption d
AE in accordance with the asset transfer agreement.

August 31, 2011, NASDAQ approved the substitution of one share of SAE, Inc. stock for the Company's NASDAQ listing, effective at
, each of the Company's ordinary shares were exchanged for one share of common stock of SAE, and commenced trading on NASDA
s transaction was approved by the Company's shareholders at the Company's Extraordinary General Meeting on June 11, 2010.

E's authorized capital consists of 50,000,000 shares of common stock, $.01 par value per share, of which the board of directors has
tember 1, 2011, there were 6,476,344 shares of common stock outstanding. Each outstanding share of common stock entitles the hold
te of stockholders.

E will be a United States issuer and commenced regular quarterly reporting for the first quarter ended September 30, 2011.

5

ance of New Shares or Options

sequent to June 30, 2011, an aggregate of 13,832,280 ordinary shares were issued, and accordingly there were 16,475,411 shares of the November 30, 2011.

shares issued subsequent to June 30, 2011 include 10,000 shares issued to consultants in exchange for services rendered. $400,000 restr

ain debt securities were partially converted into 11,422,000 ordinary shares at an average per-share price of $0.42.

issuance of the converted debt was made pursuant to the exemption from registration provided pursuant to Section 4(2) of the Securiti lable because (i) no advertising or general solicitation was employed in offering the debt securities, (ii) the offering and sale thereo sfer of the debt securities was restricted in accordance with the requirements of such Act. More than one year passed between the nary shares. In accordance therewith, the resale of such shares was exempt from the registration thereof pursuant to the exemption prov

debt that was converted to equity included $2,750,000 from Palm Finance, $350,000 from 120dB Film and $725,000 of convertible n Eden.

n Finance reinvested $1,250,000 back into SAE, Inc. (PLC's successor entity) by acquiring 125,125 shares of Series A ($10 par) preferr

October 14, 2011, the Board of Directors of SAE Inc. were each issued 50,000 options at the market price of $0.44 a share.

November 21, 2011 SAE, Inc. issued 2,000,000 shares to PLC in accordance with the asset transfer agreement approved by shareholder

er of Intent Regarding David Michery

November 7, 2011, the Company signed a letter of intent to acquire the music assets of David Michery for 10,000,000 shares of preferre

ditors Liquidation of SAP Plc.

was placed into compulsory liquidation on November 8, 2011, by the English Companies Court. PLC's CEO, Mr. Peter Hoffman, this request was denied by the Courts as a result of inter alia the opposition of Parallel Pictures LLC ('Parallel'). The creditors a titioner as liquidator. The role of a liquidator is to realize a company's assets for the benefit of the creditors and shareholders. Mr. Ho stantial claims against Parallel and its defenses to Parallel's claims. Parallel has claimed in the proceedings in England and the United PLC was 'fraudulent' and may seek additional compensation or guarantees SAE Inc. Management believes that the Asset Transfer Ag ck and that Parallel will not prevail in its claims. Management believes it has the support of its creditors to resist these claims by Par lt Parallel will not obtain any relief from the courts on this issue.

ain indebtedness of PLC remained with PLC under the asset transfer agreement and will be subject to liquidation or payment in these li es of common stock of the Company in order to satisfy these obligations.

6

e of Promissory Note to RBSM LLP

September 4, 2011, SAE Inc. issued a promissory note to RBSM LLP ("RBSM"), the Group's prior registered accounting firm. The not
re the six month anniversary of the note. The note bears interest of 7% per annum but this will be waived if the note is paid off within
interest have not been paid in full then RBSM can convert the note into freely trading common shares with an issue price of 75% of th
ng the 10 days preceding the maturity date. In accordance therewith, the resale of such shares will be exempt from the registration there

owhead Action

Arrowhead Target Fund filed an action on September 22, 2010 which seeks recovery from the Group for amounts which the Grou
ements with Arrowhead. In addition, Arrowhead makes substantial additional claims against the Group, Mr. Hoffman and Seven Arts
operative agreements, including failure to properly account, failure to turn over materials, failure to remit monies collected, and si
ches of warranties for damages are $8,300,000 although Arrowhead states no basis for this amount.

Group had moved to dismiss the action against all defendants other than Seven Arts Future Flows I LLC, which is not part of the Gro
ted the Group's motion and dismissed all defendants except Seven Arts Filmed Entertainment Limited in its capacity as a collatera
m. The Group continues to believe that Arrowhead's claims against the Group are without substantial merit, and nothing has been accru

RC Investigation

July 19, 2011 Officers of Her Majesty's Revenue & Customs ("HMRC") attended the offices of Seven Arts Pictures plc (the "Comp
ngements involving the subscription for shares in a number of companies which had lost value, resulting in subscribers making claims t

Company's participation in these transactions was limited to the Company's transfer of rights to certain motion pictures to the inves
ase costs of those pictures and making available the provision of loans to fund a portion of those investments. The Company received
rms-length terms. The Company believes that it is not a subject of the HMRC investigation.

onnection with the transactions, the Company did not make any representations or warranties to any party, including the investo
sactions. Prior to the closing of the transactions the investors obtained and made available to the Company, an opinion of prominen
s, that the transactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws. The Company
acceptable under the terms of the applicable United Kingdom revenue laws.

RC has requested interviews with three officers of the Company to discuss whether those officers were involved in the arrangements fo
npany is fully cooperating with the investigation. The Company believes there is no basis for any claim of responsibility of any of its
he Company, there is no need for it to record a contingent liability in its financial statements in connection with the investigation or the

rd of Directors

Board of Directors of SAE Inc. is the existing six members of the Board of Directors of the Company, plus the addition of Robert Ka
mmittee. SAE will have four members of its Board who are independent as defined by NASDAQ.

llel Action

June 28, 2011, Seven Arts Pictures plc ("PLC") filed an action in the High Court of England against Parallel Media LLC ("Parallel"
ribution rights in Russia to four motion pictures and to confirm Parallel's obligations under both a signed and unsigned investment agre
en. On the same day Parallel filed a petition to wind up and liquidate PLC in the Companies Courts of England based on its claim of re
Winter Queen. That winding up petition will not be heard until some unspecified date after October 10, 2011. PLC is no longer part of th
ngland, which management of PLC believes will be granted and which will result in the denial of Parallel's winding up petition. The c
his administration under English law and should not affect the results of operations of the Group. On September 19, 2011, Par
ertainment Inc. ("SAE") in the Superior Court of California, asserting the same claims as in the winding up petition and seeking to enjo
uest for a preliminary injunction was denied by the Superior Court. PLC will move to dismiss this action since all the operative ag
iring exclusive jurisdiction of all litigation in the courts of England. PLC expects this motion to dismiss will be granted.

cher Joint Venture

Group entered into an agreement with BRG Investments, LLC ("BRG"), an affiliate of Fletcher Asset Management ("Fletcher") for
k of the Group and the formation of a joint venture to, among other things, produce and distribute motion pictures and make investment

8

G purported to cancel the agreement in May 2011.

October 5, 2011, the Company arranged a mutually acceptable settlement of its dispute with Fletcher arising out of an investmen
ounced in a press release on June 7, 2011. In the settlement with Fletcher, the Company waived all claims against Fletcher. Fletcher a
mpany's common stock at a price of $1.00 per share. Fletcher received a warrant to buy an additional 100,000 shares at $1.00, Fletc
,000 shares of the Company's common stock based on a volume weighted average price but no less than $1.00 or more than $1.5
tional warrant to buy an additional 100,000 shares of our common stock on the same terms as the warrant we have issued. Seven
ially fund its next motion picture production in Louisiana entitled Schism, written and to be directed by Adam Gierasch, the director of
he Company.

al Action by Arrowhead Target Fund

Arrowhead Target Fund has filed an action on September 22, 2010, which seeks recovery from the Group of the monies which the Gr
ements with Arrowhead. In addition, Arrowhead makes substantial additional claims against the Group, Mr. Hoffman and Seven Arts
operative agreements, including failure to properly account, failure to turn over materials, failure to remit monies collected, and si
aches of warranties for damages are $8,300,000 although Arrowhead states no basis for this amount. The Group does not believe th
ect to the monies withheld by the Group based on its interpretation of the applicable agreements. The Group intends to aggressiv
ussions with Arrowhead regarding the reacquisition of the 12 motion pictures subject to the Arrowhead transaction. However, the ult
time, and nothing has been accrued related to these claims.

y Office Lease in Los Angeles

December 1, 2011, SAE Inc. entered into an agreement for office space in Los Angeles. The lease is for 60 months at a monthly
ense will be shared with related parties; however, SAE Inc. is joint and severally liable.

9