



Pain Therapeutics, Inc.



*“Swings of fortune bring both predicament and promise.”*

*2008 in Review*

Dear  
Shareholder

**2008 was a tough year.**

For starters, Remoxy was not approved. In December 2008, the FDA informed us that additional non-clinical data would be required to support its approval.

Then stock markets all over the world collapsed. Investors lost confidence in all but ultra-safe investments. Our stock got hammered.

Finally, the general public lost a measure of confidence in corporate America. Drug development is lengthy, complex and expensive. We need people to trust in our work, yet trust trickles down, not up. When blue chip names go bust—AIG, Lehman, Merrill Lynch, etc.—it becomes difficult for the public to believe in small companies that engage in innovative drug development programs.

As I write, the turmoil is on-going. It reminds me of that well-known adage by Thomas Paine: these are the times that try men's souls.

In 2009, biotechnology will remain an important industry, just different, with less funding and fewer players. In this context, cash is king. Cash and fiscal discipline provide staying power to weather the storm.

**Pain Therapeutics has staying power.** We have an interesting pipeline of early and late-stage drug candidates and we don't need to raise capital. Further, in an industry rife with big spenders, Pain Therapeutics has a long history of fiscal discipline.

One of the key elements of **our strategy in 2009 is to spend carefully but to keep innovation at the top of our agenda.**

We must continue to innovate. We must continue to focus on operational excellence and fiscal discipline. We must not be afraid to take measured risks. We must continue to believe that people want new drugs to treat serious conditions. I've told my

Thomas Paine's words, written in 1776, were the opening lines of an aptly named pamphlet, *The American Crisis*. Paine also made it clear that swings of fortune bring both predicament and promise. In our case, the predicament is that drug development is risky and investors are in the midst of re-pricing risk. When this process resets, **I'm confident Pain Therapeutics will regain visibility within the investment community.** Until then, our sector is simply out of favor. The promise is that the regulatory approval of Remoxy may result in rivers of income from a recession-proof product.



managers that if they are energized by these concepts and want to make a difference, then this is a thrilling time to be a part of Pain Therapeutics.

I concede **it takes courage to stay true to your convictions** in these times. With your support, you have my pledge that we'll maintain our mission of making major advances in clinical medicine, always with the certainty of fiscal discipline. This is how we'll emerge as a more valuable company.

Respectfully,

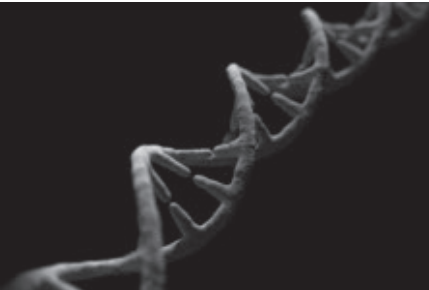
*Remi Barbier*

Remi Barbier  
Shareholder Since 1998  
Chairman of the Board, President & CEO

## Corporate Overview

Pain Therapeutics, Inc. is a biopharmaceutical company based outside of San Francisco. We develop novel drugs. In addition to REMOXY®, a unique, abuse-resistant controlled-release oxycodone, **we have three drug candidates in clinical programs**, including a monoclonal antibody to treat metastatic melanoma. We are also working on a new biological treatment for patients with hemophilia.

The strength of Pain Therapeutics is in our science objectives and our fiscal discipline. We ended the year 2008 with over \$190 million in cash and investments and no debt. In 2009, we expect our net cash burn will be approximately \$10 million.



## Monoclonal Antibody

Pain Therapeutics has a novel monoclonal antibody technology to treat **metastatic melanoma**, a rare but deadly form of skin cancer.

Historically, monoclonal antibodies have been ineffective in melanoma. In a new twist, a research team from Albert Einstein College of Medicine **developed a novel approach** to treat metastatic melanoma based on targeting melanin, a skin pigment that is released from melanotic tumor cells. Radio-labeled monoclonal antibodies seek out unbound melanin and destroy tumor cells with a lethal dose of ionizing radiation, thus achieving a therapeutic effect. Melanin in normal, healthy tissue is not targeted because it is inside the cells and thus not accessible to the antibody.

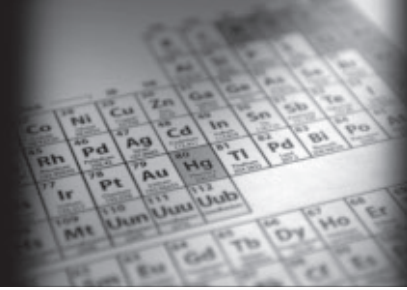
In June 2008, we announced the **successful completion** of our first clinical study in metastatic melanoma. A second clinical study began in 2009.

We own exclusive worldwide commercial rights to this antibody.

## Product Pipeline

Drug Candidate	Indication	Status	Commercial Rights
<b>Monoclonal Antibody</b>	<b>Metastatic melanoma</b>	<b>Phase I</b>	<b>Pain Therapeutics, Inc.</b>
<b>Factor IX Replacement</b>	<b>Hemophilia</b>	<b>Pre-clinical</b>	<b>Pain Therapeutics, Inc.</b>
<b>REMOXY</b>	<b>Moderate/severe chronic pain</b>	<b>Phase III successful; FDA Response Q4 '08</b>	<b>King Pharmaceuticals, Inc.</b>
<b>PTI-202</b>	<b>Moderate/severe chronic pain</b>	<b>Phase I</b>	<b>King Pharmaceuticals, Inc.</b>

Note: None of our drug candidates are approved by the U.S. Food and Drug Administration.



## Factor IX Replacement

Researchers at Stanford University have developed a **novel gene integration technology to treat hemophilia**, a rare blood disorder. This patented technology proposes to replace daily or weekly protein replacement therapy with a single, lasting procedure that promotes normal blood coagulation. The key is to insert a healthy copy of the human gene for Factor IX, a protein responsible for blood clotting, into the cells of a hemophilia patient. If this method promotes robust, persistent and normal levels of Factor IX, patients may be cured of hemophilia.

Importantly, this method of gene integration does not rely on viral vectors. Instead, researchers have demonstrated that a bacteriophage integration system provides a **precise method for directing and inserting a gene** of interest into chromosomes.

In a pre-clinical experiment published in *Nature Biotechnology*, this method of gene integration was shown to be **highly site-specific**. It also resulted in robust, persistent and normal levels of Factor IX in mice.

Pain Therapeutics owns exclusive worldwide commercial rights to this technology.

*Pain Therapeutics, Inc.*  
2008 Form 10-K





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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**Form 10-K**

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(Mark One)

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

For the Fiscal Year Ended December 31, 2008

or

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

Commission File Number: **000-29959**

**Pain Therapeutics, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**91-1911336**  
(I.R.S. Employer  
Identification Number)

**2211 Bridgepointe Parkway  
Suite 500  
San Mateo, CA 94404  
(650) 624-8200**

(Address, including zip code, or registrant's principal executive offices and  
telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act: Common Stock, \$0.001 par value**

**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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to 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, 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

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates was \$419,667,047 computed by reference to the last sales price of \$7.90 as reported on the NASDAQ Global Market, as of the last business day of the Registrant's most recently completed second fiscal quarter, June 30, 2008.

The number of shares outstanding of the Registrant's common stock on January 12, 2009 was 42,078,231.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's Proxy Statement for its 2009 Annual Meeting of Stockholders (the "Proxy Statement"), to be filed with the Securities and Exchange Commission, are incorporated by reference to Part III of this Form 10-K Report.

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**PAIN THERAPEUTICS, INC.**

**FORM 10-K  
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## PART I

This document contains forward-looking statements that are based upon current expectations that are within the meaning of the Private Securities Reform Act of 1995. We intend that such statements be protected by the safe harbor created thereby. Forward-looking statements involve risks and uncertainties and our actual results and the timing of events may differ significantly from the results discussed in the forward-looking statements. Examples of such forward-looking statements include, but are not limited to statements about:

- submission of additional non-clinical data to the U.S. Food and Drug Administration, or FDA, to support the potential approval of the New Drug Application, or NDA, for Remoxy®;
- royalty, milestone or collaboration revenue we may receive from King Pharmaceuticals, Inc., or King, and other payments we may receive from our strategic alliances;
- the duration of the development period for all four expected drug candidates under our collaboration with King;
- anticipated clinical trials and preclinical studies;
- potential sources of commercial supply of Remoxy and its components;
- expansion of our potential product line, including the formulation of additional dosage forms of our drug candidates;
- future operating losses and anticipated operating and capital expenditures;
- uses of proceeds from our securities offerings;
- the potential benefits of our drug candidates;
- the sufficiency of materials required for the clinical development of our drug candidates;
- the size of the potential market for our products;
- the utility of protection of our intellectual property;
- expected future sources of revenue and capital and increasing cash needs;
- potential competitors or competitive products;
- future market acceptance of our drug candidates and potential drug candidates;
- expenses increasing or fluctuations in our operating results;
- future expectations regarding trade secrets, technological innovations, licensing agreements and outsourcing of certain business functions;
- anticipated hiring and development of our internal systems and infrastructure;
- the sufficiency of our current resources to fund our operations over the next twelve months;
- assumptions and estimates used for our disclosures regarding stock-based compensation; and
- estimates concerning the provision for (benefit from) income taxes and realization of deferred tax assets.

Such forward-looking statements involve risks and uncertainties, including, but not limited to, those risks and uncertainties relating to:

- the possibility of the FDA requesting additional non-clinical data which would significantly delay or prevent the potential approval of Remoxy;
- the successful development and commercialization of Remoxy and other drug candidates pursuant to our collaboration agreement with King and development of other drug candidates pursuant to our other collaboration agreements, and the continuation of such agreements;
- difficulties or delays in development, testing, clinical trials (including patient enrollment), regulatory approval, production and commercialization of our drug candidates;

- unexpected adverse side effects or inadequate therapeutic efficacy of our drug candidates that could slow or prevent product approval (including the risk that current and past results of clinical trials are not indicative of future results of clinical trials) or potential post-approval market acceptance;
- the uncertainty of protection of our intellectual property rights or trade secrets;
- potential infringement of the intellectual property rights of third parties;
- pursuing in-license and acquisition opportunities;
- maintenance or third party funding of our collaboration and license agreements;
- hiring and retaining personnel; and
- our financial position and our ability to obtain additional financing if necessary.

In addition, such statements are subject to the risks and uncertainties discussed in the “Risk Factors” section and elsewhere in this document.

## **Item 1. *Business***

### **Overview**

We are a biopharmaceutical company that develops novel drugs. In June 2008, we submitted an NDA for Remoxy with the FDA. In August 2008, we and King announced that an NDA for Remoxy was accepted by the FDA and granted Priority Review, which generally results in a reduction in the time for FDA review of an NDA from 12 months to approximately 6 months from the date of the NDA submission. In December 2008, we received a Complete Response Letter for our NDA for Remoxy in which the FDA determined that the NDA was not approved. The FDA indicated additional non-clinical data will be required to support the approval of REMOXY. The FDA has not requested or recommended additional clinical efficacy studies prior to approval. We plan to meet with the FDA in the second quarter of 2009 regarding the NDA for Remoxy. We believe this FDA meeting will provide us with a more reliable context in which to make projections about Remoxy.

We also have the following investigational drug candidates in clinical programs:

- PTI-202 and PTI-721, which are proprietary, abuse-resistant forms of opioid drugs.
- A novel radio-labeled monoclonal antibody drug candidate to treat metastatic melanoma, a deadly form of skin cancer.

We and King are engaged in a strategic alliance to develop and commercialize Remoxy, PTI-202, PTI-721 and another abuse-resistant opioid painkiller. King is also obligated to fund certain development expenses incurred by us pursuant to the collaboration agreement.

### *Remoxy*

Remoxy is a novel controlled-release oral capsule form of oxycodone in a highly viscous liquid formulation matrix that includes novel excipients. It is specifically formulated to help address issues of abuse and misuse of time-release oxycodone tablets. Sales of time-release oxycodone were estimated to be over \$2.0 billion in 2008.

The analgesic action of extracts of the opium poppy plant has been known for millennia. In more recent decades, semi-synthetic opium derivatives, such as oxycodone, a generic drug in clinical use since the 1930's, have become a standard of care for treating moderate-to-severe pain.

It is also well-known that medicinal opioids such as oxycodone can produce both analgesia and euphoria. The search for euphoric effects can lead to drug-seeking behavior, tolerance and dependence. In particular, rapid increases in plasma levels of oxycodone may lead to overdose, respiratory depression or death.

Opioid misuse and abuse are significant public health problems. The active drug ingredient in time-release oxycodone is oxycodone, an FDA approved substance for the relief of moderate to severe pain. Oxycodone is generally considered safe and effective when properly prescribed, dispensed and administered for legitimate medical purposes.

However, the U.S Drug Enforcement Administration, or DEA, has reported that time-release oxycodone tablet abuse has substantially increased since FDA approval of time-release oxycodone tablet abuse. Abusers can quickly and easily extract large amounts of oxycodone by simply breaking or crushing time-release oxycodone tablets. Doing so disrupts this time release mechanism and allows an abuser to immediately ingest, snort or inject a large dose of oxycodone that was originally intended to be slowly release over 12 hours. Rapid increases in plasma levels of oxycodone may lead to overdose, respiratory depression or death. Patients may mistakenly cut or crush the time-release oxycodone tablets, which may also lead to accidental overdose.

The Remoxy formulation is designed to resist common methods of chemical or physical manipulation. Remoxy's capsule dosage form provides therapeutic drug levels of oxycodone on a twice-daily dosing schedule, while resisting the rapid increases in plasma levels of oxycodone associated with common methods of abuse and misuse. Its formulation also resists delivery by unapproved routes of administration, such as injection, snorting or inhalation.

Remoxy is intended to meet the needs of physicians who appropriately prescribe opioid painkillers and who seek to minimize the risks of drug diversion, abuse or accidental patient misuse as well as the needs of pharmacists and the managed care healthcare system in the United States.

#### *Other abuse resistant product candidates*

We believe the abuse-resistant technology used in Remoxy is applicable to different oral opioid painkillers. Our strategic alliance with King includes three other product candidates. PTI-202 and PTI-721 have completed Phase I clinical trials. The active ingredients in PTI-202 and PTI-721 are opioids whose identities have not been announced. These Phase I clinical trials were designed to investigate the safety, tolerability, pharmacokinetics and pharmacodynamic profile of a single, oral dose of the drug candidates in healthy volunteers. We believe results also indicate these product candidates are safe and well-tolerated and their release profile appears well-suited to use with a chronic pain population. Like Remoxy, PTI-202 and PTI-721 are intended to meet the needs of physicians who appropriately prescribe opioid painkillers and who seek to minimize the risks of drug diversion, abuse or accidental patient misuse. King made milestone payments to us of \$5.0 million in 2008 in connection with the acceptance by the FDA of the investigational new drug application, or IND, for PTI-721 and \$5.0 million in 2006 in connection with the acceptance by the FDA of the IND for PTI-202. We and King are also conducting pre-clinical development of a fourth product candidate.

#### *Metastatic Melanoma*

Our monoclonal antibody program, developed at Albert Einstein College of Medicine, is aimed at treating patients with metastatic melanoma. These monoclonal antibodies deliver lethal radiation to melanoma tumors. The technology may also have therapeutic uses outside of oncology, such as infectious diseases. We licensed exclusive worldwide commercial rights to this technology from Albert Einstein College of Medicine.

We believe that this antibody technology may enable clinicians to provide effective medical treatment for metastatic melanoma, a deadly form of skin cancer and that the specificity of this treatment may be effective against tumors without harming normal tissue.

In June 2008, we announced the successful completion of our first clinical study using the radio-labeled monoclonal antibody technology. The objectives of this study were to assess safety, pharmacokinetics and

dosimetry. Top-line results of this clinical study indicate this antibody binds to melanoma tumor sites. No drug-related serious adverse events were observed in this study. In 2009, we plan to initiate a second clinical study in which patients will receive increasing amounts of the radio-labeled antibody. We expect to complete the second clinical study in the second half of 2009.

The antibody technology being developed for metastatic melanoma may also have therapeutic uses outside of oncology. We are conducting pre-clinical studies using this technology in certain infectious diseases. We plan to continue these pre-clinical studies in 2009.

### *Hemophilia*

Our gene transfer program, developed at Stanford University, is aimed at correcting an underlying genetic defect in patients with hemophilia. Sometimes known as ‘the bleeding disease’, hemophilia affects 400,000 people worldwide with average treatments ranging between \$60,000 and \$150,000 per patient/year. We licensed this technology from Poetic Genetics, LLC, or Poetic. During 2008, we conducted a variety of pre-clinical studies with this technology. We expect to complete an animal study with this technology in 2009.

### **Strategy**

Our goal is to continue to develop novel drugs that are more effective or safer than drugs used in the clinic today. Our strategy includes the following elements:

*Focus on Clinical Development Stage Products.* We believe this focus will enable us to generate product revenues earlier than if we were focused on early-stage research and discovery activities.

*Retain Significant Rights to Our Drugs.* We currently retain worldwide commercialization rights to all of our technology and drug candidates in all markets and indications, except for Remoxy and certain other abuse-resistant drugs that are subject to our strategic alliance with King. In general, we intend to independently develop our drug candidates through late-stage clinical trials. In market segments that require large or specialized sales forces, we may seek sales and marketing alliances with third parties.

*Outsource Key Functions.* We intend to continue to outsource preclinical studies, clinical trials and formulation and manufacturing activities. We believe outsourcing permits significant time savings and allows for more efficient deployment of our resources.

*Pursue In-licensing or Acquisition Opportunities.* We intend to evaluate promising drug candidates or technologies to further expand our product pipeline. Our in-licensing strategy consists of evaluating clinical or preclinical stage opportunities in therapeutic areas that can benefit from our core expertise in drug development. Such in-licensing or acquisition opportunities may be in pain management or in other therapeutic areas outside of pain management. We believe this element of our corporate strategy could diversify some of the risks inherent in focusing on a single therapeutic area and could also increase our probability of commercial success.

We also conduct basic research in collaboration with academic and other partners. Company sponsored research and development expenditures were \$46.8 million, \$47.7 million and \$45.8 million in 2006, 2007, and 2008 respectively. We recorded contract revenue of \$22.7 million, \$42.7 million \$29.4 million in 2006, 2007, and 2008 respectively, related to customer-sponsored research activities under our collaboration with King.

### **Our Intellectual Property**

We seek to protect our technology by, among other methods, filing and prosecuting U.S. and foreign patents and patent applications with respect to our technology and products and their uses. The focus of our patent strategy is to secure and maintain intellectual property rights to technology for the following categories of our business:

- the technology that forms the basis of Remoxy and our other abuse resistant drug candidates drug candidates;

- the clinical use of an ultra-low-dose opioid antagonist, either alone or in combination with an opioid painkiller, for pain management and opioid and other addiction;
- the use of an ultra-low-dose opioid antagonist to render opioid-based products more effective;
- the clinical use of an ultra-low-dose opioid antagonist, either alone or in combination with any opioid painkiller, for the treatment of other conditions;
- the clinical use of radio-labeled monoclonal antibodies for the treatment of metastatic melanoma and certain therapeutic uses outside of oncology;
- the clinical uses of a unique gene integration system intended to treat hemophilia or pain;
- the technologies or intellectual property related to our pre-clinical product candidates; and
- the manufacture and use of our drug candidates.

We plan to prosecute and defend our patent applications, issued patents and proprietary information. Our competitive position and potential future revenues will depend in large part upon our ability to protect our intellectual property from challenges and to enforce our patent rights against potential infringements.

We and our collaborators have filed patent applications with the U.S. Patent Office to further protect our technologies. Certain patents are issued and a number of patent applications are pending. If issued, we believe these applications would protect certain of our technologies through at least 2020. If these patent applications do not result in issued patents, the duration or scope of our patent rights may be limited and our future revenues could be lower as a result.

If our competitors are able to successfully challenge the validity or scope of our patent rights, based on the existence of prior art or otherwise, they might be able to market products that contain features and clinical benefits similar to those of our drug candidates, and demand for our drug candidates could decline as a result.

We may be involved in additional challenges to our intellectual property. An adverse outcome of any challenges to our intellectual property could result in loss of claims of these patents that pertain to certain drugs we currently have under development and could have a material adverse impact on our future revenues.

### **Strategic Alliance with King Pharmaceuticals, Inc.**

We have a collaboration agreement and a license agreement with King to develop and commercialize Remoxy and other abuse-resistant opioid painkillers. King made an upfront cash payment of \$150.0 million to us at the closing of this strategic alliance in 2005.

In 2008, we received \$20.0 million in cumulative milestone payments from King for achieving clinical and regulatory milestones, including \$15.0 million related to acceptance by the FDA of the NDA for Remoxy, and \$5.0 million of acceptance by the FDA of the IND for PTI-721. In 2006, we received \$5.0 million for the acceptance by the FDA of the IND for PTI-202. We could also receive from King up to \$125.0 million in additional milestone payments in the course of clinical development of Remoxy and other abuse-resistant opioid painkillers under the strategic alliance. In addition, subject to certain limitations, King is obligated to fund development expenses incurred by us pursuant to the collaboration agreement.

Pursuant to the license agreement, King is obligated to fund the commercialization expenses of, and has the exclusive right to market and sell, drugs developed pursuant to the strategic alliance, and is obligated to pay us a 20% royalty on net sales, except as to the first \$1.0 billion in cumulative net sales, for which the royalty is set at 15%. King is also obligated to reimburse us for our payment of third-party royalty obligations related to this strategic alliance.

We formed a joint oversight committee, or JOC, with King to oversee drug development and commercialization strategies for the strategic alliance. Pursuant to the collaboration agreement in the strategic alliance, we retain sole control of drug development activities in the United States through Phase II clinical trials. We and King will jointly manage Phase III clinical trials and NDA submissions in the United States. King has responsibility for these development activities outside the United States. Upon regulatory approval, King will assume sole control and worldwide responsibility to exclusively commercialize abuse-resistant opioid drugs developed pursuant to the strategic alliance. We retain all development and commercial rights in Australia and New Zealand.

The collaboration agreement continues until the later of the expiration of any patent rights licensed under the license agreement or developed under the collaboration agreement and the expiration of all periods of market exclusivity with respect to Remoxy and other abuse-resistant opioid drug candidates being developed under the strategic alliance. We and King can terminate the collaboration agreement under certain circumstances, including material breach and insolvency. King can terminate the collaboration agreement six months after the third anniversary of the effective date of the collaboration agreement, or sooner if the JOC determines that the development program under the collaboration agreement is unlikely to generate any marketable products. Our license agreement with King terminates at the time that the collaboration agreement terminates.

### **Formulation Agreement with Durect Corporation**

We have an exclusive, worldwide licensing agreement with Durect Corporation, or Durect, to use a patented technology that forms the basis for a number of oral gel-cap drug candidates, including Remoxy. We have sub-licensed to King certain rights to develop and to commercialize Remoxy and certain other opioid drugs formulated in part with technology we licensed from Durect. Under the agreement with Durect, we control all of the preclinical, clinical, commercial manufacturing and sales/marketing activities for Remoxy and other abuse-resistant opioid painkillers. We reimburse Durect for formulation and related work, and make milestone payments based on the achievement of certain technical, clinical or regulatory milestones. Durect will supply us with certain components of Remoxy and other abuse-resistant opioid painkillers on a cost-plus basis. We also are obligated to pay Durect royalties on any related drug sales. In turn, King is obligated to reimburse us for costs we incur under the agreement with Durect, including milestone payments and royalties.

Under our license agreement with King, we are obligated not to amend or terminate our agreement with Durect if an amendment or termination would alter the rights or obligations of King under the collaboration agreement or license agreement.

### **License of Technology from Albert Einstein College of Medicine**

We have licensed certain technology, including antibody technology, from Albert Einstein College of Medicine. We have a worldwide exclusive license to the technology and all intellectual property rights arising from the technology. Pursuant to the agreements for the licensed technology, we are required to pay Albert Einstein College of Medicine clinical milestone payments and royalties based on a percentage of net drug sales. If a product is combined with a drug or other substance for which we are paying an additional royalty, the royalty that we pay to Albert Einstein College of Medicine will be reduced by up to one-half of the amount of such additional royalty.

Albert Einstein College of Medicine originally received grants from the U.S. federal government to research some of the technology that we license. The terms of these grants provide the U.S. federal government with a non-exclusive, non-transferable paid-up license to practice inventions made with federal funds. Thus, our licenses are non-exclusive to the extent of the U.S. federal government's license. If the U.S. federal government exercises its rights under this license, it could make use of the same technology that we license and the size of our potential market could thereby be reduced.



## **License of Technology from Poetic Genetics, LLC**

We have licensed novel gene integration technology from Poetic. We have worldwide commercial rights and all intellectual property rights arising from the technology in all indications in hemophilia and pain management. In connection with the license, we paid Poetic an undisclosed upfront fee and we are obliged to pay Poetic milestone payments of up to \$4 million in the aggregate, based on clinical and regulatory progress, and a 4% royalty on net sales, or 6% if the first U.S. sale of a licensed product to treat hemophilia occurs before January 1, 2011.

## **Manufacturing**

We do not own any manufacturing facilities. We plan to continue to outsource formulation, manufacturing and related activities.

We rely on a limited number of third-party manufacturers to formulate, manufacture, fill, label, ship or store all of our drug candidates. We have entered into agreements with and rely upon qualified third parties for the formulation or manufacture of our clinical supplies. These supplies and the manufacturing facilities must comply with DEA regulations and current good manufacturing practices, or GMPs, enforced by the FDA and other government agencies.

We and King rely on Durect and other third-party manufacturers to formulate, manufacture, fill, label, ship or store Remoxy and other abuse-resistant drug candidates and their components. King is responsible for commercial manufacturing and supply of Remoxy. Remoxy and other product candidates under our strategic alliance with King are formulated using, in part, proprietary technology licensed from Durect. Remoxy uses bulk oxycodone supplied by Noramco, Inc.

## **Government Regulation**

Regulation by governmental authorities in the United States and other countries is a significant factor in the manufacture and marketing of pharmaceuticals and in our ongoing research and development activities. All of our products will require regulatory approval by governmental agencies prior to commercialization. In particular, human therapeutic products are subject to rigorous preclinical testing and clinical trials and other pre-marketing approval requirements by the FDA and regulatory authorities in other countries. In the United States, various federal, and in some cases state, statutes and regulations also govern or impact upon the manufacturing, safety, labeling, storage, record keeping and marketing of our products. The lengthy process of seeking required approvals and the continuing need for compliance with applicable statutes and regulations require us to spend substantial resources. Regulatory approval, when and if obtained, may be limited in scope which may significantly limit the indicated uses for which our products may be marketed. Further, approved drugs, as well as their manufacturers, are subject to ongoing review and discovery of previously unknown problems with such products that may result in restrictions on their manufacture, sale or use or in their withdrawal from the market. For example, on February 9, 2009, the FDA announced it had invited the sponsors of opioid drug products to a private meeting in March 2009 in order to begin the process of developing Risk Evaluation and Mitigation Strategies for opioid drugs. According to FDA's announcement, opioid drugs affected by this announcement include both brand name and generic products that contain fentanyl, hydromorphone, methadone, morphine, oxycodone and oxymorphone.

Applicable FDA regulations require the filing of an NDA or a Biologic License Application, or BLA and approval by the FDA prior to commercialization of any of our drug candidates in the United States.

### *The Drug Approval Process*

We will be required to complete several activities before we can market any of our drug candidates for human use in the United States, including:

- preclinical studies;

- submission to the FDA of an IND which must become effective before human clinical trials commence;
- adequate and well-controlled human clinical trials to establish the safety and efficacy of the drug candidate;
- submission to the FDA of an NDA; and
- FDA approval of the NDA prior to any commercial sale or shipment of the drug.

Preclinical tests include laboratory evaluation of product chemistry and formulation, as well as animal studies to assess the potential safety of the product. Preclinical safety tests must be conducted by laboratories that comply with FDA regulations regarding Good Laboratory Practice. We submitted the results of preclinical tests to the FDA as part of our INDs prior to commencing clinical trials. We may be required to conduct additional toxicology studies.

Based on preclinical testing, an IND is filed with the FDA to begin human testing of the drug in the United States. The IND becomes effective if not rejected by the FDA within 30 days. The IND must indicate the results of previous experiments, how, where and by whom the new clinical trials will be conducted, the chemical structure of the compound, the method by which it is believed to work in the human body, any toxic effects of the compound found in the animal studies and how the compound is manufactured. All clinical trials must be conducted in accordance with Good Clinical Practice. In addition, an Institutional Review Board, or IRB, generally comprised of physicians at the hospital or clinic where the proposed clinical trials will be conducted, must review and approve the IND. The IRB also continues to monitor the clinical trial. We must submit progress reports detailing the results of the clinical trials to the FDA at least annually. In addition, the FDA may, at any time during the 30-day period or at any time thereafter, impose a clinical hold on proposed or ongoing clinical trials. If the FDA imposes a clinical hold, clinical trials under the IND cannot commence or recommence without FDA authorization and then only under terms authorized by the FDA. An FDA imposed clinical hold on an IND application can result in substantial delay and large, unforeseen expenses, and it may cancel the viability of developing a new drug candidate in the United States.

Clinical trials are typically conducted in three sequential phases that may overlap. Phase I clinical trials typically study a drug's safety profile, and may include the safe dosage range. Phase I clinical trials also determine how a drug is absorbed, distributed, metabolized and excreted by the body, and the duration of its action. In addition, we may, to the extent feasible, assess early indicators of a drug's efficacy in our Phase I clinical trials. In Phase II clinical trials, controlled studies are conducted on volunteer patients with the targeted disease or condition. The primary purpose of these tests is to evaluate the effectiveness of the drug on the volunteer patients as well as to determine a drug's side effect profile. These clinical trials may be conducted concurrently with Phase I clinical trials. In addition, Phase I/II clinical trials may be conducted to evaluate not only the efficacy of the drug on the patient population, but also its safety. During Phase III clinical trials, the drug is studied in an expanded patient population and in multiple sites. Physicians monitor the patients to determine efficacy and to observe and report adverse events that may result from use of the drug.

Our clinical trials are designed to produce clinical information about how our drugs perform compared to placebo or compared to existing opioid drugs where appropriate. We have designed most Phase II and Phase III clinical trials to date as randomized, double-blind, placebo-controlled, dose-ranging studies. A randomized clinical trial is one in which patients are randomly assigned to the various study treatment arms. A double-blind clinical trial is one in which the patient, the physician and our trial monitor are unaware if the patient is receiving placebo or study drug in order to preserve the integrity of the clinical trial and reduce bias. A placebo-controlled clinical trial is one in which a subset of patients is purposefully given inactive medication.

We may not successfully complete Phase I, Phase II or Phase III clinical trials within any specified time period, or at all, with respect to any of our drug candidates. Furthermore, we or the FDA may suspend clinical trials at any time in response to concerns that participants are exposed to an unacceptable health risk.

After the completion of clinical trials, if there is substantial evidence that the drug is safe and effective, an NDA is filed with the FDA. The NDA must contain all of the information on the drug gathered to that date, including data from the clinical trials. NDAs are often the equivalent of over 100,000 pages in length.

The FDA reviews all NDAs submitted before it accepts them for filing and may request additional information rather than accepting an NDA for filing. In such an event, the NDA must be resubmitted with the additional information and, again, is subject to review before filing. Once the submission is accepted for filing, the FDA begins an in-depth review of the NDA. Under the Federal Food, Drug and Cosmetic Act, the FDA has 180 days in which to review the NDA and respond to the applicant. The review process is typically extended for significant amounts of time by the FDA's requests for additional information or clarification regarding information already provided in the submission. The FDA may refer the application to an appropriate advisory committee, typically a panel of clinicians, for review, evaluation and a recommendation as to whether the application should be approved. The FDA is not bound by the recommendation of an advisory committee. If the FDA's evaluations of the NDA and the manufacturing facilities are favorable, the FDA may issue either a Complete Response Letter indicating either an approval or may identify conditions that must be met in order to secure final approval of the NDA. When and if those conditions have been met to the FDA's satisfaction, the FDA will issue an approval letter, authorizing commercial marketing of the drug for certain indications. If the FDA's evaluation of the NDA submission or manufacturing facilities is not favorable, the FDA may refuse to approve the NDA or issue a not approvable letter.

If the FDA approves the NDA, the drug becomes available for physicians to prescribe. Periodic reports must be submitted to the FDA, including descriptions of any adverse reactions reported. The FDA may request additional post marketing studies, or Phase IV clinical trials, to evaluate long-term effects of the approved drug.

The process for FDA approval of a BLA is similar to the process for FDA approval of an NDA.

#### *Other Regulatory Requirements*

The FDA mandates that drugs be manufactured in conformity with current GMP. If the FDA approves any of our drug candidates we will be subject to requirements for labeling, advertising, record keeping and adverse experience reporting. Failure to comply with these requirements could result, among other things, in suspension of regulatory approval, recalls, injunctions or civil or criminal sanctions. We may also be subject to regulations under other federal, state, and local laws, including the Occupational Safety and Health Act, the Environmental Protection Act, the Clean Air Act, national restrictions on technology transfer, and import, export, and customs regulations. In addition, any of our products that contain narcotics will be subject to DEA regulations relating to manufacturing, storage, distribution and physician prescribing procedures. It is possible that any portion of the regulatory framework under which we operate may change and that such change could have a negative impact on our current and anticipated operations.

The Controlled Substances Act imposes various registration, record-keeping and reporting requirements, procurement and manufacturing quotas, labeling and packaging requirements, security controls and a restriction on prescription refills on certain pharmaceutical products. A principal factor in determining the particular requirements, if any, applicable to a product is its actual or potential abuse profile. 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. Any of our drug candidates that contain a scheduled substance will be subject to regulation by the DEA.

#### **Competition**

Our success will depend, in part, upon our ability to achieve market share at the expense of existing and established and future products in the relevant target markets. Existing and future products, therapies, technological approaches or delivery systems will compete directly with our products. Competing products may provide greater therapeutic benefits for a specific indication, or may offer comparable performance at a lower cost. Companies that currently sell generic or proprietary opioid formulations include, but are not limited to,

Roxane Laboratories, Purdue Pharma, Abbott Laboratories, Cephalon, Endo Pharmaceuticals, Teva Pharmaceuticals, Elkins-Sinn, Watson Laboratories, Ortho-McNeil Pharmaceutical and Forest Pharmaceuticals. Alternative technologies are being developed to increase opioid potency, as well as alternatives to opioid therapy for pain management, and improved treatments for metastatic melanoma and hemophilia, several of which are in clinical trials or are awaiting approval from the FDA.

We compete with fully integrated pharmaceutical companies, smaller companies that are collaborating with larger pharmaceutical companies, academic institutions, government agencies and other public and private research organizations. Many of these competitors have opioid drugs already approved by the FDA or in development and operate larger research and development programs in these fields than we do. In addition, many of these competitors, either alone or together with their collaborative partners, have substantially greater financial resources than we do, as well as significantly greater experience in:

- developing drugs;
- undertaking preclinical testing and human clinical trials;
- obtaining FDA and other regulatory approvals of drugs;
- formulating and manufacturing drugs; and
- launching, marketing, distributing and selling drugs.

Developments by competitors may render our drug candidates or technologies obsolete or non-competitive. We also compete with these companies for qualified personnel and opportunities for product acquisitions, joint ventures or other strategic alliances

### **Incorporation**

We were incorporated in Delaware in May 1998.

### **Employees**

As of December 31, 2008, we had 48 employees. We engage consultants from time to time to perform services on a per diem or hourly basis.

### **Available Information**

We file electronically with the Securities and Exchange Commission, or SEC, our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. The public may read or copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, 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. The address of that site is <http://www.sec.gov>.

You may obtain a free copy of our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K and amendments to those reports on the day of filing with the SEC on our website on the World Wide Web at <http://www.paintrials.com>, by contacting the Investor Relations Department at our corporate offices by calling 650-624-8200 or by sending an e-mail message to [cwaarich@paintrials.com](mailto:cwaarich@paintrials.com).

### **Item 1A. Risk Factors**

Our future operating results may vary substantially from anticipated results due to a number of factors, many of which are beyond our control. The following discussion highlights some of these factors and the possible impact of these factors on future results of operations. You should carefully consider these factors

before making an investment decision. If any of the following factors actually occur, our business, financial condition or results of operations could be harmed. In that case, the price of our common stock could decline, and you could experience losses on your investment in our common stock.

### *Clinical and Regulatory Risks*

**If we fail to obtain the necessary regulatory approvals, or if such approval is limited, we will not be allowed to commercialize our drug candidates, and we will not generate product revenues.**

Satisfaction of all regulatory requirements typically takes many years, is dependent upon the type, complexity and novelty of the drug candidate, and requires the expenditure of substantial resources for research and development. In June 2008, we filed a New Drug Application, or NDA with the U.S. Food and Drug Administration, or FDA for our drug candidate Remoxy. In December 2008, we received a Complete Response Letter from the FDA for our NDA for Remoxy. The FDA indicated additional non-clinical data will be required to support the approval of REMOXY. We plan to meet with the FDA in the second quarter of 2009 regarding the NDA for Remoxy. We believe this FDA meeting will provide us with a more reliable context in which to make projections about Remoxy. If the FDA were to require additional data, providing such data may significantly delay the potential approval of Remoxy.

Our research and clinical approaches may not lead to drugs that the FDA considers safe for humans and effective for indicated uses we are studying. The FDA may require us to conduct additional non-clinical studies, in which case we would have to expend additional time and resources and would likely delay the date of potentially receiving regulatory approval. The approval process may also be delayed by changes in government regulation, future legislation or administrative action or changes in FDA policy that occur prior to or during our regulatory review. Delays in obtaining regulatory approvals would:

- delay commercialization of, and product revenues from, our drug candidates; and
- diminish the competitive advantages that we may have otherwise enjoyed, which would have an adverse effect on our operating results and financial condition.

Even if we comply with all FDA regulatory requirements, we may never obtain regulatory approval for any of our drug candidates. If we fail to obtain regulatory approval for any of our drug candidates we will have fewer commercial products, if any, and corresponding lower product revenues, if any. Even if we receive regulatory approval of our drug candidates, such approval may involve limitations on the indications and conditions of use or marketing claims we may make for our products. Further, later discovery of previously unknown problems or adverse events could result in additional regulatory restrictions, including withdrawal of products. The FDA may also require us to commit to perform lengthy Phase IV post-approval clinical trials, for which we would have to expend additional resources, which could have an adverse effect on our operating results and financial condition.

In jurisdictions outside the United States, we must receive marketing authorizations from the appropriate regulatory authorities before we can commercialize our drugs. Regulatory approval processes outside the United States generally include all of the aforementioned requirements and risks associated with FDA approval.

**If we are unable to design, conduct and complete clinical trials successfully, we will not be able to obtain regulatory approval for our drug candidates.**

In order to obtain FDA approval for any of our drug candidates, we must submit to the FDA an NDA that demonstrates with substantive evidence that the drug candidate is both safe and effective in humans for its intended use. This demonstration requires significant research and animal tests, which are referred to as preclinical studies, as well as human tests, which are referred to as clinical trials.

Results from our Phase I clinical programs may not support moving a drug candidate to Phase II or Phase III clinical trials. Our Phase III clinical trials may not demonstrate the safety or efficacy of our drug candidates.

Success in preclinical studies and early clinical trials does not ensure that later clinical trials will be successful. Results of later clinical trials may not replicate the results of prior clinical trials and preclinical studies. Even if the results of our Phase III clinical trials are positive, we may have to commit substantial time and additional resources to conducting further preclinical studies and clinical trials before we can obtain FDA approval for any of our drug candidates.

Clinical trials are very expensive and difficult to design and implement, in part because they are subject to rigorous requirements. The clinical trial process also consumes a significant amount of time. Furthermore, if participating patients in clinical trials suffer drug-related adverse reactions during the course of such clinical trials, or if we or the FDA believe that participating patients are being exposed to unacceptable health risks, we will have to suspend or terminate our clinical trials. Failure can occur at any stage of the clinical trials, and we could encounter problems that cause us to abandon or repeat clinical trials.

Our clinical trials with Remoxy and our future clinical trials for other drug candidates for treatment of pain measure clinical symptoms, such as pain and physical dependence. These symptoms are not biologically measurable. The success of Remoxy and our other abuse resistant drug candidates in clinical trials depends on reaching statistically significant changes in patients' symptoms based on clinician-rated scales. Due in part to a lack of consensus on standardized processes for assessing clinical outcomes, these scores may or may not be reliable, useful or acceptable to regulatory agencies.

We have no history of developing metastatic melanoma or hemophilia drug candidates. We do not know whether any of our planned clinical trials in metastatic melanoma or hemophilia will result in marketable drugs.

In addition, completion of clinical trials can be delayed by numerous factors, including:

- delays in identifying and agreeing on acceptable terms with prospective clinical trial sites;
- slower than expected rates of patient recruitment and enrollment;
- unanticipated patient drop out rates;
- increases in time required to complete monitoring of patients during or after participation in a clinical trial; and
- unexpected need for additional patient-related data.

Any of these delays could significantly impact the timing, approval and commercialization of our drug candidates and could significantly increase our overall costs of drug development.

Even if our clinical trials are completed as planned, their results may not support our expectations or intended marketing claims. The clinical trials process may fail to demonstrate that our drug candidates are safe and effective for indicated uses. Such failure would cause us to abandon a drug candidate and could delay development of other drug candidates.

**Clinical trial designs that were discussed with authorities prior to their commencement may subsequently be considered insufficient for approval at the time of application for regulatory approval.**

We discuss with and obtain guidance from regulatory authorities on certain of our clinical development activities. With the exception of our Special Protocol Assessment, or SPA, such as the one we completed with the FDA with respect to our Phase III clinical trial for Remoxy, these discussions are not binding obligations on the part of regulatory authorities.

Regulatory authorities may revise previous guidance or decide to ignore previous guidance at any time during the course of our clinical activities or after the completion of our clinical trials. Even with successful clinical safety and efficacy data, including such data from a clinical trial conducted pursuant to an SPA, we may be required to conduct additional, expensive clinical trials to obtain regulatory approval.



**Developments by competitors may establish standards of care that affect our ability to conduct our clinical trials as planned.**

We have conducted clinical trials of our drug candidates comparing our drug candidates to both placebo and other approved drugs. Changes in standards related to clinical trial design could affect our ability to design and conduct clinical trials as planned. For example, regulatory authorities may not allow us to compare our drug candidates to placebo in a particular clinical indication where approved products are available. In that case, both the cost and the amount of time required to conduct a clinical trial could increase.

**The DEA limits the availability of the active ingredients in certain of our current drug candidates and, as a result, our quotas may not be sufficient to complete clinical trials, or to meet commercial demand or may result in clinical delays.**

The U.S. Drug Enforcement Administration, or 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. Certain active ingredients in our current drug candidates, such as oxycodone, are listed by the DEA as Schedule II under the Controlled Substances Act of 1970. Consequently, their manufacture, research, shipment, storage, sale and use are subject to a high degree of oversight and regulation. For example, all Schedule II drug prescriptions must be signed by a physician, physically presented to a pharmacist and may not be refilled without a new prescription. Furthermore, the amount of Schedule II substances we can obtain for clinical trials and commercial distribution is limited by the DEA and our quota may not be sufficient to complete clinical trials or meet commercial demand. There is a risk that DEA regulations may interfere with the supply of the drugs used in our clinical trials, and, in the future, our ability to produce and distribute our products in the volume needed to meet commercial demand.

**Conducting clinical trials of our drug candidates or potential commercial sales of a drug candidate may expose us to expensive product liability claims and we may not be able to maintain product liability insurance on reasonable terms or at all.**

The risk of product liability is inherent in the testing of pharmaceutical products. If we cannot successfully defend ourselves against product liability claims, we may incur substantial liabilities or be required to limit or terminate testing of one or more of our drug candidates. Our inability to obtain sufficient product liability insurance at an acceptable cost to protect against potential product liability claims could prevent or inhibit the commercialization of our drug candidates. We currently carry clinical trial insurance but do not carry product liability insurance. If we successfully commercialize one or more of our drug candidates, we may face product liability claims, regardless of FDA approval for commercial manufacturing and sale. We may not be able to obtain such insurance at a reasonable cost, if at all. Even if our agreements with any current or future corporate collaborators entitle us to indemnification against product liability losses, such indemnification may not be available or adequate should any claim arise.

**If we receive regulatory approval for our drug candidates, we and our collaborators will also be subject to ongoing FDA obligations and continued regulatory review, such as continued safety reporting requirements, and we and our collaborators may also be subject to additional FDA post-marketing obligations or new regulations, all of which may result in significant expense and limit our ability to commercialize our potential drugs.**

Any regulatory approvals that we receive for our drug candidates may also be subject to limitations on the indicated uses for which the drug may be marketed or contain requirements for potentially costly post-marketing follow-up studies. In addition, if the FDA approves any of our drug candidates, the labeling, packaging, adverse event reporting, storage, advertising, promotion and record keeping for the drug will be subject to extensive regulatory requirements. The subsequent discovery of previously unknown problems with the drug, including but not limited to adverse events of unanticipated severity or frequency, or the discovery that adverse events

previously observed in preclinical research or clinical trials that were believed to be minor actually constitute much more serious problems, may result in restrictions on the marketing of the drug, and could include withdrawal of the drug from the market.

The FDA's policies may change and additional government regulations may be enacted that could prevent or delay regulatory approval of our drug candidates. For example, on February 9, 2009, the FDA announced it had invited the sponsors of opioid drug products to a private meeting in March 2009 in order to begin the process of developing Risk Evaluation and Mitigation Strategies for opioid drugs. According to FDA's announcement, opioid drugs affected by this announcement include both brand name and generic products that contain fentanyl, hydromorphone, methadone, morphine, oxycodone and oxymorphone. We cannot predict the likelihood, nature or extent of adverse government regulation that may arise from future legislation or administrative action, either in the United States or abroad. If we are not able to maintain regulatory compliance, we may be subject to fines, suspension or withdrawal of regulatory approvals, product recalls, seizure of products, operating restrictions and criminal prosecution. Any of these events could prevent us from marketing our drugs and our business could suffer.

### ***Risks Relating to Commercialization***

**If physicians and patients do not accept and use our drugs, we will not achieve sufficient product revenues and our business will suffer.**

Even if the FDA approves our drugs, physicians and patients may not accept and use them. Acceptance and use of our drugs will depend on a number of factors including:

- perceptions by members of the healthcare community, including physicians, about the safety, effectiveness, and abuse resistant qualities of Remoxy;
- perceptions by physicians regarding the cost benefit of the abuse resistant quality of Remoxy;
- published studies demonstrating the cost-effectiveness of our drugs relative to competing products;
- availability of reimbursement for our products from government or healthcare payers;
- our ability to implement a risk management plan prior to the distribution of any Schedule II drug; and
- effectiveness of marketing and distribution efforts by King, us and other licensees and distributors.

Because we expect to rely on sales generated by our current lead drug candidates for substantially all of our revenues for the foreseeable future, the failure of any of these drugs to find market acceptance would harm our business and could require us to seek additional financing.

**If King is not successful in commercializing Remoxy and other abuse resistant opioid drugs, our revenues and our business will suffer.**

Our ability to earn royalties from sales of Remoxy and other abuse-resistant drugs will depend on King's abilities to maintain regulatory approval and achieve market acceptance of such drugs once commercialized. King may elect to independently develop drugs that could compete with ours or fail to commit sufficient resources to the marketing and distribution of Remoxy and other abuse-resistant drugs developed under our strategic alliance. King may not proceed with the commercialization of Remoxy and other abuse-resistant drugs developed under our strategic alliance with the same degree of urgency as we would because of other priorities they face. If King is not successful in commercializing Remoxy for a variety of reasons, including but not limited to competition from other pharmaceutical companies, or if King fails to perform as we expect, our potential for revenue from drugs developed in connection with our strategic alliance with King, if any, could be dramatically reduced and our business would suffer.



**If we are unable to develop our own sales, marketing and distribution capabilities, or if we are not successful in contracting with third parties for these services on favorable terms, or at all, our product revenues could be disappointing.**

We currently have no sales, marketing or distribution capabilities. Except with regard to products developed under our strategic alliance with King, in order to commercialize our products, if any are approved by the FDA, we will either have to develop such capabilities internally or collaborate with third parties who can perform these services for us. If we decide to commercialize any of our drugs ourselves, we may not be able to hire the necessary experienced personnel and build sales, marketing and distribution operations which are capable of successfully launching new drugs and generating sufficient product revenues. In addition, establishing such operations will take time and involve significant expense.

If we decide to enter into new co-promotion or other licensing arrangements with third parties, we may be unable to locate acceptable collaborators because the number of potential collaborators is limited and because of competition from others for similar alliances with potential collaborators. Even if we are able to identify one or more acceptable new collaborators, we may not be able to enter into any collaborative arrangements on favorable terms, or at all.

In addition, due to the nature of the market for our drug candidates, it may be necessary for us to license all or substantially all of our drug candidates not covered by our strategic alliance with King to a single collaborator, thereby eliminating our opportunity to commercialize these other products independently. If we enter into any such new collaborative arrangements, our revenues are likely to be lower than if we marketed and sold our products ourselves.

In addition, any revenues we receive would depend upon our collaborators' efforts which may not be adequate due to lack of attention or resource commitments, management turnover, change of strategic focus, business combinations or other factors outside of our control. Depending upon the terms of our collaboration, the remedies we have against an under-performing collaborator may be limited. If we were to terminate the relationship, it may be difficult or impossible to find a replacement collaborator on acceptable terms, or at all.

**If we cannot compete successfully for market share against other drug companies, we may not achieve sufficient product revenues and our business will suffer.**

The market for our drug candidates is characterized by intense competition and rapid technological advances. If our drug candidates receive FDA approval, they will compete with a number of existing and future drugs and therapies developed, manufactured and marketed by others. Existing or future competing products may provide greater therapeutic convenience or clinical or other benefits for a specific indication than our products, or may offer comparable performance at a lower cost. If our products are unable to capture and maintain market share, we may not achieve sufficient product revenues and our business will suffer.

We and our collaborators will compete for market share against fully integrated pharmaceutical companies or other companies that are collaborating with larger pharmaceutical companies, academic institutions, government agencies and other public and private research organizations. Many of these competitors have drugs already approved or drug candidates in development that will or may compete against our approved drug candidates. In addition, many of these competitors, either alone or together with their collaborative partners, operate larger research and development programs and have substantially greater financial resources than we do, as well as significantly greater experience in:

- developing drugs;
- conducting preclinical testing and human clinical trials;
- obtaining FDA and other regulatory approvals of drugs;
- formulating and manufacturing drugs; and

- launching, marketing, distributing and selling drugs.

**Our ability to generate product revenues will be diminished if we fail to obtain acceptable prices or an adequate level of reimbursement for our products from healthcare payers.**

Our ability to commercialize our drugs, alone or with collaborators, will depend in part on the extent to which reimbursement will be available from:

- government and health administration authorities;
- private health maintenance organizations and health insurers; and
- other healthcare payers.

Significant uncertainty exists as to the reimbursement status of newly approved healthcare products. Healthcare payers, including Medicare, health maintenance organizations and managed care organizations, are challenging the prices charged for medical products and services and/or are seeking pharmacoeconomic data to justify formulary acceptance and reimbursement practices. We currently have not generated pharmacoeconomic data on any of our drug candidates. Government and other healthcare payers increasingly are attempting to contain healthcare costs by limiting both coverage and the level of reimbursement for drugs, and by refusing, in some cases, to provide coverage for uses of approved products for disease indications for which the FDA has or has not granted labeling approval. Adequate third-party insurance coverage may not be available to patients for any products we discover and develop, alone or with collaborators. If government and other healthcare payers do not provide adequate coverage and reimbursement levels for our products, market acceptance of our drug candidates could be limited.

**Government agencies may establish and promulgate usage guidelines that could limit the use of our drug candidates.**

Government agencies, professional and medical societies, and other groups may establish usage guidelines that apply to our drug candidates. These guidelines could address such matters as usage and dose, among other factors. Application of such guidelines could limit the clinical use or commercial appeal of our drug candidates.

***Risks Relating to our Collaboration Agreements***

**If King or other outside collaborators fail to devote sufficient time and resources to our drug development programs, or if their performance is substandard, our regulatory submissions and our product introductions may be delayed.**

Pursuant to our strategic alliance with King, we jointly manage and prepare Phase III clinical trials and NDA submissions in the United States for Remoxy and other abuse-resistant drug candidates with King. We rely on King to devote time and resources to the development, manufacturing and commercialization of Remoxy and other abuse-resistant drug candidates. King may develop or acquire drugs or drug candidates that compete for resources with our drug candidates that are subject to this strategic alliance. For instance, King has acquired a drug candidate for the acute pain market and has acquired another company that has abuse resistant technologies and two NDAs in place with the FDA for abuse resistant opioids. While we believe these drug candidates will not compete directly with our drug candidates being developed under the collaboration with King, there can be no assurance that King's other drug candidates will not become competitive with our drug candidates being developed under the collaboration with King. If King limits its time and resources devoted to the strategic alliance or fails to fund the continued development of PTI-202, PTI-721, or other abuse-resistant opioid potential products as required by our agreement with King, or otherwise fails to perform as we expect, we may not achieve clinical and regulatory milestones and regulatory submissions and related product introductions may be delayed or prevented, and revenues that we would receive from these activities will be less than expected. In addition, if King fails to perform as required under our collaboration agreement, their failure may jeopardize our rights under our license with Durect.

We depend on independent investigators and collaborators, such as universities and medical institutions, to conduct our clinical trials under agreements with us. These investigators and collaborators are not our employees and we cannot control the amount or timing of resources that they devote to our programs. They may not assign as great a priority to our programs or pursue them as diligently as we would if we were undertaking such activities ourselves. If these investigators or collaborators fail to devote sufficient time and resources to our drug development programs, or if their performance is substandard, the approval of our regulatory submissions and our introductions of new drugs will be delayed or prevented.

Our collaborators may also have relationships with other commercial entities, some of which may compete with us. If outside collaborators assist our competitors to our detriment, the approval of our regulatory submissions will be delayed and the sales from our products, if any are commercialized, will be less than expected.

**If we fail to maintain our collaboration agreements and licenses for Remoxy and other abuse-resistant drugs, we may have to reduce or delay our drug candidate development.**

Our plan for developing, manufacturing and commercializing Remoxy and other abuse-resistant drugs currently requires us to successfully maintain our strategic alliance with King to advance our programs and provide funding to support our expenditures on Remoxy and other drug candidates and to maintain our license from Durect. If we are not able to maintain our existing strategic alliance with King or if King doesn't provide the required funding under the strategic alliance, we may have to limit the size or scope of, or delay or abandon the development of Remoxy and other abuse-resistant drug candidates or undertake and fund development of these drug candidates ourselves and if we are unable to maintain our license with Durect for one or more potential products we may lose the rights to utilize Durect's technology for such potential products. If we elect to fund drug development efforts with respect to Remoxy and other abuse-resistant drug candidates on our own, we may need to obtain additional capital, which may not be available on acceptable terms, or at all.

**We may not succeed at in-licensing drug candidates or technologies to expand our product pipeline.**

We may not successfully in-license drug candidates or technologies to expand our product pipeline. The number of such candidates or technologies is limited. Competition among large pharmaceutical companies and biopharmaceutical companies for promising drug candidates or technologies is intense because such companies generally desire to expand their product pipelines through in-licensing. If we fail to carry out such in-licensing and expand our product pipeline, our potential future revenues may suffer.

**Our collaborative agreements may not succeed or may give rise to disputes over intellectual property, disputes concerning the scope of collaboration activities or other issues.**

Our strategy to focus on drug development requires us to enter into collaborative agreements with third parties, such as our strategic alliance with King and our license agreement with Durect. Such agreements are generally complex and contain provisions that could give rise to legal disputes, including potential disputes concerning ownership of intellectual property under collaborations or disputes concerning the scope of collaboration activities. Such disputes can delay or prevent the development of potential new drug products, or can lead to lengthy, expensive litigation or arbitration. Other factors relating to collaborative agreements may adversely affect the success of our drug candidates, including:

- the development of parallel products by our collaborators or by a competitor;
- arrangements with collaborative partners that limit or preclude us from developing certain products or technologies;
- premature termination of a collaborative or license agreement; or
- failure by a collaborative partner to provide required funding or to devote sufficient resources to the development of or legal defense of our potential products.

### *Risks Relating to our Intellectual Property*

**Our ability to commercialize our drug candidates will depend on our ability to sell such products without infringing the patent or proprietary rights of third parties. If we are sued for infringing the intellectual property rights of third parties, such litigation will be costly and time consuming and an unfavorable outcome would have a significant adverse effect on our business.**

Our ability to commercialize our drug candidates will depend on our ability to sell such products without infringing the patents or other proprietary rights of third parties. Intellectual property rights in the areas of controlled-release oxycodone, antibodies, gene integration and more generally, in oncology, neurology, radiopharmaceutical technologies and gene therapy are complicated and are continuously evolving. Holders of patent rights in these areas may allege that the commercialization of Remoxy or our other drug candidates infringes such patent rights. While we believe that we would have valid defenses to any claim of infringement, there can be no assurance that these or other third party patents will not limit our ability to commercialize Remoxy or our other drug candidates.

In addition, because patent applications are published 18 months after their filing, and because applications can take several years to issue, there may be currently pending third-party patent applications that are unknown to us, which may later result in issued patents. If a third-party claims that we infringe on its patents or other proprietary rights, we could face a number of issues that could seriously harm our competitive position, including:

- infringement claims that, with or without merit, can be costly and time consuming to litigate, can delay the regulatory approval process and can divert management's attention from our core business strategy;
- substantial damages for past infringement which we may have to pay if a court determines that our products or technologies infringe upon a competitor's patent or other proprietary rights;
- a court order prohibiting us from commercializing our products or technologies unless the holder licenses the patent or other proprietary rights to us, which such holder is not required to do;
- if a license is available from a holder, we may have to pay substantial royalties or grant cross licenses to our patents or other proprietary rights; and
- redesigning our process so that it does not infringe the third-party intellectual property rights, which may not be possible, or which may require substantial time and expense including delays in bringing our own products to market. Such actions could harm our competitive position and our ability to generate revenue and could result in increased costs.

**If we are unable to protect our intellectual property our competitors could develop and market products with similar features that may reduce demand for our drug candidates.**

Our success, competitive position and potential future revenues will depend in part on our ability to protect our intellectual property. If we or our collaborators fail to file, prosecute, obtain or maintain certain patents, our competitors could market products that contain features and clinical benefits similar to those of our products, and demand for our products could decline as a result.

We and our collaborators have filed patent applications with the U.S. Patent and Trademark Office to further protect our technologies. If these patent applications do not result in issued patents, the duration or scope of our patent rights may be limited and our future revenues could be lower as a result.

We may be involved in challenges to our intellectual property. An adverse outcome of a challenge to our intellectual property could result in loss of claims of patents or other intellectual property rights that pertain to certain drugs we currently have under development and could have a material adverse impact on our future revenues.

We intend to file additional patent applications relating to our technology, products and processes. We may direct our collaborators to file additional patent applications relating to the licensed technology or we may do so ourselves. However, our competitors may challenge, invalidate or circumvent any of our current or future patents. These patents may also fail to provide us with meaningful competitive advantages.

**We may become involved in expensive litigation or other legal proceedings related to our existing intellectual property rights, including patents.**

We expect that we will rely upon patents, trade secrets, know-how, continuing technological innovations and licensing opportunities to develop and maintain our competitive position. Others may independently develop substantially equivalent proprietary information or be issued patents that may prevent the sale of our products or know-how or require us to license such information and pay significant fees or royalties in order to produce our products.

Our technology could infringe upon claims of patents owned by others. If we were found to be infringing on a patent held by another, we might have to seek a license to use the patented technology. In that case, we might not be able to obtain such a license on terms acceptable to us, or at all. If a legal action were to be brought against us or our licensors, we could incur substantial defense costs, and any such action might not be resolved in our favor. If such a dispute were to be resolved against us, we could have to pay the other party large sums of money and our use of our technology and the testing, manufacture, marketing or sale of one or more of our proposed products could be restricted or prohibited.

***Risks Relating to our Business and Strategy***

**Competition for qualified personnel in the pharmaceutical industry is intense, and if we are not successful in attracting and retaining qualified personnel, we could experience delays in completing necessary clinical trials, in the regulatory approval process or in formulating, manufacturing, marketing and selling our potential products.**

We will need to hire additional qualified personnel with expertise in clinical research, preclinical testing, government regulation, formulation and manufacturing and sales and marketing. We compete for qualified individuals with numerous biopharmaceutical companies, universities and other research institutions. Competition for such individuals, particularly in the San Francisco Bay area, is intense, and our search for such personnel may not be successful. Attracting and retaining qualified personnel is critical to our success.

**If third-party manufacturers of our drug candidates fail to devote sufficient time and resources to our concerns, or if their performance is substandard, our clinical trials and product introductions may be delayed and our costs may be higher than expected.**

We have no manufacturing facilities and have limited experience in drug product development and commercial manufacturing. We lack the resources and expertise to formulate, manufacture or test the technical performance of our drug candidates. We currently rely on a limited number of experienced personnel and a small number of contract manufacturers and other vendors to formulate, test, supply, store and distribute drug supplies for our clinical trials. Our reliance on a limited number of vendors exposes us to the following risks, any of which could delay our clinical trials, and, consequently, FDA approval of our drug candidates and commercialization of our products, result in higher costs, or deprive us of potential product revenues:

- Contract commercial manufacturers, their sub-contractors or other third parties we rely on, may encounter difficulties in achieving the volume of production needed to satisfy clinical needs or commercial demand, may experience technical issues that impact quality or compliance with applicable and strictly enforced regulations governing the manufacture of pharmaceutical products, and may experience shortages of qualified personnel to adequately staff production operations.
- Our contract manufacturers could default on their agreements with us to provide clinical supplies or meet our requirements for commercialization of our products.

- For certain of our drug candidates, the use of alternate manufacturers may be difficult because the number of potential manufacturers that have the necessary governmental licenses to produce narcotic products is limited. Additionally, the FDA and the DEA must approve any alternative manufacturer of our products before we may use the alternative manufacturer to produce our supplies.
- It may be difficult or impossible for us to find a replacement manufacturer on acceptable terms quickly, or at all. Our contract manufacturers and vendors may not perform as agreed or may not remain in the contract manufacturing business for the time required to successfully produce, store and distribute our products.
- If any contract manufacturer makes improvements in the manufacturing process for our products, we may not own, or may have to share, the intellectual property rights to such innovation.

**We expanded our research and development activities to include development of potential drug candidates for indications other than pain, and we may not be able to successfully develop or commercialize these potential new drug candidates.**

We have expanded our research and development activities to include development of potential drug candidates for indications other than pain, such as metastatic melanoma and hemophilia. We completed a Phase I clinical trial of our drug candidate in metastatic melanoma in 2008, and plan to initiate another study in such indication. We have no history of developing metastatic melanoma or hemophilia drug candidates or manufacturing radiopharmaceuticals. We do not know whether any of our planned clinical trials in metastatic melanoma or hemophilia will result in marketable products. We do not anticipate that any drug candidates in these areas will reach the market for at least several years, if at all.

**Our employees and consultants are generally subject to confidentiality or other agreements with their former employers and they may inadvertently or otherwise violate those agreements.**

Many of our employees and consultants were previously employed at universities or biotechnology or pharmaceutical companies. While we require our employees and consultants to honor any agreements they may have entered into prior to working with us, we may be subject to claims that we inadvertently or otherwise used or disclosed trade secrets or other confidential information belonging to former employers. Failure to defend such claims could result in loss of valuable rights or personnel, which in turn could harm or prevent commercialization of our drug candidates. Successful defense against such claims can be expensive and might distract us from executing our strategies.

**Law enforcement concerns over diversion of opioids and social issues around abuse of opioids may make the regulatory approval process and commercialization of our drug candidates very difficult.**

Media stories regarding the diversion of opioids and other controlled substances are commonplace. Law enforcement agencies or regulatory agencies may apply policies that seek to limit the availability of opioids. Such efforts may adversely affect the regulatory approval and commercialization of our drug candidates.

**Developments by competitors may render our products or technologies obsolete or non-competitive.**

Alternative technologies and products are being developed to improve or replace the use of opioids for pain management, several of which are in clinical trials or are awaiting approval from the FDA. In addition, the active ingredients in nearly all opioid drugs are available in generic form. Drug companies that sell generic opioid drugs represent substantial competition. Many of these organizations competing with us have substantially greater capital resources, larger research and development staffs and facilities, greater experience in drug development and in obtaining regulatory approvals and greater manufacturing and marketing capabilities than we do. Our competitors may market less expensive or more effective drugs that would compete with our drug candidates or reach market with competing drugs before we are able to reach market with our drug candidates. These organizations also compete with us to attract qualified personnel and partners for acquisitions, joint ventures or other collaborations.



**Business interruptions could limit our ability to operate our business.**

Our operations as well as those of our collaborators on which we depend are vulnerable to damage or interruption from computer viruses, human error, natural disasters, electrical and telecommunication failures, international acts of terror and similar events. We have not established a formal disaster recovery plan and our back-up operations and our business interruption insurance may not be adequate to compensate us for losses we may suffer. A significant business interruption could result in losses or damages incurred by us and require us to cease or curtail our operations.

***Risks Relating to Manufacturing***

**We rely on third-party commercial drug manufacturers for drug supply.**

Approved third-party commercial drug manufacturers may subsequently be stopped from producing, storing, shipping or testing our drug products due to their non-compliance with federal, state or local regulations. Drug manufacturers are subject to ongoing periodic unannounced inspection by the FDA, the DEA, and corresponding state and foreign government agencies to ensure strict compliance with GMP and other government regulations and corresponding foreign standards. We do not have control over third-party manufacturers' compliance with these regulations and standards.

In addition, even if we enter into long-term supply arrangements with third-party suppliers, we cannot control changes in strategy by third-party suppliers that affect their ability or willingness to continue to supply our drug products on acceptable terms.

If our drug supply for one of our drug candidates was interrupted, our operations could be negatively affected.

**If we cannot formulate and scale-up a wide range of dosage forms of Remoxy and other abuse-resistant drug candidates, we and King might determine that the commercial opportunity for Remoxy and other abuse resistant drug candidates in certain dosage forms is too limited to warrant further investment in clinical testing and development.**

We plan to formulate and scale-up a wide range of dosage forms of Remoxy and other abuse-resistant drug candidates. We may not be able to successfully complete our formulation or scale-up activities or we may determine that the commercial opportunity for Remoxy and other abuse resistant drug candidates in certain dosage forms is too limited to warrant further investment. If we are unsuccessful in our formulation or scale-up activities with Remoxy and other abuse-resistant drug candidates, our future revenue from milestones and royalties under our strategic alliance with King may be less than expected and our operations may suffer.

**We and King rely solely on Durect to provide us with certain components of Remoxy and other abuse-resistant drug candidates and will continue to rely on Durect to produce commercial supplies of these components.**

We and King rely on Durect as the sole source provider of certain components of Remoxy and other abuse-resistant drug candidates, and will rely solely on Durect to produce commercial supplies of these components. Durect's failure to achieve and maintain satisfactory manufacturing standards could result in product recalls or withdrawals, delays or failures in product testing or delivery, cost overruns or other problems that could materially harm our business. Durect may encounter manufacturing difficulties involving production yields, quality control and quality assurance. Durect is subject to ongoing periodic unannounced inspection by the FDA and corresponding state and foreign agencies to ensure strict compliance with government regulations and corresponding foreign standards. We cannot control Durect's compliance with these regulations and standards.

To date, Durect has not produced commercial-scale supply of these components. If we and King receive marketing approval for and commercially launch Remoxy or other abuse resistant candidates, we anticipate that

Durect will need to materially expand its manufacturing capacity. Durect may not be able to increase its manufacturing capacity for Remoxy and other abuse-resistant drug candidates in a timely or economic manner, or at all. Moreover, significant scale up of manufacturing will require additional validation studies, which are subject to FDA review and approval. If Durect is unable to successfully increase the manufacturing capacity for such components of Remoxy and other abuse-resistant drugs, at an acceptable cost or otherwise, and we are unable to establish alternative manufacturing capabilities, the commercial launch or continued commercialization after a commercial launch of Remoxy and other abuse-resistant drugs may be delayed, prevented or impaired or there may be a shortage in supply, which would harm our future revenues and cause our business to suffer.

***Risks Relating to our Financial Position and Need for Financing***

**Our operating history may make it difficult for you to evaluate our business to date and to assess its future viability.**

Our operations from our inception to date have been limited to organizing and staffing our company, acquiring, developing and securing our technology, undertaking preclinical studies and clinical trials of our drug candidates and forming collaborations. We have not yet demonstrated our ability to obtain regulatory approval, formulate and manufacture our drug candidates on a commercial scale or conduct sales and marketing activities. Consequently, any predictions you make about our future success or viability may not be as accurate as they could be if we had a longer operating history.

**We have a history of losses and expect to incur substantial losses and negative operating cash flows for the foreseeable future.**

Although we were profitable in 2006, 2007 and 2008 based on payments from King and interest income, we have yet to generate any revenues from product sales. We had an accumulated deficit of \$114.1 million as of December 31, 2008. Even if we succeed in developing and commercializing one or more of our drug candidates, we expect to continue to use significant cash resources in our operations for the foreseeable future. We anticipate that our expenses will increase substantially in the foreseeable future as we:

- continue to conduct preclinical studies and clinical trials for our drug candidates;
- seek regulatory approvals for our drug candidates;
- develop, formulate, manufacture and commercialize our drug candidates;
- implement additional internal systems and develop new infrastructure;
- acquire or in-license additional products or technologies, or expand the use of our technology;
- maintain, defend and expand the scope of our intellectual property; and
- hire additional personnel.

We will need to generate significant revenues to achieve and maintain profitability. If we cannot successfully develop, obtain regulatory approval for and commercialize our drug candidates, we will not be able to generate such revenues or achieve profitability in the future. Our failure to achieve or maintain profitability would have a material adverse impact on the market price of our common stock.

**If we cannot raise additional capital on acceptable terms, we may be unable to complete planned clinical trials of any or some of our drug candidates or to pursue attractive business opportunities.**

We have funded all of our operations and capital expenditures with the proceeds from our public and private stock offerings, payments received under our strategic alliance with King, and interest earned on our investments. We expect that our current cash, cash equivalents and marketable securities will be sufficient to meet our working capital and capital expenditure needs for at least the next twelve months. However, we may elect to raise additional funds within such twelve-month period or need to raise additional funds thereafter and additional



financing may not be available on favorable terms, if at all. Even if we succeed in selling additional securities to raise funds, our existing stockholders' ownership percentage would be reduced and new investors may demand rights, preferences or privileges senior to those of existing stockholders. If we raise additional capital through debt financing, if available, such financings may involve covenants that restrict our business activities. If we raise additional capital through strategic alliance and license arrangements such as our strategic alliance with King, we may have to trade our rights to our technology, intellectual property or drug candidates to others in such arrangements on terms that may not be favorable to us.

If we determine that we need to raise additional funds and we are not successful in doing so, we may be unable to complete the clinical development of some or all of our drug candidates or to seek or obtain FDA approval of our drug candidates. We then could be forced to discontinue product development, enter into a relationship with an additional strategic partner earlier than currently intended, reduce sales and marketing efforts or forego attractive business opportunities.

### *Risks Relating to an Investment in our Common Stock*

#### **Our stock price has been volatile and could experience a sudden decline in value.**

Our common stock has experienced significant price and volume fluctuations and may continue to experience volatility in the future. You may not be able to sell your shares quickly or at the latest market price if trading in our stock is not active or the volume is low. The following factors, in addition to other risk factors described in this section, may have a significant impact on the market price of our common stock:

- results of or delays in our efforts to seek regulatory approval for Remoxy, and in preclinical studies and clinical trials for our other drug candidates;
- the success of our collaboration agreements;
- publicity regarding actual or potential medical results relating to products under development by us or others;
- announcements of technological innovations or new commercial products by us or others;
- developments in patent or other proprietary rights by us or others;
- comments or opinions by securities analysts or major stockholders;
- future sales of our common stock by existing stockholders;
- regulatory developments or changes in regulatory guidance enacted by applicable governmental or other authorities;
- litigation or threats of litigation;
- economic and other external factors or other disaster or crises;
- the departure of any of our officers, directors or key employees;
- period-to-period fluctuations in financial results; and
- limited daily trading volume.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, SEC regulations and the rules of The NASDAQ Stock Market LLC create uncertainty for public companies. If we were unable to continue to comply with these requirements, we could be delisted from trading on the NASDAQ Global Market, or Nasdaq, and thereafter trading in our common stock, if any, may be conducted through the over-the-counter or other market. As a consequence of such delisting, an investor would likely find it more difficult to dispose of, or to obtain quotations as to the price of, our common stock. Delisting of our common stock could also result in lower prices per share of our common stock than would otherwise prevail.

**There may be “naked” short selling in our common stock, which may lead to extraordinary volatility in the market price of our common stock, even in the absence of new fundamental information regarding our business.**

Short selling is a form of speculation that allows an investor to sell stock that they do not own. In order to short sell a stock, an investor normally borrows shares from a third party and agrees to return these shares at some future date. “Naked” short selling occurs when a trader short sells a stock with no actual delivery of shares taking place to close the transaction. The legality of this practice is unclear. As of January 15, 2009, Nasdaq reported short interest of approximately 4.9 million shares in our common stock. We believe this amount may represent a significant percentage of our outstanding common stock available to borrow. Such short interest may also include a significant amount of naked short selling. Widespread naked short selling may increase volatility of our common stock and may have a significant, transient and highly negative impact on the market price of our common stock.

**Anti-takeover provisions in our charter documents, our Stockholder Rights Plan and Delaware law may prevent or delay removal of incumbent management or a change of control.**

Anti-takeover provisions of our amended and restated certificate of incorporation and amended and restated bylaws, our Stockholder Rights Plan and Delaware law may have the effect of deterring or delaying attempts by our stockholders to remove or replace management, engage in proxy contests and effect changes in control. The provisions of our charter documents include:

- a classified board so that only one of the three classes of directors on our board of directors is elected each year;
- elimination of cumulative voting in the election of directors;
- procedures for advance notification of stockholder nominations and proposals;
- the ability of our board of directors to amend our bylaws without stockholder approval; and
- the ability of our board of directors to issue up to 10,000,000 shares of preferred stock without stockholder approval upon the terms and conditions and with the rights, privileges and preferences as our board of directors may determine.

The rights issued pursuant to our Stockholder Rights Plan will become exercisable, subject to certain exceptions, the tenth day after a person or group announces acquisition of 15% or more of our common stock or announces commencement of a tender or exchange offer the consummation of which would result in ownership by the person or group of 15% or more of our common stock.

In addition, as a Delaware corporation, we are subject to Delaware law, including Section 203 of the Delaware General Corporation Law. In general, Section 203 prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years following the date that the stockholder became an interested stockholder unless certain specific requirements are met as set forth in Section 203.

These provisions, alone or together, could have the effect of deterring or delaying changes in incumbent management, proxy contests or changes in control.

**Volatility in the stock prices of other companies may contribute to volatility in our stock price.**

The stock market in general, Nasdaq and the market for technology companies in particular, have experienced significant price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Further, there has been particular volatility in the market prices of securities of early stage life sciences companies. These broad market and industry factors may seriously harm the

market price of our common stock, regardless of our operating performance. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted. A securities class action suit against us could result in substantial costs, potential liabilities and the diversion of management's attention and resources.

**Our share ownership is concentrated, and our officers, directors and principal stockholders can exert significant control over matters requiring stockholder approval.**

Due to their combined stock holdings, our officers, directors and principal stockholders (stockholders holding greater than 5% of our common stock) acting collectively may have the ability to exercise significant influence over matters requiring stockholder approval including the election of directors and approval of significant corporate transactions. This concentration of ownership may delay or prevent a change in control of the Company and may make some transactions more difficult or impossible to complete without the support of these stockholders.

Publicly available information regarding stockholders' ownership may not be comprehensive because the SEC does not require certain large stockholders to publicly disclose their stock ownership positions.

**Our operating results may fluctuate from quarter to quarter and this fluctuation may cause our stock price to decline.**

Our quarterly operating results have fluctuated in the past and are likely to fluctuate in the future. Factors contributing to these fluctuations include, among other items, the timing and amounts of collaboration revenue recognized from King, the timing and enrollment rates of clinical trials for our drug candidates, our need for clinical supplies and the valuation of stock-based compensation. Thus, quarter-to-quarter comparisons of our operating results are not indicative of what we might expect in the future. As a result, in some future quarters our clinical, financial or operating results may not meet the expectations of securities analysts and investors that could result in a decline in the price of our stock.

**There may not be an active, liquid trading market for our common stock.**

There is no guarantee that an active trading market for our common stock will be maintained on Nasdaq. Investors may not be able to sell their shares quickly or at the latest market price if trading in our stock is not active.

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

None.

**Item 2. *Properties***

We currently lease approximately 41,200 square feet of space in San Mateo and South San Francisco, California. All of our operations are located at our office space in San Mateo. We believe that our facilities are adequate and suitable for our current needs.

**Item 3. *Legal Proceedings***

We are not a party to any legal proceedings.

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

There were no matters submitted to a vote of the security holders during the fourth quarter of 2008.

## PART II

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

Our common stock is quoted on the NASDAQ Global Market under the symbol "PTIE." The following table sets forth the high and low sales prices per share of our common stock as reported on the NASDAQ Global Market for the periods indicated.

	Sales Prices	
	High	Low
<b>Fiscal 2007:</b>		
First Quarter .....	\$ 9.20	\$7.00
Second Quarter .....	\$ 9.00	\$7.54
Third Quarter .....	\$ 9.86	\$8.20
Fourth Quarter .....	\$11.50	\$9.35
<b>Fiscal 2008:</b>		
First Quarter .....	\$10.73	\$7.48
Second Quarter .....	\$ 8.86	\$6.80
Third Quarter .....	\$10.32	\$7.35
Fourth Quarter .....	\$10.09	\$5.50

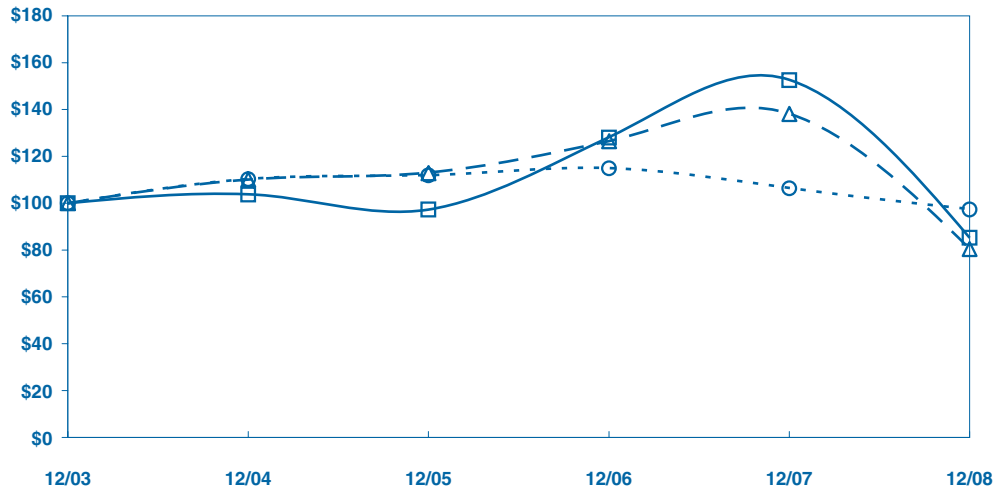
We currently expect to retain future earnings, if any, for use in the operation and expansion of our business and have not paid and do not anticipate paying any cash dividends in the foreseeable future. As of January 12, 2009, there were approximately 72 holders of record of our common stock.

## Performance Graph

The following line graph compares the percentage change in the cumulative return to the stockholders of the our common stock with the cumulative return of the NASDAQ Composite Index and the NASDAQ Pharmaceutical Index for the period commencing December 31, 2003.

### COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\*

Among Pain Therapeutics, Inc., The NASDAQ Composite Index  
And The NASDAQ Pharmaceutical Index



—□— Pain Therapeutics, Inc.      - △ - NASDAQ Composite      - - ○ - - NASDAQ Pharmaceutical

\* The graph assumes that \$100 was invested on 12/31/03 in our common stock or index and that all dividends were reinvested. We have not declared or paid any dividends on our common stock. Stockholder returns over the indicated period should not be considered indicative of future stockholder returns.

**Item 6. Selected Financial Data (in thousands except per share data)**

The following selected financial data should be read together with the “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our financial statements and related notes included elsewhere in this report. The selected balance sheet data at December 31, 2008 and 2007 and the selected statement of operations data for each year ended December 31, 2008, 2007, and 2006 have been derived from our audited financial statements that are included elsewhere in this report. The selected balance sheets data at December 31, 2006, 2005, and 2004 and the statements of operations for each year ended December 31, 2005 and 2004 have been derived from our audited financial statements not included in this report. Historical results are not necessarily indicative of the results to be expected in the future.

	Years ended December 31,				
	2008 <sup>(1)</sup>	2007 <sup>(1)</sup>	2006 <sup>(1)</sup>	2005	2004
<b>Statement of operations data:</b>					
Collaboration revenue	\$ 29,377	\$ 42,746	\$ 22,717	\$ 1,368	\$ —
Program fee revenue	14,348	23,238	26,201	3,712	—
Milestone revenue	20,000	—	5,000	—	—
Total revenue	63,725	65,984	53,918	5,080	—
Research and development expense	45,817	47,730	46,803	32,938	35,093
General and administrative expense	9,196	8,085	7,668	4,859	3,868
Total operating expenses	55,013	55,815	54,471	37,797	38,961
Operating income (loss)	8,712	10,169	(553)	(32,717)	(38,961)
Interest and other income, net	6,018	10,136	9,668	2,047	1,185
Income (loss) before provision for (benefit from)					
income taxes	14,730	20,305	9,115	(30,670)	(37,776)
Provision for (benefit from) income taxes	(617)	—	2,927	—	—
Net income (loss)	\$ 15,347	\$ 20,305	\$ 6,188	\$ (30,670)	\$ (37,776)
Net income (loss) per share:					
Basic	\$ 0.36	\$ 0.46	\$ 0.14	\$ (0.70)	\$ (1.01)
Diluted	\$ 0.35	\$ 0.44	\$ 0.14	\$ (0.70)	\$ (1.01)
Weighted average shares used in computing net income (loss) per share:					
Basic	42,252	44,150	44,146	43,795	37,267
Diluted	43,857	45,676	45,475	43,795	37,267
	December 31,				
	2008	2007	2006	2005	2004
<b>Balance sheet data:</b>					
Cash and cash equivalents	\$153,158	\$ 86,567	\$ 16,386	\$ 95,651	\$ 1,379
Marketable securities	36,937	118,504	188,014	117,001	98,018
Working capital	170,522	184,717	170,460	181,817	91,860
Total assets	193,436	207,625	208,456	215,795	101,192
Deferred program fee revenue	82,502	96,849	120,087	146,288	—
Total liabilities	89,150	103,711	130,541	152,435	7,796
Total stockholders’ equity	104,286	103,914	77,915	63,360	93,396

(1) Includes stock option expense after adoption of the Financial Statement Accounting Board, Statement No. 123R on January 1, 2006.

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

This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included elsewhere in this report. Operating results are not necessarily indicative of results that may occur in future periods.

### **Overview**

We are a biopharmaceutical company that develops novel drugs. In June 2008, we filed an NDA for Remoxy with the FDA. In August 2008, we and King announced that an NDA for Remoxy was accepted by the FDA and granted Priority Review. A Priority Review generally results in a reduction in the time for FDA review of an NDA from 12 months to approximately 6 months from the date of the NDA submission. In December 2008, we received a Complete Response Letter for our NDA for Remoxy in which the FDA determined that the NDA was not approved. The FDA indicated additional non-clinical data will be required to support the approval of REMOXY. The FDA has not requested or recommended additional clinical efficacy studies prior to approval. We plan to meet with the FDA in the second quarter of 2009 regarding the NDA for Remoxy. We believe this FDA meeting will provide us with a more reliable context in which to make projections about Remoxy.

We also have the following investigational drug candidates in clinical programs:

- PTI-202 and PTI-721, which are proprietary, abuse-resistant forms of opioid drugs.
- A novel radio-labeled monoclonal antibody drug candidate to treat metastatic melanoma, a deadly form of skin cancer.

We and King are engaged in a strategic alliance to develop and commercialize Remoxy, PTI-202, PTI-721 and another abuse-resistant opioid painkiller. King is also obligated to fund development expenses incurred by us pursuant to the collaboration agreement.

All of our collaboration, contract and milestone revenues are recognized pursuant to our strategic alliance with King. King made an upfront cash payment of \$150.0 million to us at the closing of this strategic alliance in 2005. King made milestone payments to us of \$15.0 million related to acceptance by the FDA of the NDA for Remoxy and \$5.0 million in 2008 in connection with the acceptance by the FDA of the investigational new drug application, or IND for PTI-721 and \$5.0 million in 2006 in connection with the acceptance by the FDA of the IND for PTI-202.

We could also receive from King up to \$125.0 million in additional milestone payments in the course of clinical development of Remoxy, PTI-202, PTI-721 and other abuse-resistant opioid painkillers under the strategic alliance. Subject to certain limitations, King is also obligated to fund certain development expenses incurred by us pursuant to the collaboration agreement. King is obligated to fund the commercialization expenses of, and has the exclusive right to market and sell, drugs developed in connection with the strategic alliance. King is obligated to pay us a 20% royalty on net sales of drugs developed in connection with the strategic alliance, except as to the first \$1.0 billion in net sales of such drugs, for which the royalty is set at 15%.

Although we were profitable in 2006, 2007 and 2008 based on payments received from King and interest income, we have yet to generate any revenues from product sales. Through December 31, 2008, we have recorded an accumulated deficit of approximately \$114.1 million. These losses have resulted principally from costs incurred in connection with research and development activities, salaries and other personnel-related costs and general corporate expenses. Research and development activities include costs of preclinical and clinical trials as well as clinical supplies associated with our drug candidates. Salaries and other personnel-related costs include non-cash stock-based compensation associated with options granted to employees and non-employees. Our operating results may fluctuate substantially from period to period as a result of the timing and enrollment rates of clinical trials for our drug candidates and our need for clinical supplies.

We expect to continue to use significant cash resources in our operations for the next several years. Our cash requirements for operating activities and capital expenditures will increase substantially in the future as we:

- continue to conduct preclinical and clinical trials for our drug candidates;
- seek regulatory approvals for our drug candidates;
- develop, formulate, manufacture and commercialize our drug candidates;
- implement additional internal systems and develop new infrastructure;
- acquire or in-license additional products or technologies, or expand the use of our technology;
- maintain, defend and expand the scope of our intellectual property; and
- hire additional personnel.

Product revenue will depend on our ability to receive regulatory approvals for, and successfully market, our drug candidates. If our development efforts result in regulatory approval and successful commercialization of our drug candidates, we will generate revenue from direct sales of our drugs and/or, if we license our drugs to future collaborators, from the receipt of license fees and royalties from sales of licensed products. We conduct our research and development programs through a combination of internal and collaborative programs. We rely on arrangements with universities, our collaborators, contract research organizations and clinical research sites for a significant portion of our product development efforts.

We focus substantially all our research and development efforts on the research and development of opioid drugs for the treatment of pain. The following table summarizes expenses by category for research and development efforts (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2008</b>	<b>2007</b>	<b>2006</b>
Compensation . . . . .	\$15,117	\$11,126	\$ 9,746
Contractor fees <sup>(1)</sup> . . . . .	22,112	26,405	30,367
Supplies <sup>(2)</sup> . . . . .	3,668	6,325	4,317
Other common costs <sup>(3)</sup> . . . . .	4,920	3,874	2,373
	<u>\$45,817</u>	<u>\$47,730</u>	<u>\$46,803</u>

- (1) Contractor fees generally include expenses for preclinical studies and clinical trials.  
(2) Supplies generally include costs for formulation and manufacturing activities.  
(3) Other generally includes the allocation of common costs such as facilities.

Our technology has been applied across certain of our portfolio of drug candidates. Data, know-how, personnel, clinical results, research results and other matters related to the research and development of any one of our drug candidates also relate to, and further the development of, our other drug candidates. For example, we expect that results of non-clinical studies, such as pharmacokinetics, toxicology and other studies, regarding certain components of our drug candidate Remoxy to be applicable to the other potential drug candidates that may arise out of our collaboration with King since all such potential drug candidates are expected to utilize such components. As a result, costs allocated to a specific drug candidate may not necessarily reflect the actual costs surrounding research and development of that drug candidate due to cross application of the foregoing.

We are developing a novel antibody technology that may transform how metastatic melanoma is treated. We spent approximately \$2.8, \$3.2 million and \$3.0 million on this technology, primarily in contractor fees and supplies, during 2008, 2007 and 2006, respectively. In 2007, we announced that we licensed certain technology and are developing this technology for hemophilia and pain management. We spent approximately \$6.0 and \$1.0 million, primarily in contractor fees and supplies during 2008 and 2007 on this technology.



Estimating the dates of completion of clinical development, and the costs to complete development, of our drug candidates would be highly speculative, subjective and potentially misleading. Pharmaceutical products take a significant amount of time to research, develop and commercialize. The clinical trial portion of the development of a new drug alone usually spans several years. We expect to reassess our future research and development plans based on our review of data we receive from our current research and development activities. The cost and pace of our future research and development activities are linked and subject to change.

### **Critical Accounting Policies**

The preparation of our financial statements in accordance with United States generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and interest income in our financial statements and accompanying notes. We evaluate our estimates on an ongoing basis, including those estimates related to contract agreements, research collaborations and investments. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The following items in our financial statements require significant estimates and judgments:

- *Expenses for clinical trials.* Expenses for clinical trials are incurred from planning through patient enrollment to reporting of the underlying data. We estimate expenses incurred for clinical trials that are in process based on patient enrollment and based on clinical data collection and management. Costs that are associated with patient enrollment are recognized as each patient in the clinical trial completes enrollment. Estimated clinical trial costs related to enrollment can vary based on numerous factors, including expected number of patients in trials, the number of patients that do not complete participation in a trial, and when a patient drops out of a trial. Information about patient enrollment can become available significantly after we report our expenses for clinical trials, in which case we would change our estimate of the remaining cost of a trial. Costs that are based on clinical data collection and management are recognized based on estimates of unbilled goods and services received. In the event of early termination of a clinical trial, we would accrue an amount based on estimates of the remaining non-cancelable obligations associated with winding down the clinical trial.
- *Stock-based compensation.* The Financial Accounting Standards Board, or FASB, Statement No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R, requires companies to recognize expense in the income statement for the fair value of all share-based payments to employees and directors, including grants of employee stock options and other share based awards. We adopted SFAS 123R on January 1, 2006 using the modified-prospective transition method. We record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption. We use the Black-Scholes option valuation model, or Black-Scholes and use the single-option award approach and straight-line attribution method for stock options granted since January 1, 2006. Using this approach, the compensation cost is amortized on a straight-line basis over the vesting period of each respective stock option, generally four years.

We estimate forfeitures when recognizing expense under SFAS 123R and adjust this estimate periodically based on the extent to which future actual forfeitures differ, or are expected to differ, from such estimates. Accordingly, we have estimated forfeiture percentages for the unvested portion of previously granted awards that remain outstanding at the date of adoption and for awards granted subsequent to the date of adoption.

We have granted share-based awards that vest upon achievement of certain performance criteria, or Performance Awards. The value of these awards is the product of the number of shares of our common stock to be issued under the award multiplied by the fair market value of a share of our common stock on the date of grant. These awards include future performance conditions. We estimate an implicit service period for achieving these performance conditions. Performance Awards vest and common stock

is issued on achieving performance conditions. We recognize stock-based compensation expense for Performance Awards when we conclude that achieving a performance condition is probable, consistent with FASB Statement No. 5, *Accounting for Contingencies*. We periodically review and update as appropriate our estimates of the implicit service periods and the likelihood of achieving the performance conditions.

- *Revenue recognition and deferred program fee revenue.* In connection with our strategic alliance with King we recognize program fee revenue, collaboration revenue and milestone revenue. Program fee revenue is derived from the upfront payment from King received in December 2005 and is recognized ratably over our estimate of the development period of four drug candidates expected to be developed under the strategic alliance with King. Of those drug candidates, Remoxy has completed a Phase III clinical trial, one drug candidate is in Phase I clinical trials and two potential drug candidates are at the pre-clinical stage. We currently estimate the development period for all four expected drug candidates to extend through September 2014. We review the estimated development period on a quarterly basis and change it if appropriate based upon our latest expectations. For example, in the fourth quarter of 2007 we determined that the development period should be extended from the third quarter of 2011 based upon recent clinical developments and updated communications with King regarding product development plans. Collaboration revenues from reimbursement of development expenses are generally recognized when King has completed its review of the expenses invoiced to them. King is obligated to pay us milestone payments contingent upon the achievement of certain substantive events in the clinical development of Remoxy and the other abuse-resistant opioid painkillers under the strategic alliance. We recognize milestone payments from King as revenue when we achieve the underlying developmental milestone as the milestone payments are not dependent upon any other future activities or achievement of any other future milestones and the achievement of each of the developmental milestones were substantively at risk and contingent at the effective date of the collaboration. Substantial effort is involved in achieving each of the developmental milestones. These milestones represent the culmination of discrete earnings processes and the amount of each milestone payment is reasonable in relation with the level of effort associated with the achievement of the milestone. Each milestone payment is non-refundable and non-creditable when made. The ongoing research and development services being provided to King under the collaboration are priced at fair value based upon the reimbursement of expenses incurred pursuant to the collaboration with King.
- *Taxes.* We make estimates and judgments in determining our provision for (benefit from) income taxes. We have accumulated significant deferred tax assets. Deferred income taxes reflect the tax effects of net operating loss and tax credit carryovers and temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Realization of deferred tax assets is dependent upon future earnings, if any. We are uncertain of the timing and amount of any future earnings. Accordingly, except for \$1.9 million of net deferred tax assets recognized on our balance sheet included in other assets as of December 31, 2008, we offset the net deferred tax assets with a valuation allowance. We may in the future determine that more of our deferred tax assets will likely be realized, in which case we will reduce our valuation allowance in the quarter in which such determination is made. If the valuation allowance is reduced, we may recognize a benefit from income taxes in our statement of operations in that period.

## **Results of Operations**

### *Years Ended December 31, 2008 and 2007*

#### *Revenue—Program fee revenue*

King paid us a \$150.0 million upfront fee in connection with the closing of our strategic alliance with King in December 2005. Revenues recognized from amortization of this upfront fee were 14.3 million and \$23.2 million in the years ended December 31, 2008 and 2007, respectively. The decrease of \$8.9 million from 2007 to 2008 is due to the extension of the development period over which we recognize the program fee revenue in the

fourth quarter of 2007 based upon recent clinical developments and communications with King regarding product development plans. We expect to recognize the rest of the program fee ratably over our estimate of the remainder of the development period under the strategic alliance with King. We currently estimate the development period for all four expected drug candidates to extend through September 2014.

#### *Revenue—Collaboration revenue*

Collaboration revenues were \$29.4 million and \$42.7 million in the years ended December 31, 2008 and 2007, respectively. These revenues related to reimbursement of our development expenses incurred pursuant to the King strategic alliance. The decrease of \$13.3 million in 2008 was primarily because 2007 revenue included recognition of approximately \$10.4 million in costs incurred by us between September and December 2006 that were subject to completion of King's review. King reviewed and paid for these expenses in 2007. We incurred expenses of \$3.8 million in 2007, which were reimbursement by King in 2008. We incurred expenses of \$1.1 million in 2008 for which we expect King to complete their review and to reimburse us in 2009.

We expect the amount and timing of collaboration revenue to fluctuate in relation to the amount and timing of the underlying research and development expenses, as well as the timing of completion of King's review of submitted expenses.

#### *Revenue—Milestone revenue*

Milestone revenue was \$20.0 million in the year ended December 31, 2008. King made a milestone payments of \$15.0 million to us on acceptance of the NDA for Remoxy by the FDA and \$5.0 million in connection with the acceptance by the FDA of the IND for PTI-202.

#### *Research and Development Expense*

Research and development expense consists primarily of costs of drug development work associated with our drug candidates, including:

- preclinical testing,
- clinical trials,
- clinical supplies and related formulation and design costs, and
- salaries and other personnel-related expenses.

Research and development expense decreased to \$45.8 million from \$47.7 million in the years ended December 31, 2008 and 2007, respectively. The decrease was primarily due to decreases in clinical and development activities for Remoxy partially offset by increased activities in metastatic melanoma, hemophilia and other projects. Research and development expenses included non-cash stock related compensation costs of \$6.1 million and \$3.7 million in the twelve months ended December 31, 2008 and 2007, respectively. Non-cash stock related compensation costs in 2008 included \$1.7 million associated with vesting of Performance Awards.

We expect research and development expenses to fluctuate over the next several years as we continue our development efforts. We expect our development efforts to result in our drug candidates progressing through various stages of clinical trials, including current and potential clinical trials for our other abuse-resistant drug candidates, as well as further clinical development of our product candidates in metastatic melanoma and hemophilia. King is obligated to reimburse development expenses for our abuse-resistant drug candidates pursuant to our collaboration. Our research and development expenses may fluctuate from period to period due to the timing and scope of our development activities and the results of clinical trials and preclinical studies.

### *General and Administrative Expense*

General and administrative expenses consist primarily of compensation and other general corporate expenses. General and administrative expenses increased to \$9.2 million from \$8.1 million in the years ended December 31, 2008 and 2007, respectively. The increase was primarily due to increases in non-cash stock-related compensation costs. General and administrative expenses included non-cash stock related compensation costs of \$4.1 million and \$2.6 million in the twelve months ended December 31, 2008 and 2007, respectively. Non-cash stock related compensation costs in 2008 included \$1.6 million associated with vesting of Performance Awards. We expect general and administrative expenses to increase over the next several years in connection with support of precommercialization and commercialization activities for our drug candidates. The increase may fluctuate from period to period due to the timing and scope of these activities and the results of clinical trials and preclinical studies.

### *Interest and Other Income, Net*

Interest and other income, net, decreased to \$6.0 million from \$10.1 million for the years ended December 31, 2008 and 2007, respectively, primarily due to decreases in prevailing interest rates on investments in marketable securities and, to a lesser extent, decreased average balances of marketable securities. We expect our interest income to decrease in the future as we use cash to fund our operations.

### *Benefit from Income Taxes*

In 2008 we had an income tax benefit of \$0.6 million comprised of a federal tax benefit of \$0.8 million, net of a provision for state taxes of \$0.2 million. The federal income tax benefit is primarily due to the recognition in 2008 of previously generated net operating losses and tax credits. We did not provide for income taxes in 2007 because we did not have taxable income in 2007, primarily due to all of our program fee revenue having been recognized for tax purposes in prior years.

### ***Years Ended December 31, 2007 and 2006***

#### *Revenue—Program fee revenue*

King paid us a \$150.0 million upfront fee in connection with the closing of our strategic alliance with King in December 2005. Revenues recognized from amortization of this upfront fee were \$23.2 million and \$26.2 million in the years ended December 31, 2007 and 2006, respectively. The decrease of \$3.0 million in 2007 is due to the extension of the development period over which we recognize the program fee revenue in the fourth quarter of 2007 based upon recent clinical developments and communications with King regarding product development plans.

#### *Revenue—Collaboration revenue*

Collaboration revenues were \$42.7 million and \$22.7 million in the years ended December 31, 2007 and 2006, respectively. These revenues related to reimbursement of our development expenses incurred pursuant to the King strategic alliance. The increase of \$20.0 million in 2007 was primarily because in 2006 we deferred recognition of approximately \$10.4 million in costs incurred by us between September and December 2006 that were subject to completion of King's review. King reviewed and paid for these expenses in 2007. We incurred expenses of \$3.8 million in 2007 for which King completed their review and reimbursed us in 2008.

#### *Revenue—Milestone revenue*

We did not have any milestone revenue in the year ended December 31, 2007. Milestone revenue was \$5.0 million for the year end December 31, 2006. In connection with the acceptance by the FDA of the investigational new drug application for PTI-202, King made a milestone payment to us of \$5.0 million.

### *Research and Development Expense*

Research and development expense consists primarily of costs of drug development work associated with our drug candidates, including:

- preclinical testing,
- clinical trials,
- clinical supplies and related formulation and design costs, and
- salaries and other personnel-related expenses.

Research and development expense increased to \$47.7 million from \$46.8 million in the years ended December 31, 2007 and 2006, respectively. The increase was primarily due to increases in clinical and development activities for Remoxy, metastatic melanoma and hemophilia. Research and development expenses included non-cash stock related compensation costs of \$3.7 million and \$3.8 million in the twelve months ended December 31, 2007 and 2006, respectively.

### *General and Administrative Expense*

General and administrative expenses consist primarily of compensation and other general corporate expenses. General and administrative expenses increased to \$8.1 million from \$7.7 million in the years ended December 31, 2007 and 2006, respectively. The increase was primarily due to increases in non-cash stock-related compensation costs associated with the adoption of SFAS 123R. General and administrative expenses included non-cash stock related compensation costs of \$2.6 million and \$2.7 million in the twelve months ended December 31, 2007 and 2006, respectively.

### *Interest and Other Income, Net*

Interest and other income net, increased to \$10.1 million from \$9.7 million for the years ended December 31, 2007 and 2006, respectively, primarily due to increases in average balances of marketable securities and, to a lesser extent, increases in prevailing interest rates on investments in marketable securities.

### *Provision for Income Taxes*

We did not provide for income taxes in 2007 because we did not have taxable income in 2007, primarily due to all of our program fee revenue having been recognized for tax purposes in prior years.

In 2005, King made an upfront cash payment of \$150.0 million to us in connection with our strategic alliance. We had taxable income for 2006 primarily due to the recognition in 2006 of \$146.3 million of the upfront cash payment for income tax purposes. We reduced our taxable income for 2006 with deductions related to a combination of our net operating losses and tax credits from prior years.

### *Liquidity and Capital Resources*

Since inception, we have financed our operations primarily through public and private stock offerings, payments received under our strategic alliance with King, and interest earned on our investments. We intend to continue to use our capital resources to fund research and development activities, capital expenditures, working capital requirements and other general corporate purposes. As of December 31, 2008, cash, cash equivalents and marketable securities were \$190.1 million.

Net cash provided by operating activities was \$11.2 million for the year ended December 31, 2008 compared to net cash provided by operating activities of \$2.2 million for the year ended December 31, 2007. The change was primarily due to the increase in 2008 of \$20.0 million received in milestone payments offset in part by a \$13.3 million decrease in collaboration revenue.

Net cash provided by investing activities was \$80.2 million in the year ended December 31, 2008 and \$69.1 million for the year ended December 31, 2007. Investing activities for both years consisted primarily of the purchase and sale of marketable securities. Our investing activities to purchase property, equipment and leasehold improvements used no cash for the year ended December 31, 2008 and \$0.7 million for the year ended December 31, 2007. In the year ended December 31, 2008, we wrote-off our property, equipment and leasehold improvements and accumulated depreciation and amortization related to our lease of office space in South San Francisco because we no longer use that office space. We expect to continue to invest in our infrastructure to support our operations.

Net cash used in financing activities was \$24.8 million in the year ended December 31, 2008 and \$1.1 million in the year ended December 31, 2007. In 2008, we completed a stock buyback plan for the repurchase of up to \$30.0 million of our common stock. We used cash of \$26.2 million in 2008 and \$3.8 million in 2007 to purchase our common stock on the open market. Other cash from financing activities in both 2008 and 2007 consisted primarily of proceeds received from the issuance of our common stock pursuant to stock option exercises and stock purchased by employees pursuant to our 2000 Employee Stock Purchase Plan.

We have \$43.5 million of total deferred tax assets at December 31, 2008. Realization of these deferred tax assets is dependent on future earnings, if any. We are uncertain about the timing and amount of any future earnings. We have concluded that it is more likely than not that such deferred tax assets will not be realized. Accordingly, except for \$1.9 million of deferred tax assets included in other assets as of December 31, 2008, we offset the deferred tax asset with a valuation allowance. There is a high degree of uncertainty regarding the timing of future cash outflows associated with our FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," or Interpretation 48 liabilities. Our net Interpretation 48 liability at December 31, 2008 does not result in a material contractual obligation.

We currently lease approximately 41,200 square feet of general office space pursuant to non-cancelable operating leases that will expire in 2010 and 2012. Future minimum lease payments for our leases are as follows for the years ended December 31, (in thousands):

	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>Total</u>
Future minimum lease payments . . . . .	\$743	\$713	\$570	\$339	\$2,365

We believe that our facilities are adequate and suitable for our current needs.

We have license agreements that require us to make milestone payments upon the successful achievement of milestones, including clinical milestones. Our license agreements also require us to pay certain royalties to our licensors if we succeed in fully commercializing products under these license agreements. All of these potential future payments are cancelable as of December 31, 2008. Our formulation agreement with Durect Corporation obligates us to make certain milestone payments upon achieving clinical milestones and regulatory milestones. King is obligated to reimburse us for any of our milestone payments and royalty payments to Durect Corporation.

We have an accumulated deficit of \$114.1 million at December 31, 2008. We expect our cash requirements to be significant in the future. The amount and timing of our future cash requirements will depend on regulatory and market acceptance of our drug candidates and the resources we devote to researching and developing, formulating, manufacturing, commercializing and supporting our products. We believe that our current resources should be sufficient to fund our operations for at least the next 12 months. We may seek additional future funding through public or private financing within this timeframe, if such funding is available and on terms acceptable to us.

***Off-balance Sheet Arrangements***

As of December 31, 2008, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have



been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts. Therefore, we are not materially exposed to financing, liquidity, market or credit risk that could arise if we had engaged in these relationships. We do not have relationships or transactions with persons or entities that derive benefits from their non-independent relationship with us or our related parties.

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

The primary objective of our cash investment activities is to preserve principal while at the same time maximizing the income we receive from our investments without significantly increasing risk. Some of the securities that we invest in may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing rate and the interest rate later rises, the principal amount of our investment will probably decline. A hypothetical 50 basis point increase in interest rates reduces the fair value of our available-for-sale securities at December 31, 2008 by approximately \$0.1 million. To minimize this risk in the future, we intend to maintain our portfolio of cash equivalents and marketable securities in a variety of securities, including commercial paper, government and non-government debt securities and/or money market funds that invest in such securities. We have no holdings of derivative financial or commodity instruments. As of December 31, 2008, our investments consisted of investments in corporate and government notes and obligations or in money market accounts and checking funds with variable market rates of interest. We believe our credit risk is immaterial.



**Item 8. *Financial Statements and Supplementary Data***

**INDEX TO FINANCIAL STATEMENTS**

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

The Board of Directors and Stockholders  
Pain Therapeutics, Inc.

We have audited the accompanying balance sheets of Pain Therapeutics, Inc. as of December 31, 2008 and 2007, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pain Therapeutics, Inc. at December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 8 and 9 to the financial statements, in 2007, Pain Therapeutics, Inc. changed its methods of accounting for uncertainty in income taxes and sabbatical leave in accordance with guidance provided in Statement of Financial Accounting Standards No. 48, "Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109" and Emerging Issues Task Force Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43."

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Pain Therapeutics, Inc.'s internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 11, 2009 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

San Jose, California  
February 11, 2009

**PAIN THERAPEUTICS, INC.**  
**BALANCE SHEETS**  
(in thousands except share and per share data)

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents .....	\$ 153,158	\$ 86,567
Marketable securities .....	36,937	118,504
Other current assets .....	541	303
Total current assets .....	190,636	205,374
Property and equipment, net .....	774	1,607
Other assets .....	2,026	644
Total assets .....	\$ 193,436	\$ 207,625
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable .....	\$ 2,216	\$ 3,624
Accrued development expense .....	1,029	817
Deferred program fee revenue—current portion .....	14,348	14,348
Other accrued liabilities .....	2,521	1,868
Total current liabilities .....	20,114	20,657
Non-current liabilities		
Deferred program fee revenue—non-current portion .....	68,154	82,501
Deferred tax liabilities .....	882	553
Total liabilities .....	89,150	103,711
Commitments and contingencies		
Stockholders' equity		
Preferred stock, \$.001 par value; 10,000,000 shares authorized, none issued and outstanding .....	—	—
Common stock, \$.001 par value; 120,000,000 shares authorized; 42,068,752 and 44,305,103 shares issued and outstanding in 2008 and 2007, respectively .....	42	44
Additional paid-in-capital .....	218,021	221,415
Accumulated other comprehensive income .....	325	584
Accumulated deficit .....	(114,102)	(118,129)
Total stockholders' equity .....	104,286	103,914
Total liabilities and stockholders' equity .....	\$ 193,436	\$ 207,625

See accompanying notes to financial statements.

**PAIN THERAPEUTICS, INC.**  
**STATEMENTS OF OPERATIONS**  
(in thousands except per share data)

	<u>Years ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Revenue			
Collaboration revenue .....	\$29,377	\$42,746	\$22,717
Program fee revenue .....	14,348	23,238	26,201
Milestone revenue .....	20,000	—	5,000
Total revenue .....	<u>63,725</u>	<u>65,984</u>	<u>53,918</u>
Operating expenses			
Research and development .....	45,817	47,730	46,803
General and administrative .....	9,196	8,085	7,668
Total operating expenses .....	<u>55,013</u>	<u>55,815</u>	<u>54,471</u>
Operating income (loss) .....	8,712	10,169	(553)
Interest and other income, net .....	<u>6,018</u>	<u>10,136</u>	<u>9,668</u>
Income before provision for (benefit from) income taxes .....	14,730	20,305	9,115
Provision for (benefit from) income taxes .....	(617)	—	2,927
Net income .....	<u>\$15,347</u>	<u>\$20,305</u>	<u>\$ 6,188</u>
Net income per share			
Basic .....	<u>\$ 0.36</u>	<u>\$ 0.46</u>	<u>\$ 0.14</u>
Diluted .....	<u>\$ 0.35</u>	<u>\$ 0.44</u>	<u>\$ 0.14</u>
Weighted-average shares used in computing net income per share			
Basic .....	<u>42,252</u>	<u>44,150</u>	<u>44,146</u>
Diluted .....	<u>43,857</u>	<u>45,676</u>	<u>45,475</u>

See accompanying notes to financial statements.

**PAIN THERAPEUTICS, INC.**  
**STATEMENT OF STOCKHOLDERS' EQUITY**  
(in thousands except share data)

	Common stock		Additional paid-in capital	Accumulated other comprehensive income (loss)	Accumulated deficit	Total stockholders' equity
	Shares	Par value				
<b>Balance at December 31, 2005</b>	43,936,088	\$ 44	\$206,489	\$(479)	\$(142,694)	\$ 63,360
Issuance of common stock pursuant to exercise of stock options	304,180	—	1,312	—	—	1,312
Issuance of common stock related to employee stock purchase plan	73,735	—	330	—	—	330
Compensation with respect to non-employee option grants	—	—	242	—	—	242
Compensation with respect to employee option grants	—	—	6,228	—	—	6,228
Tax benefits from the exercise of options	—	—	148	—	—	148
Net unrealized gains on investment in marketable securities	—	—	—	107	—	107
Net income	—	—	—	—	6,188	6,188
Comprehensive income	—	—	—	—	6,188	6,295
<b>Balance at December 31, 2006</b>	44,314,003	44	214,749	(372)	(136,506)	77,915
Issuance of common stock pursuant to exercise of stock options	400,442	—	2,284	—	—	2,284
Issuance of common stock related to employee stock purchase plan	71,358	—	368	—	—	368
Compensation with respect to non-employee option grants	—	—	437	—	—	437
Compensation with respect to employee option grants	—	—	5,857	—	—	5,857
Accrued sabbatical benefits	—	—	—	—	(415)	(415)
Purchase of stock pursuant to the stock repurchase plan	(480,700)	—	(2,280)	—	(1,513)	(3,793)
Net unrealized gains on investment in marketable securities	—	—	—	956	—	956
Net income	—	—	—	—	20,305	20,305
Comprehensive income	—	—	—	—	20,305	21,261
<b>Balance at December 31, 2007</b>	44,305,103	44	221,415	584	(118,129)	103,914
Issuance of common stock pursuant to exercise of stock options	819,058	1	638	—	—	639
Issuance of common stock related to employee stock purchase plan	73,354	—	462	—	—	462
Compensation with respect to non-employee option grants	—	—	128	—	—	128
Compensation with respect to employee option grants and share based awards	—	—	10,077	—	—	10,077
Purchase of stock pursuant to the stock repurchase plan	(3,128,763)	(3)	(14,884)	—	(11,320)	(26,207)
Tax benefits from the exercise of options	—	—	185	—	—	185
Net unrealized losses on investments in marketable securities	—	—	—	(259)	—	(259)
Net income	—	—	—	—	15,347	15,347
Comprehensive income	—	—	—	—	15,347	15,088
<b>Balance at December 31, 2008</b>	42,068,752	\$ 42	\$218,021	\$ 325	\$(114,102)	\$104,286

See accompanying notes to financial statements.

**PAIN THERAPEUTICS, INC**  
**STATEMENTS OF CASH FLOWS**  
(in thousands)

	<u>Years ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Cash flows provided by (used in) operating activities:			
Net income .....	\$ 15,347	\$ 20,305	\$ 6,188
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Non-cash stock based compensation .....	10,205	6,294	6,470
Depreciation and amortization .....	452	356	345
Non-cash net interest income .....	1,073	679	(1,858)
Loss on disposal of property and equipment .....	381	—	38
Changes in operating assets and liabilities:			
Deferred program fee revenue .....	(14,348)	(23,238)	(26,201)
Other current assets .....	(238)	2,411	(1,202)
Other assets .....	(1,060)	(86)	—
Accounts payable .....	(1,408)	2,639	(13)
Accrued development expense .....	212	(4,960)	1,316
Income taxes payable .....	—	(2,779)	2,779
Tax benefits from equity-based compensation plans .....	185	—	148
Excess tax benefits from equity-based compensation plans .....	(298)	—	(62)
Other accrued liabilities .....	660	610	225
Net cash provided by (used in) operating activities .....	<u>11,163</u>	<u>2,231</u>	<u>(11,827)</u>
Cash flows provided by (used in) investing activities:			
Purchase of property and equipment .....	—	(696)	(94)
Purchase of marketable securities .....	(2,122)	(138,394)	(136,119)
Sales of marketable securities .....	52,887	199,681	27,261
Maturities of marketable securities .....	29,471	8,500	39,810
Net cash provided by (used in) investing activities .....	<u>80,236</u>	<u>69,091</u>	<u>(69,142)</u>
Cash flows provided by (used in) financing activities:			
Excess tax benefits from equity-based compensation plans .....	298	—	62
Proceeds from issuance of common stock, net .....	1,101	2,652	1,642
Purchase of stock pursuant to the stock repurchase plan .....	(26,207)	(3,793)	—
Net cash provided by (used in) financing activities .....	<u>(24,808)</u>	<u>(1,141)</u>	<u>1,704</u>
Net increase (decrease) in cash and cash equivalents .....	66,591	70,181	(79,265)
Cash and cash equivalents at beginning of the year .....	<u>86,567</u>	<u>16,386</u>	<u>95,651</u>
Cash and cash equivalents at end of the year .....	<u>\$153,158</u>	<u>\$ 86,567</u>	<u>\$ 16,386</u>
Supplemental cash flow information:			
Cash paid for income taxes .....	<u>\$ —</u>	<u>\$ 2,800</u>	<u>\$ —</u>

See accompanying notes to financial statements.

**PAIN THERAPEUTICS, INC.**  
**NOTES TO FINANCIAL STATEMENTS**

**1. Business**

Pain Therapeutics, Inc. is a biopharmaceutical company that develops novel drugs. We have four drug candidates in clinical programs, including Remoxy, PTI-202, PTI-721 and a novel radio-labeled monoclonal antibody to treat metastatic melanoma. We are also working on a new treatment for patients with hemophilia.

Although we were profitable in 2006, 2007 and 2008 based on payments from King Pharmaceuticals, Inc., or King, and interest income, in the course of our development activities, we have sustained cumulative operating losses. There are no assurances that additional financing will be available on favorable terms, or at all.

**2. Summary of Significant Accounting Policies**

*Use of Estimates*

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

*Revenue Recognition and Deferred Program Fee Revenue*

Revenue is recognized when there is persuasive evidence that an arrangement exists, delivery has occurred, the price is fixed and determinable, and collection is reasonably assured.

In November 2005, we and King announced a strategic alliance to develop and commercialize Remoxy and up to three other abuse-resistant opioid painkillers. In connection with the strategic alliance, we recognize program fee revenue, collaboration revenue and milestone revenue. Program fee revenue is derived from the upfront payment from King and is recognized ratably over our estimate of the development period of four drug candidates expected to be developed under the strategic alliance with King. We currently estimate the development period for all four expected drug candidates to extend through September 2014. We review the estimated development period on a quarterly basis and change it if appropriate based upon our latest expectations. In the fourth quarter of 2007 we determined that the development period should be extended from the third quarter of 2011 based upon recent clinical developments and communications to us from King regarding King's development plans and forecast expenditures. Deferred program fee revenue represents the amount of the upfront payment that has not been recognized as revenue to date.

Collaboration revenues from reimbursement of development expenses are generally recognized when King has completed its review of the expenses invoiced to them.

King is obligated to pay us milestone payments contingent upon the achievement of certain substantive events in the clinical development of Remoxy and the other abuse-resistant opioid painkillers under the strategic alliance. We recognize milestone payments from King as revenue when we achieve the underlying developmental milestone as the milestone payments are not dependent upon any other future activities or achievement of any other future milestones and the achievement of each of the developmental milestones were substantively at risk and contingent at the effective date of the collaboration. Substantial effort is involved in achieving each of the developmental milestones. These milestones represent the culmination of discrete earnings processes and the amount of each milestone payment is reasonable in relation with the level of effort associated with the achievement of the milestone. Each milestone payment is non-refundable and non-creditable when made. The ongoing research and development services being provided to King under the collaboration are priced at fair value based upon the reimbursement of expenses incurred pursuant to the collaboration with King.



**PAIN THERAPEUTICS, INC.**  
**NOTES TO FINANCIAL STATEMENTS—(Continued)**

***Cash, Cash Equivalents and Concentration of Credit Risk***

We consider all highly liquid financial instruments with original maturities of three months or less to be cash equivalents. Cash and cash equivalents consist of cash maintained at two financial institutions and in money market funds. We believe the financial risks associated with these instruments are minimal. We have not experienced material losses from our investments in these securities.

***Marketable Securities and Fair Value Measurements***

Our marketable securities are held as “available-for-sale” pursuant to Statement of Financial Accounting Standards No. 115, “Accounting for Certain Investments in Debt and Equity Securities.” We classify these investments as current assets and carry them at fair value. Unrealized gains and losses are recorded as a separate component of stockholders’ equity as accumulated other comprehensive income. We recognize all realized gains and losses on our available-for-sale securities in interest and other income in the accompanying statement of operations. Our marketable securities are maintained at one financial institution and are governed by our investment policy as approved by our Board of Directors.

To date we have not recorded any impairment charges on marketable securities related to other-than-temporary declines in market value. We would recognize an impairment charge when the decline in the estimated fair value of a marketable security below the amortized cost is determined to be other-than-temporary. We consider various factors in determining whether to recognize an impairment charge, including the duration of time and the severity to which the fair value has been less than our amortized cost, any adverse changes in the investees’ financial condition and our intent and ability to hold the marketable security for a period of time sufficient to allow for any anticipated recovery in market value.

We adopted Statement of Financial Accounting Standards No. 157, “Fair Value Measurements”, or SFAS 157, on January 1, 2008. SFAS 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value and expands disclosure about such fair value measurements. The adoption of SFAS 157 did not have an impact on our results of operations or financial position.

We measure our cash equivalents and marketable securities at fair value on a recurring basis and have significant observable inputs where there are identical or comparable assets in the market to use in establishing our fair value measurements. We use significant observable inputs that include but are not limited to benchmark yields, reported trades, broker/dealer quotes and issuer spreads. Generally, the types of instruments we invest in are not traded on a market such as the NASDAQ Global Market. We consider these inputs to be Level 2 as defined by SFAS 157. We do not have any investments that would require inputs considered to be Level 3 as defined by SFAS 157. We use the bid price to establish fair value.

We adopted Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment of FASB Statement No. 115”, or SFAS 159, on January 1, 2008. Under this statement, an entity may elect to use fair value to measure eligible items. We adopted SFAS 159 by electing not to apply the fair value election of SFAS 159. The adoption of this statement did not have an impact on our results of operations or financial condition.

***Property and Equipment***

Property and equipment are stated at cost, net of accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the respective assets (generally two to five years). Leasehold improvements are amortized over the shorter of the estimated useful life of the assets or the lease term.

## PAIN THERAPEUTICS, INC.

### NOTES TO FINANCIAL STATEMENTS—(Continued)

#### *Impairment of Long-Lived Assets*

We regularly perform reviews to determine if the carrying value of our long-lived assets is impaired. We consider facts or circumstances, either internal, or external that indicate that we may not recover the carrying value of the asset. No events or changes in circumstances have occurred with respect to our long-lived assets that would indicate that an impairment analysis should have been performed.

#### *Business Segments*

Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*, requires an enterprise to report segment information based on how management internally evaluates the operating performance of its business units (segments). Our operations are confined to one business segment: the development of novel drugs.

#### *Expenses for Clinical Trials*

Research and development expense includes the cost of clinical trials. Expenses for clinical trials are incurred from planning through patient enrollment to reporting of the underlying data. We estimate expenses incurred for clinical trials that are in process based on patient enrollment and based on clinical data collection and management. Costs that are associated with patient enrollment are recognized as each patient in the clinical trial completes enrollment. Estimated clinical trial costs related to enrollment can vary based on numerous factors, including expected number of patients in trials, the number of patients that do not complete participation in a trial, and when a patient drops out of a trial. Information about patient enrollment can become available significantly after we report our expenses for clinical trials, in which case we would change our estimate of the remaining cost of a trial. Costs that are based on clinical data collection and management are recognized based on estimates of unbilled goods and services received. In the event of early termination of a clinical trial, we would accrue an amount based on estimates of the remaining non-cancelable obligations associated with winding down the clinical trial.

#### *Stock Based Compensation*

The Financial Accounting Standards Board, or FASB, Statement No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R, requires companies to recognize expense in the income statement for the fair value of all share-based payments to employees and directors, including grants of employee stock options and other share based awards. We adopted SFAS 123R on January 1, 2006 using the modified-prospective transition method. We record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that were outstanding at the date of adoption. We use the Black-Scholes option valuation model, or Black-Scholes and use the single-option award approach and straight-line attribution method for stock options granted since January 1, 2006. Using this approach, the compensation cost is amortized on a straight-line basis over the vesting period of each respective stock option, generally four years.

We estimate forfeitures when recognizing expense under SFAS 123R and adjust this estimate periodically based on the extent to which future actual forfeitures differ, or are expected to differ, from such estimates. Accordingly, we have estimated forfeiture percentages for the unvested portion of previously granted awards that remain outstanding at the date of adoption and for awards granted subsequent to the date of adoption.

We have granted share-based awards that vest upon achievement of certain performance criteria, or performance awards. The value of these performance awards is the product of the number of shares of our common stock to be issued under the award multiplied by the fair market value of a share of our common stock

**PAIN THERAPEUTICS, INC.**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**

on the date of grant. These performance awards include future performance conditions. We estimate an implicit service period for achieving these performance conditions. Performance awards vest and common stock is issued on achieving performance conditions. We recognize stock-based compensation expense for performance awards when we conclude that achieving a performance condition is probable, consistent with FASB Statement No. 5, *Accounting for Contingencies*, or SFAS5. We periodically review and update as appropriate our estimates of the implicit service periods and the likelihood of achieving the performance conditions.

***Net Income per Share***

Basic net income per share is computed on the basis of the weighted-average number of common shares outstanding for the reporting period. Diluted net income per share is computed on the basis of the weighted-average number of common shares outstanding plus dilutive potential common shares outstanding using the treasury-stock method. Potential dilutive common shares consist of outstanding stock options and warrants.

The numerators and denominators in the calculation of basic and diluted net income per share were as follows (in thousands):

	Years Ended December 31,		
	2008	2007	2006
Numerators:			
Net income .....	\$15,347	\$20,305	\$ 6,188
Denominator			
Weighted average shares used to compute basic net income per share .....	42,252	44,150	44,146
Effect of dilutive securities:			
Dilution from employee stock plans .....	1,605	1,393	1,196
Dilution from warrants .....	—	133	133
Potential dilutive common shares .....	1,605	1,526	1,329
Weighted average shares used to compute diluted net income per share .....	43,857	45,676	45,475
Net income per share:			
Basic .....	\$ 0.36	\$ 0.46	\$ 0.14
Diluted .....	\$ 0.35	\$ 0.44	\$ 0.14

In 2008, 2007, and 2006, we excluded 5.1 million, 3.2 million and 2.2 million shares from diluted net income per share, respectively, as the option exercise price was greater than the average market price per share and the effect would be anti-dilutive.

***Comprehensive Income***

Comprehensive income is comprised of net income and unrealized holding gains and losses on available-for-sale securities as follows (in thousands):

	Years Ended December 31,		
	2008	2007	2006
Net income .....	\$15,347	\$20,305	\$6,188
Other comprehensive income (loss) .....	(259)	956	107
Comprehensive income .....	\$15,088	\$21,261	\$6,295

## PAIN THERAPEUTICS, INC.

### NOTES TO FINANCIAL STATEMENTS—(Continued)

#### *Income Taxes*

We make estimates and judgments in determining our provision for (benefit from) income taxes. We have accumulated significant deferred tax assets. Deferred income taxes reflect the tax effects of net operating loss and tax credit carryovers and temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Realization of deferred tax assets is dependent upon future earnings, if any. We are uncertain of the timing and amount of any future earnings. Accordingly, except for \$1.9 million of deferred tax assets included in other assets as of December 31, 2008, we offset the net deferred tax assets with a valuation allowance. We may in the future determine that more of our deferred tax assets will likely be realized, in which case we will reduce our valuation allowance in the quarter in which such determination is made. If the valuation allowance is reduced, we may recognize a benefit from income taxes in our statement of operations in that period.

#### **3. Collaboration Agreements**

##### *King Pharmaceuticals, Inc.*

In November 2005, we and King announced a strategic alliance to develop and commercialize Remoxy and other abuse-resistant opioid painkillers. King made an upfront cash payment of \$150.0 million to us at the closing of this strategic alliance in December 2005, of which \$14.3 million, \$23.2 million, and \$26.2 million were recorded as program fee revenue for the year ended December 31, 2008, 2007 and 2006, respectively. The strategic alliance provides for us to receive from King up to \$150.0 million in milestone payments in the course of clinical development of Remoxy and other abuse-resistant opioid painkillers, of which we received \$5.0 million in milestone revenue in the year ended December 31, 2006 and \$20.0 million in the year ended December 31, 2008. In addition, subject to certain limitations, King is obligated to fund development expenses incurred by us pursuant to the collaboration agreement, of which \$29.4 million, \$42.7 million, and \$22.7 million was recorded as collaboration revenue for the year ended December 31, 2008, 2007 and 2006, respectively. King is obligated to fund the commercialization expenses of, and has the exclusive right to market and sell, drugs developed in connection with the strategic alliance. King is obligated to pay us a 20% royalty on net sales of drugs developed in connection with the strategic alliance, except as to the first \$1.0 billion in net sales of such drugs, for which the royalty is set at 15%.

##### *Direct Corporation*

We have an exclusive, worldwide licensing agreement with Direct Corporation to use a patented technology that forms the basis for a number of oral gel-cap drug candidates, including Remoxy. We have sub-licensed to King certain rights to develop and to commercialize Remoxy and certain other opioid drugs formulated in part with technology we licensed from Direct. Under the agreement with Direct, we control all of the preclinical, clinical, commercial manufacturing and sales/marketing activities for Remoxy and other abuse-resistant opioid painkillers. We reimburse Direct for formulation and related work, and will make milestone payments based on the achievement of certain technical, clinical or regulatory milestones. Direct will supply us with certain components of Remoxy and other abuse-resistant opioid painkillers on a cost-plus basis. We also are responsible to pay Direct royalties on any related drug sales. King is obligated to reimburse us for costs we incur under the agreement with Direct, including royalties.

**PAIN THERAPEUTICS, INC.**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**

**4. Cash and Cash Equivalents and Marketable Securities**

Cash, cash equivalents and marketable securities held as available-for-sale consisted of the following (in thousands):

	<u>Cash, Cash Equivalents and Marketable Securities</u>				
	<u>Amortized Cost</u>	<u>Accrued Interest</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Estimated Fair Value</u>
<b>December 31, 2008</b>					
Cash and cash equivalents:					
Money market securities .....	\$153,060	\$ 98	\$—	\$—	\$153,158
	153,060	98	—	—	153,158
Marketable securities available-for-sale:					
U.S. government and agency obligations .....	8,016	79	233	—	8,328
Corporate obligations .....	25,348	540	98	(1)	25,985
Asset-backed securities .....	2,624	5	—	(5)	2,624
	<u>35,988</u>	<u>624</u>	<u>331</u>	<u>(6)</u>	<u>36,937</u>
	<u>\$189,048</u>	<u>\$ 722</u>	<u>\$331</u>	<u>\$ (6)</u>	<u>\$190,095</u>
<b>December 31, 2007</b>					
Cash and cash equivalents:					
Money market securities .....	\$ 86,344	\$ 224	\$—	\$ (1)	\$ 86,567
	86,344	224	—	(1)	86,567
Marketable securities available-for-sale:					
U.S. government and agency obligations .....	20,836	350	133	—	21,319
Corporate obligations .....	47,760	749	294	(12)	48,791
Asset-backed securities .....	48,068	156	170	—	48,394
	<u>116,664</u>	<u>1,255</u>	<u>597</u>	<u>(12)</u>	<u>118,504</u>
	<u>\$203,008</u>	<u>\$1,479</u>	<u>\$597</u>	<u>\$ (13)</u>	<u>\$205,071</u>

To date we have not recorded any impairment charges on marketable securities related to other-than-temporary declines in market value. We would recognize an impairment charge when the decline in the estimated fair value of a marketable security below the amortized cost is determined to be other-than-temporary. We consider various factors in determining whether to recognize an impairment charge, including the duration of time and the severity to which the fair value has been less than our amortized cost, any adverse changes in the investees' financial condition and our intent and ability to hold the marketable security for a period of time sufficient to allow for any anticipated recovery in market value.

The gross realized losses and gains on the sale of available-for-sale securities during the years ended December 31, 2008, 2007 and 2006 were not material.

The contractual maturities of our cash equivalents and marketable securities at December 31, 2008 were less than one year.

**PAIN THERAPEUTICS, INC.**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**

The following table presents our assets measured at fair value on a recurring basis at December 31, 2008:

	<u>Level 1</u>	<u>Level 2</u>	<u>Total</u>
Money market fund . . . . .	\$—	\$153,158	153,158
U.S. government and agency obligations . . . . .	—	8,328	8,328
Corporate obligations . . . . .	—	28,609	28,609
	<u>\$—</u>	<u>\$190,095</u>	<u>\$190,095</u>

**5. Property and Equipment**

Property and equipment consists of the following (in thousands):

	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
Furniture, fixtures and equipment . . . . .	\$ 672	\$ 1,182
Computers and software . . . . .	—	94
Leasehold improvement . . . . .	658	2,546
	<u>1,330</u>	<u>3,822</u>
Accumulated depreciation and amortization . . . . .	(556)	(2,215)
	<u>\$ 774</u>	<u>\$ 1,607</u>

In the year ended December 31, 2008, we wrote-off our property, equipment and leasehold improvements and related accumulated depreciation and amortization related to our lease of office space in South San Francisco because we no longer use that office space. Depreciation and amortization expenses were \$452,000, \$356,000 and \$345,000 in 2008, 2007 and 2006, respectively.

**6. Stockholders' Equity and Stock-Based Compensation**

***Common Stock***

The shelf registration statements we filed with the Securities and Exchange Commission in 2005 and 2003 expired unused in 2008.

***Preferred Stock***

Our Board of Directors has the authority to issue preferred stock in one or more series and to fix the rights, preferences, privileges, restrictions and the number of shares constituting any series or the designation of the series.

We have a stockholder rights plan designed to guard against partial tender offers and other coercive tactics to gain control of the Company without offering a fair and adequate price and terms to all of the Company's stockholders. Pursuant to the stockholder rights plan, our Board of Directors declared and paid a dividend of one right to purchase one one-thousandth share of the Company's Series A Participating Preferred Stock for each outstanding share of our common stock. Each of these rights entitles the registered holder to purchase from us one one-thousandth of a share of Series A Preferred at an exercise price of \$40.00, subject to adjustment at any time.

## PAIN THERAPEUTICS, INC.

### NOTES TO FINANCIAL STATEMENTS—(Continued)

#### *Stock-Based Compensation*

We recognized \$10.2 million, \$6.3 million and \$6.5 million in stock-based compensation expense for the years ended December 31, 2008, 2007 and 2006, respectively. Given our current estimates of future forfeitures, we expect to recognize the compensation cost related to non-vested options as of December 31, 2008 of \$14.1 million over the weighted average remaining recognition period of 2.7 years. If all outstanding LTIP awards vest, we would recognize an additional \$13.8 million over the remaining recognition period of 3.6 years.

#### *2008 Equity Incentive Plan and 1998 Stock Plan*

In 2008, our stockholders approved the 2008 Equity Incentive Plan, or 2008 Equity Plan, to replace the 1998 Stock Plan. The 1998 Stock Plan terminated in 2008. Under the 2008 Equity Plan, our employees, directors and consultants may be granted options that allow for the purchase of shares of our common stock. Incentive stock options may only be granted to employees. Through December 31, 2008 a total of 22,600,000 shares of common stock were authorized for issuance under the 2008 Equity Plan and the 1998 Stock Plan. The 2008 Equity Plan was established with a 10-year duration and terminates in 2018.

Our Board of Directors or a designated Committee of the Board is responsible for administration of the 2008 Equity Plan and the 1998 Stock Plan and determines the terms and conditions of each option granted, consistent with the terms of the plan. Incentive stock options may be granted at a price not less than 100% of the fair market value of the stock on the date of grant (not less than 110% of the fair market value on the date of grant in the case of holders of more than 10% of our voting stock). Options granted under the 2008 Equity Plan and the 1998 Stock Plan generally expire ten years from the date of grant (five years for incentive stock options granted to holders of more than 10% of our voting stock). Forfeited options become available for reissuance under the 2008 Equity Plan.

The 2008 Equity Plan also provides for the automatic grant of options to purchase shares of common stock to outside directors. On the date of each annual stockholders' meeting, each outside director is automatically granted an option to purchase 25,000 shares of common stock. The term of the option is ten years, the exercise price is 100% of the fair market value of the stock on the date of grant, and the option becomes exercisable as to 25% of the shares on the anniversary of its date of grant provided the optionee continues to serve as a director on such dates.



**PAIN THERAPEUTICS, INC.**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**

The following summarizes stock option activity for the years ended December 31, 2008, 2007 and 2006:

	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term In years</u>	<u>Aggregate Intrinsic Value In millions</u>
Options outstanding as of December 31, 2005 . . . .	6,993,492	\$6.74		
Granted . . . . .	1,617,200	\$8.35		
Exercised . . . . .	(304,180)	\$4.31		
Forfeited . . . . .	<u>(93,527)</u>	\$8.56		
Options outstanding as of December 31, 2006 . . . .	8,212,985	\$7.12		
Granted . . . . .	2,263,400	\$9.01		
Exercised . . . . .	(400,442)	\$5.70		
Forfeited . . . . .	<u>(78,197)</u>	\$8.06		
Options outstanding as of December 31, 2007 . . . .	<u>9,997,746</u>	\$7.60	6.93	\$30.9
Granted . . . . .	1,835,600	\$7.37		
Exercised . . . . .	(284,308)	\$6.44		
Forfeited . . . . .	<u>(91,223)</u>	\$8.64		
Options outstanding as of December 31, 2008 . . . .	<u>11,457,815</u>	\$7.58	6.52	\$ 1.8
Vested and expected to vest at December 31, 2008 . . . . .	<u>11,188,544</u>	\$7.57	6.46	\$ 1.8
Exercisable at December 31, 2008 . . . . .	<u>7,484,079</u>	\$7.33	5.35	\$ 1.7

The pre-tax intrinsic value of options exercised was approximately \$4.1 million in 2008, \$1.6 million in 2007 and \$1.5 million in 2006, calculated by multiplying options exercised each year by the difference between our stock price on the date of exercise and the exercise price of the options. Shares reserved for issuance and available for grant under the 2008 Equity Incentive Plan were 5,868,485 as of December 31, 2008 and 1,488,436 under our 1998 Stock Plan as of December and 2007.

The following summarizes information about stock options outstanding at December 31, 2008:

<u>Range of exercise prices</u>	<u>Options outstanding</u>			<u>Options exercisable</u>	
	<u>Number of options</u>	<u>Weighted average remaining contractual life (in years)</u>	<u>Weighted average exercise price</u>	<u>Number of vested options</u>	<u>Weighted average exercise price</u>
\$ 0.10—\$ 6.71	2,735,709	5.71	\$ 5.52	2,167,853	\$ 5.37
6.82— 7.51	3,095,013	6.33	7.23	1,990,253	7.09
7.60— 8.25	2,767,144	7.10	8.04	1,702,747	7.94
8.32— 10.53	2,704,949	7.23	9.10	1,468,226	8.90
14.13— 18.63	<u>155,000</u>	1.84	16.30	<u>155,000</u>	16.30
\$ 0.10—\$18.63	<u>11,457,815</u>	6.52	\$ 7.58	<u>7,484,079</u>	\$ 7.33

**PAIN THERAPEUTICS, INC.**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**

*Determining the Fair Value of Options*

We use Black-Scholes to estimate the fair value of options granted. Black-Scholes considers a number of factors, including the market price and volatility of our common stock. We used the following forward-looking range of assumptions to value each stock option granted to employees and directors during the years ended December 31, 2008, 2007 and 2006:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Volatility .....	48% to 54%	60% to 67%	68% to 74%
Risk-free interest rates .....	2% to 4%	4% to 5%	5%
Expected life of option .....	5 years	5 years	5 years
Dividend yield .....	—	—	—

Our volatility assumption is based on reviews of the historical volatility of our common stock. Our risk-free interest rate assumption is based on yields of US treasury notes in effect at the date of grant. Our expected life of options granted assumption is based on actual historical option exercises. Our dividend yield assumption is based on the fact that we have never paid cash dividends and do not anticipate paying cash dividends in the foreseeable future. Using Black-Scholes and these factors, the weighted average fair value of stock options granted to employees and directors was \$7.37 for the year ended December 31, 2008 and \$5.16 for the years ended December 31, 2007 and 2006. In 2006, 2007 and 2008 we used an expected forfeiture rate of 5%. Our estimated expected forfeiture rate is based on historical cancellations of options.

We estimate the fair value of stock options granted to non-employees using forward-looking assumptions similar to those used for stock options granted to employees and directors and appropriate for the terms underlying the stock options granted to non-employees. We re-measure the compensation expense for options granted to non-employees over the related vesting period. The expense related to stock options granted to non-employees was approximately \$0.1 million, \$0.4 million, and \$0.2 million for the years ended December 31, 2008, 2007 and 2006, respectively.

*Performance Awards*

We granted performance awards in 2008 for 2.0 million shares. The total value of these performance awards was \$17.1 million. In connection with FDA acceptance for filing of the NDA for Remoxy, 0.4 million of these performance awards vested. We recognized related stock-based compensation expense of \$1.7 million in research and development expenses and \$1.6 million in general and administrative expenses. If the remaining 1.6 million shares of performance awards do not vest within four years of the date of grant, the awards expire and the underlying shares are returned to the 2008 Equity Incentive Plan.

**2000 Employee Stock Purchase Plan**

Under the 2000 Employee Stock Purchase Plan, or the Purchase Plan, eligible employees may purchase common stock through payroll deductions of up to 15% of the employee's compensation. The purchase price of the stock is generally 85% of the lower of the fair market value of the common stock at the beginning of the offering period or at the end of the purchase period. A total of 500,000 shares of common stock have been reserved for issuance under the Purchase Plan. Shares reserved for issuance under the Purchase Plan may be automatically increased each year by the amount equal to the lesser of (i) 500,000 shares, (ii) 1% of the initially outstanding shares of common stock on such date, or (iii) an amount determined by our Board of Directors. We have issued 494,957 shares of common stock pursuant to the Purchase Plan through December 31, 2008, leaving 255,043 shares reserved for issuance.

## **PAIN THERAPEUTICS, INC.**

### **NOTES TO FINANCIAL STATEMENTS—(Continued)**

The weighted-average fair value of purchase rights granted was \$6.31, \$6.62, and \$2.15 in 2008, 2007 and 2006, respectively, calculated using Black-Scholes with an expected life of 1 year in 2008, 2007 and 2006 with no dividend yield. We assumed volatility was 40% to 49% in 2008, 34% in 2007, and 55% in 2006. We used risk free interest rates of 1% to 2% in 2008, 5% in 2007, and 5% in 2006. The expense related to the Employee Stock Purchase Plan was \$0.1 million, \$0.1 million and \$0.2 million for the years ended December 31, 2008, 2007 and 2006, respectively.

#### ***Stock Repurchase Program***

Under a stock repurchase program approved by our Board of Directors in March 2007 and extended in March 2008, we completed the repurchase of \$30.0 million of our common stock during the year ended December 31, 2008. We used the par value method of accounting for our stock repurchases. The excess of the cost of the shares acquired over the par value is allocated to additional paid-in capital based on the weighted average sales price per issued share with the remainder charged to accumulated deficit.

#### ***Warrants***

As of December 31, 2008, we have no outstanding exercisable warrants.

#### **7. Employee 401(k) Benefit Plan**

We have a defined-contribution savings plan under Section 401(k) of the Internal Revenue Code. The plan covers substantially all employees. Employees are eligible to participate in the plan the first day of the month after hire and may contribute up to the current statutory limits under Internal Revenue Service regulations. The 401(k) plan permits us to make additional matching contributions on behalf of all employees. Through December 31, 2008, we have not made any matching contributions.

#### **8. Accounting for Sabbatical Leave**

On January 1, 2007 we adopted EITF Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences," and recorded a one-time charge of \$0.4 million to accumulated deficit for sabbatical leave as a cumulative effect of a change in accounting principle. Our expense for sabbatical leave was immaterial for the year ended December 31, 2007 and 2008.

#### **9. Income Taxes**

We had taxable income for 2008 primarily due to the combination of milestone payments we received from King and interest income. We reduced our expected tax for 2008 with a combination of net operating losses and tax credits earned from prior years.

In 2005, King made an upfront cash payment of \$150.0 million to us in connection with our strategic alliance. We recognized as revenue for tax purposes \$3.7 million and \$146.3 million of the upfront cash payment in 2005 and 2006, respectively. We had taxable income for 2006 primarily due to the recognition in 2006 of the \$146.3 million of the upfront cash payment. We reduced our expected tax for 2006 with deductions related to a combination of our net operating losses and tax credits from prior years. While we continued to recognize program fee revenue in our income statement for 2008 and 2007 for the recognition of the upfront cash payment, this program fee revenue is excluded from our taxable income for 2008 and 2007. This exclusion combined with other differences between our income before income taxes and our taxable income results in no taxable income for 2007 and no related provision for income taxes for 2007. All of our net income is domestic.

**PAIN THERAPEUTICS, INC.**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**

*Uncertainty in Income Taxes*

We adopted the provisions of FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes,” or Interpretation 48, on January 1, 2007. As a result of the implementation of Interpretation 48, we adjusted the balance sheet as of January 1, 2007 by recording a non-current liability of \$0.8 million and a non-current deferred tax asset of \$0.7 million. The non-current liability provides a source of future taxable income against which the non-current deferred tax asset of \$0.7 million was recognized without offset by a valuation allowance.

As of the adoption date, we had unrecognized tax benefits of approximately \$3.5 million related primarily to tax credits. A reconciliation of the beginning and ending amount of liability recorded for 2008 and 2007 follows (in thousands):

	<b>2008</b>	<b>2007</b>
Beginning Balance .....	\$3,800	\$3,500
Additions based on tax positions related to the current year .....	400	300
Additions (reductions) for tax positions of prior years .....	—	—
Reductions for tax positions of prior years .....	—	—
Settlements .....	—	—
Lapse of applicable statute of limitations .....	—	—
Ending Balance .....	\$4,200	\$3,800

The total amount of unrecognized tax benefit that, if recognized, would benefit our effective tax rate, is \$67 thousand. Because of net operating loss and research credit carryforwards, substantially all of our tax years, from 1998 through 2008, remain open to U.S. federal and California state tax examinations.

We classify interest and penalties recognized pursuant to Interpretation 48 as interest expense. There were no interest or penalties related to unrecognized tax benefits accrued at December 31, 2006. Interest expense and penalties related to unrecognized tax benefits were immaterial for the years ended December 31, 2008 and 2007.

*Provision for (benefit from) income taxes*

In 2008 we had an income tax benefit of \$0.6 million comprised of a federal tax benefit of \$0.8 million, net of a provision for state taxes of \$0.2 million. The federal income tax benefit is primarily due to the recognition in 2008 of previously generated net operating losses and tax credits. We had \$1.4 million of deferred benefits and \$0.8 million in current tax expense in our benefit from income taxes in 2008. We did not have a provision for income taxes in 2007. Our provision for income taxes for 2006 was \$2.9 million, of which \$2.7 million was for federal tax and \$0.2 million was for state tax. A reconciliation between our provision for (benefit from) income taxes for 2008 and 2006 and the amounts computed by multiplying income before provision for (benefit from) income tax by the U.S. statutory tax rate follows (in thousands):

	<b>2008</b>	<b>2006</b>
Tax at U.S. statutory tax rate of 35% .....	\$ 4,968	\$3,190
State taxes .....	180	188
Research credits .....	(415)	(481)
Equity-based compensation .....	579	699
Change in valuation allowance .....	(5,935)	(679)
Other .....	6	10
Provision for income taxes .....	\$ (617)	\$2,927

**PAIN THERAPEUTICS, INC.**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**

*Deferred tax assets and valuation allowance*

Deferred tax assets reflect the tax effects of net operating loss and tax credit carryovers and temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of our deferred tax assets are as follows (in thousands):

	December 31,		
	2008	2007	2006
Deferred tax assets:			
Net operating loss carryforwards .....	\$ 100	\$ 900	\$ —
Deferred license fee revenue .....	32,900	39,400	48,800
Research & development credits .....	3,400	3,700	3,100
Stock-related compensation .....	5,700	4,000	2,500
Other .....	1,400	1,600	2,900
Total deferred tax assets .....	43,500	49,600	57,300
Valuation allowance .....	(41,600)	(49,100)	(57,300)
Net deferred tax assets .....	\$ 1,900	\$ 500	\$ —

Except for deferred tax assets recognized pursuant to Interpretation 48, realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. We have concluded that it is more likely than not that these deferred tax assets will not be realized. Accordingly, these deferred tax assets have been offset by a valuation allowance. We will continue to assess whether or not our deferred tax assets will be realized based on actual and forecasted operating results. The net operating loss carryforwards from 2007 expire in 2027. Approximately \$0.3 million of the valuation allowance at December 31, 2008 relates to the tax benefits associated with excess tax deductions resulting from stock option transactions. This amount will be credited to additional paid-in capital when realized in a reduction to income taxes payable. The valuation allowance decreased by \$7.5 million, \$8.2 million and \$4.4 million in 2008, 2007 and 2006, respectively.

As of December 31, 2008, we had federal research and development tax credits of approximately \$6.1 million, which expire in the years 2018 through 2027 and state research and development tax credits of approximately \$0.9 million.

**10. Leases and Commitments**

We conduct our product research and development programs through a combination of internal and collaborative programs that include, among others, arrangements with universities, contract research organizations and clinical research sites. We have contractual arrangements with these organizations, however these contracts are cancelable on thirty days notice and our obligations under these contracts are largely based on services performed.

We currently lease approximately 41,200 square feet of office space pursuant to non-cancelable operating leases that will expire in 2010 and 2012. Future minimum lease payments for our leases are as follows for the years ended December 31, (in thousands):

	2009	2010	2011	2012	Total
Future minimum lease payments .....	\$743	\$713	\$570	\$339	\$2,365

**PAIN THERAPEUTICS, INC.**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**

Rent expense was \$702,000, \$501,000, and \$178,000 for the years ended December 31, 2008, 2007, and 2006 respectively.

**11. Selected Quarterly Financial Data (Unaudited) (in thousands except per share data)**

	Quarters Ended			
	<u>March 31</u>	<u>June 30</u>	<u>September 30</u>	<u>December 31</u>
<b>2008</b>				
Total revenue .....	\$14,639	\$10,547	\$30,294	\$ 8,245
Net income (loss) .....	\$ 2,570	\$ (1,025)	\$15,191	\$ (1,389)
Basic income (loss) per share .....	\$ 0.06	\$ (0.02)	\$ 0.37	\$ 0.03
Diluted income (loss) per share .....	\$ 0.06	\$ (0.02)	\$ 0.35	\$ 0.03
<b>2007</b>				
Total revenue .....	\$22,054	\$14,065	\$15,810	\$14,055
Net income .....	\$12,636	\$ 3,365	\$ 3,173	\$ 1,131
Basic income per share .....	\$ 0.28	\$ 0.08	\$ 0.07	\$ 0.03
Diluted income per share .....	\$ 0.28	\$ 0.07	\$ 0.07	\$ 0.02

**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.* Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*Management's annual report on internal control over financial reporting.* We are responsible for establishing and maintaining adequate internal control over our financial reporting. We have assessed the effectiveness of internal control over financial reporting as of December 31, 2008. Our assessment was based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission, or COSO, in Internal Control—Integrated Framework.

Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. 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 our transactions and dispositions of our assets;
- (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and board of 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 financial statements.

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

Based on using the COSO criteria, we believe our internal control over financial reporting as of December 31, 2008 was effective.

*Changes in internal control over financial reporting.* There was no change in our internal control over financial reporting that occurred during the quarter ended December 31, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Our independent registered public accounting firm, Ernst & Young LLP, has audited the financial statements included in this Annual Report on Form 10-K and has issued a report on the effectiveness of our internal control over financial reporting. The attestation report of Ernst & Young LLP is included below.



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

The Board of Directors and Stockholders  
Pain Therapeutics, Inc.

We have audited Pain Therapeutics, Inc.'s internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Pain Therapeutics, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's annual report on internal control over financial reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

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

In our opinion, Pain Therapeutics, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the COSO criteria.

ERNST & YOUNG LLP

San Jose, California  
February 11, 2009

**Item 9B. Other Information**

None.

**PART III**

**Item 10. Directors and Executive Officers and Corporate Governance**

The information regarding our directors, executive officers and the audit committee of our board of directors is incorporated by reference from “Directors and Executive Officers” in our Proxy Statement for our 2009 Annual Meeting of Stockholders.

**Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934, as amended requires our executive officers and directors and persons who own more than ten percent (10%) of a registered class of our equity securities to file reports of ownership and changes in ownership with the Securities and Exchange Commission, or SEC. Executive officers, directors and greater than ten percent (10%) stockholders are required by Commission regulation to furnish us with copies of all Section 16(a) forms they file. We believe all of our executive officers and directors complied with all applicable filing requirements during the fiscal year ended December 31, 2008.

**Code of Ethics**

We have adopted a Code of Ethics that applies to all of our directors, officers and employees, including our principal executive officer, principal financial officer and principal accounting officer. We publicize the Code of Ethics through posting the policy on our website, <http://www.paintrials.com>. We will disclose on our website any waivers of, or amendments to, our Code of Ethics.

**Item 11. Executive Compensation**

The information required by this Item is incorporated by reference from our definitive Proxy Statement referred to in Item 10 above where it appears under the heading “Executive Compensation and Other Matters.”

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

The information required by this Item regarding security ownership of certain beneficial owners and management is incorporated by reference from our definitive Proxy Statement referred to in Item 10 above where it appears under the heading “Security Ownership of Certain Beneficial Owners and Management.”

The following table summarizes the securities authorized for issuance under our equity compensation plans as of December 31, 2008:

	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans
Equity compensation plans approved by stockholders . . . .	12,932,815	\$7.58	6,123,528
Equity compensation plans not approved by stockholders . . . . .	—	—	—
Total . . . . .	<u>12,932,815</u>	<u>\$7.58</u>	<u>6,123,528</u>

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

The information required by this Item is incorporated by reference from our definitive Proxy Statement referred to in Item 10 above where it appears under the heading “Certain Relationships and Related Transactions.”

**Item 14. *Principal Accountant Fees and Services***

The information required by this Item is incorporated by reference from our definitive Proxy Statement referred to in Item 10 above where it appears under the heading “Principal Accountant Fees and Services.”

**PART IV**

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

(a) The following documents are filed as part of this Form 10-K:

- (1) *Financial Statements (included in Part II of this report):*
  - Reports of Independent Registered Public Accounting Firm
  - Balance Sheets
  - Statements of Operations
  - Statement of Stockholders’ Equity
  - Statements of Cash Flows
  - Notes to Financial Statements

(2) *Financial Statement Schedules:*

All financial statement schedules are omitted because the information is inapplicable or presented in the notes to the financial statements.

(3) *Exhibits:*

<u>Exhibit Number</u>	<u>Description of Document</u>
3.1(1)	Amended and Restated Certificate of Incorporation.
3.2(2)	Amended and Restated Bylaws.
4.1(1)	Specimen Common Stock Certificate.
4.2(3)	Preferred Stock Rights Agreement, dated as of April 28, 2005, between the Company and Mellon Investor Services LLC, including the Certificate of Designation, the form of Rights Certificate and Summary of Rights attached thereto as Exhibits A, B and C, respectively.
10.1(4)	Form of Indemnification Agreement between Pain Therapeutics and each of its directors and officers.
10.2(4)	1998 Equity Incentive Plan and form of agreements thereunder.
10.3(4)	2000 Employee Stock Purchase Plan and form of agreements thereunder.
10.4(5)	Employment Agreement dated October 23, 2001, between Registrant and Nadav Friedmann, PhD. M.D.
10.5(6)	Lease Agreement dated July 21, 2000 between Registrant and Goss-Jewett Company of Northern California.
10.6(7)	Collaboration Agreement dated November 9, 2005, between Registrant and King Pharmaceuticals, Inc.

<u>Exhibit Number</u>	<u>Description of Document</u>
10.7(7)	License Agreement dated November 9, 2005, between Registrant and King Pharmaceuticals, Inc.
10.8(7)	Development and License Agreement dated December 19, 2002 between Registrant and DURECT Corporation and Southern Biosystems, Inc.
10.9(7)	Amendment dated December 15, 2005 to Development and License Agreement dated December 19, 2002 between Registrant and DURECT Corporation and Southern Biosystems, Inc.
10.10(8)	Sublease Agreement, dated as of July 17, 2007, between Registrant and Oracle USA, Inc.
10.11(9)	2008 Equity Incentive Plan and form of agreements thereunder.
10.12	Employment Agreement dated July 1, 1998 and amended December 17, 2008 between Registrant and Remi Barbier.
10.13	Employment Agreement dated August 29, 2000 and amended December 30, 2008 between Registrant and Grant L. Schoenhard, Ph.D.
10.14	Employment Agreement dated November 18, 2002 and amended December 30, 2008 between Registrant and Peter S. Roddy.
23.1	Consent of Independent Registered Public Accounting Firm.
24.1	Power of Attorney (see page 63).
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certifications of the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- 
- (1) Incorporated by reference from exhibits to our report on Form 10-Q for the period ending June 30, 2005.
  - (2) Incorporated by reference from exhibits to our report on Form 10-Q for the period ending March 31, 2005.
  - (3) Incorporated by reference from exhibits to our report on Form 8-K as filed with the Securities and Exchange Commission on May 3, 2005.
  - (4) Incorporated by reference from our registration statement on Form S-1, registration number 333-32370, declared effective by the Securities and Exchange Commission on July 13, 2000.
  - (5) Incorporated by reference from exhibits to our report on Form 10-K for the period ending December 31, 2001.
  - (6) Incorporated by reference from exhibits to our report on Form 10-Q for the period ending September 30, 2000.
  - (7) Incorporated by reference from exhibits to our report on Form 10-K for the period ending December 31, 2005.
  - (8) Incorporated by reference from exhibits to our report on Form 10-Q for the period ending September 30, 2007.
  - (9) Incorporated by reference from exhibits to our report on Form 8-K as filed with the Securities and Exchange Commission on May 29, 2008.

(b) *Exhibits*

The exhibits listed under Item 15(a)(3) hereof are filed as part of this Form 10-K other than Exhibit 32.1, which shall be deemed furnished.

(c) *Financial Statement Schedules*

All financial statement schedules are omitted because the information is inapplicable or presented in the notes to the financial statements.



## EXHIBIT INDEX

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(3) Incorporated by reference from exhibits to our report on Form 8-K as filed with the Securities and Exchange Commission on May 3, 2005.

(4) Incorporated by reference from our registration statement on Form S-1, registration number 333-32370, declared effective by the Securities and Exchange Commission on July 13, 2000.

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- (9) Incorporated by reference from exhibits to our report on Form 8-K as filed with the Securities and Exchange Commission on May 29, 2008.

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## Corporate Directory

### Corporate Headquarters

2211 Bridgepointe Parkway, Suite 500  
San Mateo, California 94404  
650.624.8200  
www.paintrials.com

### General Counsel

Wilson Sonsini Goodrich & Rosati

### Independent Auditors

Ernst & Young LLP

### Registrar and Transfer Agent

Communications concerning transfer requirements, certificate exchanges, lost certificates, changes of address and name changes should be directed to the transfer agent:

Mellon Investor Services LLC  
480 Washington Boulevard  
Jersey City, New Jersey 07310  
800.356.2017  
www.melloninvestor.com

### Investor Relations and Shareholder Inquiries

Shareholders, security analysts, investment professionals, interested investors and the media should direct their inquiries to:

H. Christine Waarich  
Senior Manager of Investor Relations  
2211 Bridgepointe Parkway, Suite 500  
San Mateo, California 94404  
650.624.8200  
cwaarich@paintrials.com

### Stock Information

Our common stock trades on The NASDAQ Stock Market® under the symbol PTIE. No dividends have been paid on the common stock to date. On January 12, 2009 there were 72 holders of record of our common stock.

### Annual Meeting

Our Annual Meeting of Stockholders will be at 10:00 a.m. Pacific Time on May 21, 2009 at the offices of Wilson Sonsini Goodrich & Rosati, 650 Page Mill Road, Palo Alto, California.

### Price Range of Common Stock

The following table lists the high and low reported sales prices for our common stock as reported on The NASDAQ Stock Market®.

	2008		2007	
	High	Low	High	Low
First Quarter	\$10.73	\$7.48	\$9.20	\$7.00
Second Quarter	\$8.86	\$6.80	\$9.00	\$7.54
Third Quarter	\$10.32	\$7.35	\$9.86	\$8.20
Fourth Quarter	\$10.09	\$5.50	\$11.50	\$9.35

*Disclaimer:* This report contains forward-looking statements that include risks and uncertainties. We disclaim any obligation to update these statements. Examples include, but are not limited to, statements about the lack of need for fundraising and the benefits of our drug candidates. Various important factors could cause actual results or events to differ materially from the forward-looking statements that we make, including risks related to unexpected expenses, difficulties or delays in developing, obtaining regulatory approval for or commercializing our drug candidates, including Remoxy, and development of alternative therapies or products by competitors. A further description of these and other risks and uncertainties pertaining to our business is contained in our Form 10-K for the year ended December 31, 2008 included with this report.

## Management

### Remi Barbier

Chairman of the Board  
President and CEO

### Nadav Friedmann, PhD, MD

Chief Medical and Operating Officer

### Peter Roddy

Vice President and Chief Financial Officer

### Grant Schoenhard, PhD

Chief Scientific Officer

### Michael Zamloot

Senior Vice President,  
Technical Operations

### George Ben Thornton, PhD

Senior Vice President, Technology

### Peter Butera

Vice President, Clinical Operations

### Michael Marsman, PharmD

Vice President, Regulatory Affairs

### Roger Fu, PhD

Vice President,  
Pharmaceutical Development

### Annelies de Kater, PhD

Vice President,  
Nonclinical Development

## Board of Directors

### Robert Gussin, PhD<sup>1,2</sup>

Former Chief Scientific Officer  
Johnson & Johnson

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### Patrick Scannon, MD, PhD<sup>1</sup>

Chief Biotechnology Officer  
Xoma Ltd.

### Remi Barbier

Chairman of the Board  
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### Nadav Friedmann, PhD, MD

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