ENTERTAINMENT PROPERTIES TRUST
Form 10-Q
July 28, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended June 30, 2009

or

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

For the transition period from __________ to __________

Commission File Number: 1-13561

ENTERTAINMENT PROPERTIES TRUST

(Exact name of registrant as specified in its charter)

Maryland	**43-1790877**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
30 West Pershing Road, Suite 201 Kansas City, Missouri	**64108**
(Address of principal executive offices)	(Zip Code)

(816) 472-1700

(Registrant s telephone number, including area code)

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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

At July 27, 2009, there were 34,949,515 common shares of beneficial interest outstanding.

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CAUTIONARY STATEMENT CONCERNING FORWARD LOOKING STATEMENTS

With the exception of historical information, certain statements contained or incorporated by reference herein constitute forward-looking statements as such term is defined in Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). The forward-looking statements may refer to our financial condition, results of operations, plans, objectives, acquisition or disposition of properties, future expenditures for development projects, capital resources, future financial performance and business. Forward-looking statements are not guarantees of performance. They involve numerous risks, uncertainties and assumptions. Our future results, financial condition and business may differ materially from those expressed in these forward-looking statements. You can find many of these statements by looking for words such as will be, continue, hope, goal, forecast, approximates, believes, expects, anti estimates, intends, plans would, may or other similar expressions in this Quarterly Report on Form 10-Q. In add references to our budgeted amounts are forward looking statements. Factors that could materially and adversely affect us include, but are not limited to, the factors listed below:

General international, national, regional and local business and economic conditions;

Current levels of market volatility are unprecedented;

Failure of current governmental efforts to stimulate the economy;

The downturn in the credit markets;

The failure of a bank to fund a request by us to borrow money;

Failure of banks in which we have deposited funds;

Defaults in the performance of lease terms by our tenants;

Defaults by our customers and counterparties on their obligations owed to us;

A mortgagor s bankruptcy or default;

A significant loan commitment for a development project that may not be completed as planned;

The obsolescence of older multiplex theaters owned by some of our tenants;

Risks of operating in the entertainment industry;

Our ability to compete effectively;

The majority of our megaplex theater properties are leased by a single tenant;

A single tenant leases or is the mortgagor of all our ski area investments;

A single tenant leases all of our charter schools;

Risks associated with use of leverage to acquire properties;

Financing arrangements that require lump-sum payments;

Our ability to sustain the rate of growth we have had in recent years;

Our ability to raise capital;

Covenants in our debt instruments that limit our ability to take certain actions;

Risks of acquiring and developing properties and real estate companies;

The lack of diversification of our investment portfolio;

Our continued qualification as a REIT;

The ability of our subsidiaries to satisfy their obligations;

Financing arrangements that expose us to funding or purchase risks;

We have a limited number of employees and the loss of personnel could harm operations;

Fluctuations in the value of real estate income and investments;

Risks relating to real estate ownership, leasing and development, for example local conditions such as an oversupply of space or a reduction in demand for real estate in the area, competition from other available space, whether tenants and users such as customers of our tenants consider a property attractive, changes in real estate taxes and other expenses, changes in market rental rates, the timing and costs associated with property improvements and rentals, changes in taxation or zoning laws or other governmental regulation, whether we are able to pass some or all of any increased operating costs through to tenants, and how well we manage our properties;

Our ability to secure adequate insurance and risk of potential uninsured losses, including from natural disasters;

Risks involved in joint ventures;

Risks in leasing multi-tenant properties;

A failure to comply with the Americans with Disabilities Act or other laws;

Risks of environmental liability;

Our real estate investments are relatively illiquid;

We own assets in foreign countries;

Risks associated with owning or financing properties for which the tenant s or mortgagor s operations may be impacted by weather conditions;

Risks associated with the ownership of vineyards;

Our ability to pay dividends in cash or at current rates;

Fluctuations in interest rates;

Fluctuations in the market prices for our shares;

Certain limits on change in control imposed under law and by our Declaration of Trust and Bylaws;

Policy changes obtained without the approval of our shareholders;

Equity issuances could dilute the value of our shares;

- Risks associated with changes in the Canadian exchange rate; and

- Changes in laws and regulations, including tax laws and regulations

These forward-looking statements represent our intentions, plans, expectations and beliefs and are subject to numerous assumptions, risks and uncertainties. Many of the factors that will determine these items are beyond our ability to control or predict. For further discussion of these factors see Item 1A. Risk Factors in the Annual Report on Form 10-K for the year ended December 31, 2008 filed with the SEC on February 24, 2009 and to the extent applicable, our Quarterly Reports on Form 10-Q.

For these statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. You are cautioned not to place undue reliance on our forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q or the date of any document incorporated by reference herein. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. We do not undertake any obligation to release publicly any revisions to our forward-looking statements to reflect events or circumstances after the date of this Quarterly Report on Form 10-Q.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

ENTERTAINMENT PROPERTIES TRUST
Consolidated Balance Sheets
(Dollars in thousands except share data)

	June 30, 2009 (Unaudited)	December 31, 2008
Assets		
Rental properties, net of accumulated depreciation of $235,472 and $214,078 at June 30, 2009 and December 31, 2008, respectively	$ 1,745,000	$ 1,735,026
Property under development	22,847	30,835
Mortgage notes and related accrued interest receivable	538,632	508,506
Investment in a direct financing lease, net	167,945	166,089
Investment in joint ventures	2,457	2,493
Cash and cash equivalents	16,202	50,082
Restricted cash	14,551	11,004
Intangible assets, net	10,188	12,400
Deferred financing costs, net	14,010	10,741
Accounts and notes receivable, net	73,241	73,312
Other assets	36,504	33,437
Total assets	$ 2,641,577	$ 2,633,925
Liabilities and Shareholders Equity		
Liabilities:		
Accounts payable and accrued liabilities	$ 27,122	$ 35,665
Common dividends payable	22,732	27,377
Preferred dividends payable	7,552	7,552
Unearned rents and interest	12,836	8,312
Long-term debt	1,225,356	1,262,368
Total liabilities	1,295,598	1,341,274
Shareholders equity:		
Common Shares, $.01 par value; 50,000,000 shares authorized; and 35,852,316 and 33,734,181 shares issued at June 30, 2009 and December 31, 2008, respectively	358	337
Preferred Shares, $.01 par value; 25,000,000 shares authorized; 3,200,000 Series B shares issued at June 30, 2009 and December 31, 2008; liquidation preference of $80,000,000	32	32
5,400,000 Series C convertible shares issued at June 30, 2009 and December 31, 2008; liquidation preference of $135,000,000	54	54
4,600,000 Series D shares issued at June 30, 2009 and December 31, 2008; liquidation preference of $115,000,000	46	46
3,450,000 Series E convertible shares issued at June 30, 2009 and December 31, 2008; liquidation preference of $86,250,000	35	35

Additional paid-in-capital	1,389,162	1,339,798
Treasury shares at cost: 904,824 and 860,084 common shares at June 30, 2009 and December 31, 2008, respectively	(27,698)	(26,357)
Loans to shareholders	(1,925)	(1,925)
Accumulated other comprehensive income	9,951	(6,169)
Distributions in excess of net income	(36,170)	(28,417)
Entertainment Properties Trust shareholders equity	1,333,845	1,277,434
Noncontrolling interests	12,134	15,217
Shareholders equity	1,345,979	1,292,651
Total liabilities and shareholders equity	$ 2,641,577	$ 2,633,925

See accompanying notes to consolidated financial statements.

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ENTERTAINMENT PROPERTIES TRUST
Consolidated Statements of Income
(Unaudited)
(Dollars in thousands except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Rental revenue	$ 50,507	$ 49,940	$ 100,918	$ 99,062
Tenant reimbursements	4,258	5,194	8,893	10,865
Other income	728	491	1,868	1,202
Mortgage and other financing income	11,224	13,130	21,742	23,484
Total revenue	66,717	68,755	133,421	134,613
Property operating expense	6,382	6,309	14,400	13,335
Other expense	854	622	1,472	1,557
General and administrative expense	4,278	3,938	8,404	8,352
Costs associated with loan refinancing	117		117	
Interest expense, net	17,482	16,960	34,919	34,428
Depreciation and amortization	11,834	10,341	24,463	21,014
Income before equity in income from joint ventures and discontinued operations	25,770	30,585	49,646	55,927
Equity in income from joint ventures	225	245	444	1,527
Income from continuing operations	$ 25,995	$ 30,830	$ 50,090	$ 57,454
Discontinued operations:				
Loss from discontinued operations		(16)		(27)
Gain on sale of real estate		119		119
Net income	25,995	30,933	50,090	57,546
Add: Net loss attributable to noncontrolling interests	1,709	478	2,943	986
Net income attributable to Entertainment Properties Trust	27,704	31,411	53,033	58,532
Preferred dividend requirements	(7,552)	(7,552)	(15,103)	(13,162)
Net income available to common shareholders of Entertainment Properties Trust	$ 20,152	$ 23,859	$ 37,930	$ 45,370
Per share data attributable to Entertainment Properties Trust common shareholders:				

Basic earnings per share data:								
Income from continuing operations available to common shareholders	$	0.58	$	0.78	$	1.09		1.54
Income from discontinued operations								0.01
Net income available to common shareholders	$	0.58	$	0.78	$	1.09	$	1.55
Diluted earnings per share data:								
Income from continuing operations available to common shareholders	$	0.58	$	0.77	$	1.09	$	1.53
Income from discontinued operations								
Net income available to common shareholders	$	0.58	$	0.77	$	1.09	$	1.53
Shares used for computation (in thousands):								
Basic		34,970		30,577		34,678		29,351
Diluted		34,992		30,913		34,686		29,663
Dividends per common share	$	0.65	$	0.84	$	1.30	$	1.68

See accompanying notes to consolidated financial statements.

ENTERTAINMENT PROPERTIES TRUST
Consolidated Statement of Changes in Shareholders Equity
Six Months Ended June 30, 2009
(Unaudited)
(Dollars in thousands)

	Entertainment Properties Trust Shareholders										
	Common Stock		Preferred Stock		Additional paid-in	Treasury	Loans to	Accumulated other comprehensive	Distributions in excess of net	Noncontrolling	
	Shares	Par	Shares	Par	capital	shares	shareholders	income	income	Interests	Total
Balance at December 31, 2008	33,734	$ 337	16,650	$ 167	$ 1,339,798	$ (26,357)	$ (1,925)	$ (6,169)	$ (28,417)	$ 15,217	$ 1,292,651
Restricted share units issued to Trustees					390						390
Issuance of nonvested shares, including nonvested shares issued for the payment of bonuses	218	2			2,413						2,415
Cancellation of 4,175 employee nonvested shares					139	(139)					
Amortization of nonvested shares					1,647						1,647
Share option expense					331						331
Foreign currency translation adjustment								10,477			10,477
Change in unrealized gain/loss on derivatives								5,643			5,643
Net income									53,033	(2,943)	50,090
						(1,202)					(1,202)

Purchase of 40,565 common shares for treasury											
Issuances of common shares, net of costs of $227 thousand	1,900	19			44,444						44,463
Dividends to common and preferred shareholders									(60,786)		(60,786)
Distributions paid to noncontrolling interests										(140)	(140)
Balance at June 30, 2009	35,852	$ 358	16,650	$ 167	$ 1,389,162	$ (27,698)	$ (1,925)	$ 9,951	$ (36,170)	$ 12,134	$ 1,345,979

See accompanying notes to consolidated financial statements.

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ENTERTAINMENT PROPERTIES TRUST
Consolidated Statements of Comprehensive Income
(Unaudited)
(Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
Net income	$ 25,995	$ 30,933	$ 50,090	$ 57,546
Other comprehensive income (loss):				
Foreign currency translation adjustment	18,143	1,159	10,477	(6,984)
Change in unrealized gain (loss) on derivatives	(5,990)	381	5,643	2,120
Comprehensive income	38,148	32,473	66,210	52,682
Comprehensive income attributable to the noncontrolling interests	1,709	478	2,943	986
Comprehensive income attributable to Entertainment Properties Trust	$ 39,857	$ 32,951	$ 69,153	$ 53,668

See accompanying notes to consolidated financial statements.

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ENTERTAINMENT PROPERTIES TRUST
Consolidated Statements of Cash Flows
(Unaudited)
(Dollars in thousands)

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Operating activities:		
Net income	$ 50,090	$ 57,546
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss from discontinued operations		(92)
Costs associated with loan refinancing	117	
Equity in income from joint ventures	(444)	(1,527)
Distributions from joint ventures	493	1,777
Depreciation and amortization	24,463	21,014
Amortization of deferred financing costs	1,449	1,622
Share-based compensation expense to management and trustees	2,155	1,987
Decrease in restricted cash	2,133	2,256
Increase in mortgage notes accrued interest receivable	(244)	(9,835)
Decrease (increase) in accounts and accrued interest on notes receivable	3,966	(3,175)
Increase in direct financing lease receivable	(1,856)	(486)
Increase in other assets	(4,253)	(3,011)
Decrease in accounts payable and accrued liabilities	(30)	(549)
Decrease in unearned rents	(1,022)	(3,997)
Net operating cash provided by continuing operations	77,017	63,530
Net operating cash used by discontinued operations		(27)
Net cash provided by operating activities	77,017	63,503
Investing activities:		
Acquisition of rental properties and other assets	(2,450)	(134,248)
Investment in unconsolidated joint venture	(13)	(38)
Investment in mortgage notes receivable	(28,536)	(24,627)
Proceeds from mortgage note receivable paydown	3,512	
Investment in promissory notes receivable	(3,858)	(10,149)
Proceeds from promissory note receivable paydown	1,000	
Investment in direct financing lease, net		(121,785)
Additions to properties under development	(12,337)	(16,317)
Net cash used in investing activities from continued operations	(42,682)	(307,164)
Net proceeds from sale of real estate from discontinued operations		986
Net cash used in investing activities	(42,682)	(306,178)
Financing activities:		
Proceeds from long-term debt facilities	43,006	136,153
Principal payments on long-term debt	(84,283)	(33,035)

Deferred financing fees paid	(4,786)	(925)
Net proceeds from issuance of common shares	44,408	111,335
Net proceeds from issuance of preferred shares		83,438
Impact of stock option exercises, net		44
Purchase of common shares for treasury	(1,202)	(777)
Distributions paid to noncontrolling interests	(140)	(90)
Dividends paid to shareholders	(65,379)	(56,262)
Net cash provided (used) by financing activities	(68,376)	239,881
Effect of exchange rate changes on cash	161	(175)
Net decrease in cash and cash equivalents	(33,880)	(2,969)
Cash and cash equivalents at beginning of the period	50,082	15,170
Cash and cash equivalents at end of the period	$ 16,202	$ 12,201

Supplemental information continued on next page.

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ENTERTAINMENT PROPERTIES TRUST
Consolidated Statements of Cash Flows
(Unaudited)
(Dollars in thousands)

Continued from previous page.

	Six Months Ended June 30,	
	2009	**2008**
Supplemental schedule of non-cash activity:		
Transfer of property under development to rental property	$22,074	$ 9,374
Issuance of nonvested shares at fair value, including nonvested shares issued for payment of bonuses	$ 3,977	$ 6,028
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	$34,469	$34,441
Cash received during the period for income taxes	$ (607)	$ (964)

See accompanying notes to consolidated financial statements.

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ENTERTAINMENT PROPERTIES TRUST
Notes to Consolidated Financial Statements (Unaudited)

1. Organization

Description of Business

Entertainment Properties Trust (the Company) is a Maryland real estate investment trust (REIT) organized on August 29, 1997. The Company develops, owns, leases and finances megaplex theatres, entertainment retail centers (centers generally anchored by an entertainment component such as a megaplex theatre and containing other entertainment-related properties), and destination recreational and specialty properties. The Company s properties are located in the United States and Canada.

2. Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ significantly from those estimates. In addition, operating results for the six-month period ended June 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

The Company consolidates certain entities if it is deemed to be the primary beneficiary in a variable interest entity (VIE), as defined in Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 46(R), Consolidation of Variable Interest Entities (FIN 46R). The equity method of accounting is applied to entities in which the Company is not the primary beneficiary as defined in FIN 46R, or does not have effective control, but can exercise influence over the entity with respect to its operations and major decisions.

In December 2007, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 160, Noncontrolling Interests in Consolidated Financial Statements (SFAS No. 160), effective for fiscal years beginning on or after December 15, 2008. The Company has adopted SFAS No. 160 effective January 1, 2009. Per SFAS No. 160, noncontrolling interest is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. The ownership interests in the subsidiary that are held by owners other than the parent are noncontrolling interests. Under SFAS No. 160, such noncontrolling interests are reported on the consolidated balance sheets within equity, separately from the Company s equity. On the consolidated statements of income, revenues, expenses and net income or loss from less-than-wholly-owned subsidiaries are reported at the consolidated amounts, including both the amounts attributable to the Company and noncontrolling interests. Consolidated statements of changes in shareholder s equity are included for both quarterly and annual financial statements, including beginning balances, activity for the period and ending balances for shareholders equity, noncontrolling interests and total equity. The Company does not have any redeemable noncontrolling interests under Emerging Issues Task Force (EITF) D-98, Classification and Measurement of Redeemable Securities.

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The consolidated balance sheet as of December 31, 2008 has been derived from the audited consolidated balance sheet at that date but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008 filed with the Securities and Exchange Commission (SEC) on February 24, 2009.

Revenue Recognition

Rents that are fixed and determinable are recognized on a straight-line basis over the minimum terms of the leases. Base rent escalation on leases that are dependent upon increases in the Consumer Price Index (CPI) is recognized when known. Straight-line rent receivable is included in accounts receivable and was $24.3 million and $23.1 million at June 30, 2009 and December 31, 2008, respectively. In addition, most of the Company s tenants are subject to additional rents if gross revenues of the properties exceed certain thresholds defined in the lease agreements (percentage rents). Percentage rents are recognized at the time when specific triggering events occur as provided by the lease agreements. Percentage rents of $649 thousand and $902 thousand were recognized for the six months ended June 30, 2009 and 2008, respectively. Lease termination fees are recognized when the related leases are canceled and the Company has no obligation to provide services to such former tenants. No termination fees were recognized during the six months ended June 30, 2009 and 2008.

Direct financing lease income is recognized on the effective interest method to produce a level yield on funds not yet recovered. Estimated unguaranteed residual values at the date of lease inception represent management s initial estimates of fair value of the leased assets at the expiration of the lease, not to exceed original cost. Significant assumptions used in estimating residual values include estimated net cash flows over the remaining lease term and expected future real estate values. The estimated unguaranteed residual value is reviewed on an annual basis to determine if there are other than temporary impairments. The Company evaluates on an annual basis during the second quarter the collectibility of its direct financing lease receivable and unguaranteed residual value to determine whether they are impaired. A direct financing lease receivable is considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the existing contractual terms. When a direct financing lease receivable is considered to be impaired, the amount of loss is calculated by comparing the recorded investment to the value determined by discounting the expected future cash flows at the direct financing lease receivable s effective interest rate or to the value of the underlying collateral, less costs to sell, if such receivable is collateralized.

Rental Properties

Rental properties are carried at cost less accumulated depreciation. Costs incurred for the acquisition and development of the properties are capitalized. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which generally are estimated to be 40 years for buildings and 3 to 25 years for furniture, fixtures and equipment. Tenant improvements, including allowances, are depreciated over the shorter of the base term of the lease or the estimated useful life. Expenditures for ordinary maintenance and repairs are charged to operations in the period incurred. Significant renovations and improvements which improve or extend the useful life of the asset are capitalized and depreciated over their estimated useful life.

The Company applies SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , for the recognition and measurement of impairment of long-lived assets to be held and used.

Management reviews a property for impairment whenever events or changes in circumstances indicate that the carrying value of a property may not be recoverable. The review of recoverability is based on an estimate of undiscounted future cash flows expected to result from its use and eventual disposition. If impairment exists due to the inability to recover the carrying value of the property, an impairment loss is recorded to the extent that the carrying value of the property exceeds its estimated fair value.

Allowance for Doubtful Accounts

The Company makes quarterly estimates of the collectibility of its accounts receivable related to base rents, tenant escalations (straight-line rents), reimbursements and other revenue or income. The Company specifically analyzes trends in accounts receivable, historical bad debts, customer credit worthiness, current economic trends and changes in customer payment terms when evaluating the adequacy of its allowance for doubtful accounts. In addition, when customers are in bankruptcy, the Company makes estimates of the expected recovery of pre-petition administrative and damage claims. These estimates have a direct impact on the Company s net income.

Mortgage Notes and Other Notes Receivable

Mortgage notes and other notes receivable, including related accrued interest receivable, consist of loans originated by the Company and the related accrued and unpaid interest income as of the balance sheet date. Mortgage notes and other notes receivable are initially recorded at the amount advanced to the borrower and the Company defers certain loan origination and commitment fees, net of certain origination costs, and amortizes them over the term of the related loan. Interest income on performing loans is accrued as earned. The Company evaluates the collectibility of both interest and principal of each of its loans to determine whether it is impaired. A loan is considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the existing contractual terms. When a loan is considered to be impaired, the amount of loss is calculated by comparing the recorded investment to the value determined by discounting the expected future cash flows at the loan s effective interest rate or to the fair value of the underlying collateral, less costs to sell, if the loan is collateralized. For impaired loans, interest income is recognized on a cash basis, unless the Company determines based on the loan to estimated fair value ratio the loan should be on the cost recovery method, and any cash payment received would then be reflected as a reduction of principal. Interest income recognition is recommenced when the impaired loan becomes contractually current and performance is demonstrated to be resumed.

Concentrations of Risk

American Multi-Cinema, Inc. (AMC) is the lessee of a substantial portion (51%) of the megaplex theatre rental properties held by the Company (including joint venture properties) at June 30, 2009 as a result of a series of sale leaseback transactions pertaining to a number of AMC megaplex theatres. A substantial portion of the Company s rental revenues (approximately $48.3 million or 48% and $48.9 million or 49% for the six months ended June 30, 2009 and 2008, respectively) result from the rental payments by AMC under the leases, or its parent, AMC Entertainment, Inc. (AMCE), as the guarantor of AMC s obligations under the leases. AMCE had total assets of $3.7 billion and $3.8 billion, total liabilities of $2.7 billion and $2.7 billion and total stockholders equity of $1.0 billion and $1.1 billion at April 2, 2009 and April 3, 2008, respectively. AMCE had a net loss of $81.2 million for the fifty-two weeks ended April 2, 2009 and net earnings of $43.4 million for the fifty-three weeks ended April 3, 2008. AMCE has publicly held debt and accordingly, its consolidated financial information is publicly available.

For the six months ended June 30, 2009 and 2008, respectively, approximately $16.9 million, or 13%, and $19.5 million, or 15%, of total revenue was derived from the Company s four entertainment retail centers in Ontario, Canada. For the six months ended June 30, 2008, $28.2

million, or 21%, of our total revenue was derived from the Company s four entertainment retail centers in Ontario, Canada combined with the mortgage financing interest related to the Company s mortgage note receivable held in Canada and initially funded on June 1, 2005. For the six months ended June 30, 2009, no mortgage financing interest income was recognized related to the Company s mortgage note receivable held in Canada as further described in Note 4. The Company s wholly owned subsidiaries that hold the Canadian entertainment retail centers, third party debt and mortgage note receivable represent approximately $233.5 million or 17% and $219.5 million or 17% of the Company s net assets as of June 30, 2009 and December 31, 2008, respectively.

Share-Based Compensation

Share-based compensation is issued to employees of the Company and non-employee Trustees pursuant to the Annual Incentive Program and the Long-Term Incentive Plan. Prior to May 9, 2007, all common shares and options to purchase common shares (share options) were issued under the 1997 Share Incentive Plan. The 2007 Equity Incentive Plan was approved by shareholders at the May 9, 2007 annual meeting and this plan replaced the 1997 Share Incentive Plan. Accordingly, all common shares and options to purchase common shares granted on or after May 9, 2007 are issued under the 2007 Equity Incentive Plan.

The Company accounts for share based compensation under the SFAS No. 123R Share-Based Payment (SFAS No. 123R). Share based compensation expense consists of share option expense, amortization of nonvested share grants, and shares and share units issued to non-employee Trustees for payment of their annual retainers. Share based compensation is included in general and administrative expense in the accompanying consolidated statements of income, and totaled $2.2 million and $2.0 million for the six months ended June 30, 2009 and 2008, respectively.

Share Options

Share options are granted to employees pursuant to the Long-Term Incentive Plan and to non-employee Trustees for their service to the Company. The fair value of share options granted is estimated at the date of grant using the Black-Scholes option pricing model. Share options granted to employees vest over a period of four to five years and share option expense for these options is recognized on a straight-line basis over the vesting period, except for those unvested options held by a retired executive which were fully expensed as of June 30, 2006. Share options granted to non-employee Trustees vest immediately but may not be exercised for a period of one year from the grant date. Share option expense for non-employee Trustees is recognized on a straight-line basis over the year of service by the non-employee Trustees.

The expense related to share options included in the determination of net income for the six months ended June 30, 2009 and 2008 was $331 thousand and $225 thousand, respectively. The following assumptions were used in applying the Black-Scholes option pricing model at the grant dates: risk-free interest rate of 2.6% to 2.8% and 3.2% to 3.5% for the six months ended June 30, 2009 and 2008, respectively, dividend yield of 6.5% to 6.6% and 6.7% for the six months ended June 30, 2009 and 2008, respectively, volatility factors in the expected market price of the Company s common shares of 31.4% to 37.5% and 23.2% for the six months ended June 30, 2009 and 2008, respectively, no expected forfeitures and an expected life of eight years. The Company uses historical data to estimate the expected life of the option and the risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. Additionally, expected volatility is computed based on the average historical volatility of the Company s publicly traded shares.

Nonvested Shares Issued to Employees

The Company grants nonvested shares to employees pursuant to both the Annual Incentive Program and the Long-Term Incentive Plan. The Company amortizes the expense related to the nonvested shares awarded to employees under the Long-Term Incentive Plan and the premium awarded under the nonvested share alternative of the Annual Incentive Program on a straight-line basis over the future vesting period (three to five years). Total expense recognized related to all nonvested shares was $1.6 million for each of the six months ended June 30, 2009 and 2008.

Shares Issued to Non-Employee Trustees

Prior to 2009, the Company issued shares to non-employee Trustees for payment of their annual retainers. These shares vested immediately but could not be sold for a period of one year from the grant date. This expense was amortized by the Company on a straight-line basis over the year of service by the non-employee Trustees. Total expense recognized related to shares issued to non-employee Trustees was $111 thousand and $173 thousand for the six months ended June 30, 2009 and 2008, respectively.

Restricted Share Units Issued to Non-Employee Trustees

In 2009, the Company issued restricted share units to non-employee Trustees for payment of their annual retainers. The fair value of the share units granted was based on the share price at the date of grant. The share units vest upon the earlier of the day preceding the next annual meeting of shareholders or a change of control. The settlement date for the shares is selected by the non-employee trustee, and ranges from three years from the grant date to upon termination of service. This expense was amortized by the Company on a straight-line basis over the year of service by the non-employee Trustees. Total expense recognized related to shares issued to non-employee Trustees was $65 thousand for the six months ended June 30, 2009.

Derivative Instruments

The Company has acquired certain derivative instruments to reduce exposure to fluctuations in foreign currency exchange rates and variable interest rates. The Company has established policies and procedures for risk assessment and the approval, reporting and monitoring of derivative financial instrument activities. These derivatives consist of foreign currency forward contracts, cross currency swaps and interest rate swaps.

SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS No. 161), amends and expands the disclosure requirements of FASB Statement No. 133 (SFAS No. 133) with the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

As required by SFAS No. 133, the Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions,

are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting under SFAS No. 133.

Reclassifications

Certain reclassifications have been made to the prior period amounts to conform to the current period presentation.

Subsequent Events

The Company evaluated subsequent events through the time of filing these financial statements with the SEC on July 28, 2009.

3. Rental Properties

The following table summarizes the carrying amounts of rental properties as of June 30, 2009 and December 31, 2008 (in thousands):

	June 30, 2009 (Unaudited)	December 31, 2008
Buildings and improvements	$ 1,477,099	$ 1,452,500
Furniture, fixtures & equipment	63,269	62,090
Land	440,104	434,514
	1,980,472	1,949,104
Accumulated depreciation	(235,472)	(214,078)
Total	$ 1,745,000	$ 1,735,026

Depreciation expense on rental properties was $21.2 million and $19.4 million for the six months ended June 30, 2009 and 2008, respectively.

4. Investments in Mortgage Notes and Notes Receivable

On August 20, 2008, a wholly-owned subsidiary of the Company provided a secured first mortgage loan of $225.0 million to Concord Resorts, LLC (Concord Resorts), an entity controlled by Louis Cappelli, related to a planned casino and resort development in Sullivan County, New York. The Company s investment is secured by a first mortgage on the resort complex real estate totaling 1,584 acres. In addition, the Company has a second mortgage on the remaining 139 acres of the casino related real estate and the loan is personally guaranteed by Louis Cappelli. The Company has certain rights to convert its mortgage interest into fee ownership as the project is further developed. The net carrying value of this mortgage note receivable at June 30, 2009 was $133.2 million which was funded under the original $225.0 million secured first mortgage commitment. Due to the economic downturn, certain other lenders on the development have either reduced their commitments or withdrawn from the project. The planned initial phase of the casino and resort development has been downsized from an estimated $1 billion to an estimated $600 million and Mr. Cappelli is attempting to secure the necessary financing. The New York legislature has passed legislation authorizing the

benefits of a special reduced tax rate on gaming receipts in Sullivan County, New York if at least $600 million is invested and 1,000 new jobs are created. As a result of these issues, the development project has been slowed, and there can be no assurance that Mr. Cappelli will obtain the financing necessary to complete the project. Due to these challenges, Concord Resorts has ceased making interest payments to the Company as contractually obligated under the loan agreement. The Company has evaluated its mortgage note receivable in accordance with the provisions of SFAS No. 114, Accounting by Creditors for Impairment of a Loan (SFAS No. 114) and has determined it is impaired due to the inability of the borrower to meet its contractual obligations per the agreement. The Company s accounting policy is to recognize interest income on impaired loans on a cash basis. Accrual interest income recognition for book purposes was ceased on January 1, 2009 and therefore no interest income has been recorded during the six months ended June 30, 2009. Management of the Company determined that no loan loss reserve was necessary for this note taking into account an independent appraisal as of April 30, 2009 of the primary collateral, 1,584 acres of land, which indicated a value significantly in excess of the loan balance.

The Company s original loan commitment to fund an additional $91.8 million to Concord Resorts is no longer applicable due to the developer s decision to downsize the initial phase of the project to an investment level of $600 million. The funding of any additional investment in the project by the Company will be subject to satisfaction of certain conditions, including but not limited to a reduction from the aforementioned $91.8 million.

The Company has two $10 million notes receivable that were due on February 28, 2009 and March 1, 2009, respectively. The notes bear interest at 10% and are included in accounts and notes receivable in the accompanying consolidated balance sheets. Neither note was repaid at maturity. One of the notes is due from the Company s minority joint venture partner in New Roc, an entertainment retail center in New Rochelle, New York, and this note is secured by such partner s interest. The minority joint venture partner is an entity controlled by Louis Cappelli and Louis Cappelli has also personally guaranteed the loan. The other note is due from Louis Cappelli personally and in conjunction with this note, the Company received an option to purchase 50% of Louis Cappelli s interest (or Louis Cappelli s related interests) in three other projects.

The Company has evaluated these two notes receivable in accordance with the provisions of SFAS No. 114, and has determined that they are impaired due to the inability of the borrower to meet its contractual obligations per the original agreements. The Company s accounting policy is to recognize interest income on impaired loans on a cash basis. Accordingly, accrual interest income recognition was ceased on January 1, 2009. Interest income of $833 thousand has been recorded during the six months ended June 30, 2009 which represents payments received by the Company. Interest income recognized on these loans for the six months ended June 30, 2008 was $839 thousand. Management of the Company has evaluated the fair value of the underlying collateral of the notes and has concluded that no loan loss reserve was necessary at June 30, 2009.

On January 26, 2009, a wholly-owned subsidiary of the Company entered into a credit agreement with Rb Wine Associates, LLC to provide a $2 million revolving credit facility that matures on January 1, 2010. This note is secured by certain pledge agreements and other collateral. Interest accrues on the outstanding principal balance at an annual rate of 15%. Interest is payable monthly at an annual rate of 9.25% and the remaining accrued but unpaid interest and principal is due at maturity. During the six months ended June 30, 2009, the Company advanced $1.1 million under this agreement.

On February 6, 2009, a wholly-owned subsidiary of the Company invested an additional $950 thousand Canadian (CAD) ($768 thousand U.S.) in the mortgage note receivable from Metropolis Limited Partnership (the Partnership) related to the construction of Toronto Life Square, a 13 level entertainment retail center in downtown Toronto that was completed in May 2008 for a total cost of approximately CAD $330 million. This advance has a stated maturity of June 2, 2010 and bears interest at 15%. Additionally, as of June 30, 2009, the Company had posted irrevocable stand-by letters of credit related to this project totaling $7.6 million which are expected to be cancelled or drawn upon during 2009. The carrying value of this mortgage note receivable at June 30, 2009 was CAD $126.7 million ($108.9 million U.S.), which includes related accrued interest receivable on both the note and the letters of credit of CAD $45.3 million ($39.0 million U.S.). The loan is denominated in Canadian dollars and is secured by Toronto Life Square. On March 2, 2009, the Company s 25% principal payment and all accrued interest to date on the second mortgage note receivable from the Partnership came due.

A group of banks (the bank syndicate) has provided first mortgage construction financing to the Partnership totaling approximately CAD $119.0 million ($102.3 million U.S.) as of June 30, 2009. The bank syndicate s first mortgage was due February 27, 2009. An additional extension was not executed during the six months ended June 30, 2009 for either the bank s first mortgage or amounts due under the Company s second mortgage. In April 2009, the Company and the bank syndicate elected to pursue a receivership after it became apparent that a restructuring of the existing equity interests was no longer possible. On April 27, 2009, the court appointed a receiver who will now oversee the sale of the property. As a result of this process, the Company could become the owner of the property if it is the highest bidder or alternatively, could settle its mortgage note receivable with the proceeds from a higher bidder. The Company is currently negotiating a refinancing of the first mortgage should it be the highest bidder for the property. While there can be no assurance regarding the success of the first mortgage refinancing or its timing, based on preliminary negotiations, the Company currently estimates a new first mortgage loan would provide proceeds of CAD $100 to $120 million. If the Company becomes the owner through the sale process, the Company expects to consolidate the financial results of the property subsequent to the purchase.

The Company has evaluated its mortgage note receivable in accordance with the provisions of SFAS No. 114. Because repayment of the mortgage note receivable did not meet the contractual terms of the agreement, the Company has determined the loan is impaired and has ceased accruing interest income as of January 1, 2009 on the loan for book purposes. Accordingly, no interest income was recognized for the six months ended June 30, 2009 and no interest income will be recognized in future periods unless collected from a third party buyer through the sale process. Interest income recognized on this loan for the six months ended June 30, 2008 was CAD $8.8 million ($8.7 million U.S.). Furthermore, management of the Company reviewed the fair market value of the property at June 30, 2009, taking into account an independent appraisal of CAD $277.0 million dated January 31, 2009 and changes in conditions from February 1, 2009 to June 30, 2009, and determined no loan loss reserve was necessary.

On February 20, 2009, a wholly-owned subsidiary of the Company entered into a $3.0 million promissory note with Sapphire Wines LLC. The note bears interest at 15% and it matures on November 1, 2009. This note is secured by certain pledge agreements and other collateral. Interest has generally been paid late and because such payments are not being received per the contractual terms of the agreement, this note is considered impaired and is included in the $11.8 million of impaired notes receivable discussed further below.

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On May 8, 2009, the Company received payment in full on its mortgage note receivable and related accrued interest of $3.7 million from Prairie Creek Properties, LLC. The Company advanced $3.5 million during the year ended December 31, 2007 under this agreement for the development of an approximately 9,000 seat amphitheatre in Hoffman Estates, Illinois.

On June 26, 2009, the Company received payment in full on its note receivable and related accrued interest of $1.0 million from an affiliate of one of its theatre operators. The Company advanced $1.0 million during the year ended December 31, 2007 under this agreement for the development of a megaplex theatre.

During the six months ended June 30, 2009, the Company advanced $27.8 million under its secured first mortgage loan agreement with SVV I, LLC for the development of a water-park anchored entertainment village in Kansas City, Kansas, the first phase of which opened in July 2009. On May 6, 2009, the Company reduced its commitment on this project from $175.0 million to $163.5 million and added to its collateral position by placing a mortgage on the two other water-parks, located in New Braunfels and South Padre Island, Texas, owned and operated by the entities controlled by the principals of SVVI, LLC. The mortgage note on the property in Kansas City, Kansas and the mortgage note on the Texas properties have cross-default and cross-collateral provisions. Per the mortgage on the Texas properties, only a seasonal line of credit secured by the Texas parks totaling not more than $5 million at any time ranks superior to the Company s collateral position. Furthermore, the interest rate increased from LIBOR plus 350 basis points to 7% on June 30, 2009, and the loan was extended from September 30, 2012 to May 1, 2019. Interest income will continue to be recognized on the accrual basis. SVVI, LLC is required to fund a debt service reserve for off-season fixed payments (those due from September to May). The reserve is to be funded by equal monthly installments during the months of June, July and August. The Company also will receive a percentage of revenue from all three parks after certain threshold levels are achieved that may increase the return on the Company s invested capital from 7% to as high as 10%. Through June 30, 2009, the Company has funded approximately $162.1 million on the mortgage notes.

Additionally, the Company has three notes receivable totaling $11.8 million at June 30, 2009 that were evaluated in accordance with the provisions of SFAS No. 114. The Company determined that these notes are impaired due to the inability of the borrowers to meet their contractual obligations per the original agreements. The Company s accounting policy is to recognize interest income on impaired loans on a cash basis. Accordingly, accrual interest income recognition for these notes was ceased on January 1, 2009. Interest income of $363 thousand has been recorded during the six months ended June 30, 2009 which represents payments received by the Company. Interest income recognized on these loans for the six months ended June 30, 2008 was $401 thousand. Management of the Company has evaluated the fair value of the underlying collateral of the notes and has concluded that no loan loss reserve was necessary at June 30, 2009.

5. Unconsolidated Real Estate Joint Ventures

At June 30, 2009, the Company had a 21.7% and 21.8% investment interest in two unconsolidated real estate joint ventures, Atlantic-EPR I and Atlantic-EPR II, respectively. The Company accounts for its investment in these joint ventures under the equity method of accounting.

The Company recognized income of $278 and $262 (in thousands) from its investment in the Atlantic-EPR I joint venture during the first six months of 2009 and 2008, respectively. The Company also received distributions from Atlantic-EPR I of $308 and $297 (in thousands) during the first six months of 2009 and 2008, respectively. Unaudited condensed financial information for Atlantic-EPR I is as follows as of and for the six months ended June 30, 2009 and 2008 (in thousands):

	2009	2008
Rental properties, net	$27,635	28,279
Cash	141	369
Long-term debt (due May 2010)	15,211	15,609
Partners equity	12,470	12,713
Rental revenue	2,216	2,194
Net income	1,210	1,186

The Company recognized income of $166 and $163 (in thousands) from its investment in the Atlantic-EPR II joint venture during the first six months of 2009 and 2008, respectively. The Company also received distributions from Atlantic-EPR II of $185 and $184 (in thousands) during the first six months of 2009 and 2008, respectively. Unaudited condensed financial information for Atlantic-EPR II is as follows as of and for the six months ended June 30, 2009 and 2008 (in thousands):

	2009	2008
Rental properties, net	$21,728	22,189
Cash	99	240
Long-term debt (due September 2013)	13,117	13,436
Note payable to Entertainment Properties Trust	117	117
Partners equity	8,386	8,535
Rental revenue	1,433	1,389
Net income	670	678

The joint venture agreements for Atlantic-EPR I and Atlantic-EPR II allow the Company s partner, Atlantic of Hamburg, Germany (Atlantic), to exchange up to a maximum of 10% of its ownership interest per year in each of the joint ventures for common shares of the Company or, at the discretion of the Company, the cash value of those shares as defined in each of the joint venture agreements. During 2008, the Company paid Atlantic-EPR I and Atlantic-EPR II cash of $133 and $79 (in thousands), respectively, in exchange for additional ownership in each joint venture of 0.7%. During the first quarter of 2009, the Company paid Atlantic cash of $105 (in thousands) in exchange for additional ownership of 0.7% for Atlantic-EPR I. These exchanges did not impact total partners equity in either Atlantic-EPR I or Atlantic-EPR II.

On April 2, 2008, the Company acquired, through a wholly-owned subsidiary, the remaining 50% ownership interest in CS Fund I and CS Fund I became a wholly-owned subsidiary. Prior to the date of this acquisition, CS Fund I was accounted for as an unconsolidated real estate joint venture. During the first six months of 2008, the Company recognized income of $1.1 million and received distributions of $1.3 million related to this investment.

6. Amendment and Restatement of Revolving Credit Facility

On June 30, 2009, the Company amended and restated its unsecured revolving credit facility (the facility). The size of the facility decreased from $235 million to $215 million and includes an accordion feature in which the facility can be increased to up to $300 million subject to certain conditions, including lender consent. The facility continues to be supported by a borrowing base of assets, and is secured by a pledge of the equity of each entity that holds a borrowing base asset. The facility bears interest at LIBOR plus 3.5%, and in the event LIBOR is less than 2%, LIBOR shall be deemed to be 2% for purposes of calculating the applicable interest rate for the period. The facility has a term expiring October 26, 2011 with a one year extension available at the Company s option.

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As a result of this amendment and restatement, the Company expensed certain unamortized financing costs, totaling approximately $117 thousand, in the second quarter of 2009.

7. Mortgage Notes Payable

On February 25, 2009, VinREIT, LLC (VinREIT), a subsidiary that holds the Company s vineyard and winery assets, obtained a $4.0 million term loan under VinREIT s $160.0 million credit facility. The loan matures on December 1, 2017, is secured by fixtures and equipment and bears interest at LIBOR plus 2.00%. Principal and interest is due monthly and this loan will be fully amortized at maturity. Subsequent to the closing of this loan, approximately $63.3 million of the facility remains available. The net proceeds from the loan were used to pay down outstanding indebtedness under the Company s revolving credit facility.

8. Derivative Instruments

Risk Management Objective of Using Derivatives

The Company is exposed to the effect of changes in foreign currency exchange rates and interest rates on its LIBOR based borrowings. The Company limits this risk by following established risk management policies and procedures including the use of derivatives. The Company s objective in using derivatives is to add stability to reported earnings and to manage its exposure to foreign exchange and interest rate movements or other identified risks. To accomplish this objective, the Company primarily uses interest rate swaps, cross currency swaps and foreign currency forwards.

Cash Flow Hedges of Interest Rate Risk

The Company s objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements on its LIBOR based borrowings. To accomplish this objective, the Company currently uses interest rate swaps as its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

At June 30, 2009, the Company had nine interest rate swaps outstanding that were designated as cash flow hedges of interest rate risk and had a combined outstanding notional amount of $205.0 million.

The effective portion of changes in the fair value of interest rate derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During the six months ending June 30, 2009, such derivatives were used to hedge the variable cash flows associated with existing variable-rate debt. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. No hedge ineffectiveness on cash flow hedges was recognized during the six months ending June 30, 2009.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Company s variable-rate debt. As of June 30, 2009, the Company estimates that during the twelve months ending June 30, 2010, $6.2 million will be reclassified from accumulated other comprehensive income to interest expense.

Cash Flow Hedges of Foreign Exchange Risk

The Company is exposed to foreign currency exchange risk against its functional currency, the US dollar, on its four Canadian properties and its mortgage note receivable denominated in Canadian

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dollars. The Company uses a cross currency swap to mitigate its exposure to fluctuations in the CAD to U.S. dollar exchange rate on its four Canadian properties. This foreign currency derivative should hedge a significant portion of the Company s expected CAD denominated cash flow of the four Canadian properties through February 2014 as their impact on the Company s cash flow when settled should move in the opposite direction of the exchange rates utilized to translate revenues and expenses of these properties.

At June 30, 2009, the Company s cross-currency swap had a fixed notional value of $76.0 million CAD and $71.5 million U.S. The net effect of this swap is to lock in an exchange rate of $1.05 CAD per U.S. dollar on approximately $13 million of annual CAD denominated cash flows.

The effective portion of changes in the fair value of foreign currency derivatives designated and that qualify as cash flow hedges of foreign exchange risk is recorded in accumulated other comprehensive income and subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivative, as well as amounts excluded from the assessment of hedge effectiveness, is recognized directly in earnings. No hedge ineffectiveness on foreign currency derivatives has been recognized for the six months ended June 30, 2009.

Net Investment Hedges

As discussed above, the Company is exposed to fluctuations in foreign exchange rates on its four Canadian properties and its mortgage note receivable denominated in Canadian dollars. As such, the Company also uses currency forward agreements to hedge its exposure to changes in foreign exchange rates on these investments. Currency forward agreements involve fixing the CAD to U.S. dollar exchange rate for delivery of a specified amount of foreign currency on a specified date. The currency forward agreements are typically cash settled in US dollars for their fair value at or close to their settlement date. In order to hedge the net investment in the Company s four Canadian properties, the Company entered into a forward contract with a fixed notional value of $100 million CAD and $96.1 million U.S. with a February 2014 settlement which coincides with the maturity of the Company s underlying mortgage on these four properties. The exchange rate of this forward contract is approximately $1.04 CAD per U.S. dollar. This forward contract should hedge a significant portion of the Company s CAD denominated net investment in these four centers through February 2014 as the impact on accumulated other comprehensive income from marking the derivative to market should move in the opposite direction of the translation adjustment on the net assets of its four Canadian properties.

For foreign currency derivatives designated as net investment hedges, the effective portion of changes in the fair value of the derivatives are reported in accumulated other comprehensive income as part of the cumulative translation adjustment. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. No hedge ineffectiveness on net investment hedges has been recognized for the six months ended June 30, 2009. Amounts are reclassified out of accumulated other comprehensive income into earnings when the hedged net investment is either sold or substantially liquidated.

See Note 9 for disclosures relating to the fair value of the Company s derivative instruments. Below is a summary of the effect of derivative instruments on the consolidated statement of income for the six months ended June 30, 2009:

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Effect of Derivative Instruments on the Consolidated Statement of Income for the six months ended June 30, 2009 (Unaudited, dollars in thousands)

Description	Amount of Gain or (Loss) Recognized in AOCI on Derivative (Effective Portion)	Amount of Income or (Expense) Reclassified from AOCI into Earnings (Effective Portion)	Amount of Gain or (Loss) Recognzied in Earnings on Derivative (Ineffective Portion)
Interest Rate Swaps	$ 6,503	$ (3,444)*	$
Cross Currency Swaps	(2,158)	780**	
Currency Forward Agreements	1,298		
Total	$ 5,643	$ (2,664)	$

* Included in Interest expense in accompanying consolidated statements of income.

** Included in Other income in the accompanying consolidated statements of income.

Credit-risk-related Contingent Features

The Company has agreements with each of its interest rate derivative counterparties that contain a provision where if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its interest rate derivative obligations.

As of June 30, 2009, the fair value of derivatives in a liability position related to these agreements was $9.1 million. If the Company breached any of the contractual provisions of the derivative contracts, it would be required to settle its obligations under the agreements at their termination value of $10.6 million.

9. Fair Value Disclosures

On January 1, 2008, the Company adopted SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 157 applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements; accordingly, the standard does not require any new fair value measurements of reported balances.

SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions

that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, SFAS No. 157 establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity s own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy). Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the asset or liability (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, which are typically based on an entity s own assumptions, as there is little, if any, related market activity. In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

Derivative Financial Instruments

The Company uses interest rate swaps, foreign currency forwards and cross currency swaps to manage its interest rate and foreign currency risk. The valuation of these instruments is determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves, foreign exchange rates, and implied volatilities. The fair values of interest rate swaps are determined using the market standard methodology of netting the discounted future fixed cash receipts and the discounted expected variable cash payments. The variable cash payments are based on an expectation of future interest rates (forward curves) derived from observable market interest rate curves. To comply with the provisions of SFAS No. 157, the Company incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty s nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Company has considered the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds, mutual puts, and guarantees.

Although the Company has determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives also utilize Level 3 inputs, such as estimates of current credit spreads, to evaluate the likelihood of default by itself and its counterparties. As of June 30, 2009, the Company has assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and has determined that the credit valuation adjustments are significant to the overall valuation of its interest rate derivatives and currency forward agreements, and therefore, has classified its interest rate derivatives and currency forward agreements as Level 3 within the fair value reporting hierarchy.

The table below presents the Company s assets and liabilities measured at fair value on a recurring basis as of June 30, 2009, aggregated by the level in the fair value hierarchy within which those measurements fall and by derivative type.

Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2009
(Unaudited, dollars in thousands)

Description	Quoted Prices in Active Markets for Identical Assets (Level I)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at June 30, 2009
Interest Rate Swaps*	$	$	$ (9,061)	$(9,061)
Cross Currency Swaps**	$	$ 5,474	$	$ 5,474
Currency Forward Agreements**	$	$	$ 9,371	$ 9,371

* Included in Accounts payable and accrued liabilities in the accompanying consolidated balance sheet.

** Included in Other Assets in the accompanying consolidated balance sheet.

The table below presents a reconciliation of the Company s beginning and ending balances of liabilities having fair value measurements based on significant unobservable inputs (Level 3) for the six months ended June 30, 2009.

Level 3 Fair Value Measurements for the Six Months Ended June 30, 2009
(Unaudited, dollars in thousands)

Description	Beginning Balance as of December 31, 2008	Transfers into Level 3	Gains (Losses) Included in Income	Gains (Losses) Included in OCI	Total Gains (Losses)	Ending Balance as of June 30, 2009
Interest Rate Swaps	$	$(15,564)	$	$ 6,503	$ 6,503	$(9,061)
Currency Forward Agreements	$	$ 14,059	$	$(4,688)	$(4,688)	$ 9,371

Nonfinancial Assets and Liabilities

In February 2008, the FASB adopted FASB Staff Position (FSP) FAS 157-2, Effective Date of FASB Statement No. 157, which allowed for a one-year deferral of fair value measurement

requirements for nonfinancial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. Accordingly, for nonfinancial assets and liabilities SFAS No. 157 became effective for the Company as of January 1, 2009, and may impact the determination of goodwill and other long-lived assets fair values, when or if the Company has to apply fair value measurements for these. During the six months ended June 30, 2009, the Company had no fair value measurements related to these assets.

10. Fair Value of Financial Instruments

Management compares the carrying value and the estimated fair value of our financial instruments. The following methods and assumptions were used by the Company to estimate the fair value of each class of financial instruments at June 30, 2009:

Mortgage notes receivable and related accrued interest receivable:

The fair value of the Company s mortgage notes receivable and related accrued interest receivable as of June 30, 2009 is estimated by discounting the future cash flows of each instrument using current market rates. At June 30, 2009, the Company had a variable rate mortgage note receivable outstanding with a carrying value of $162.6 million, including related accrued interest, with an interest rate of 4.01%. The variable mortgage note bears an interest rate of LIBOR plus 350 basis points. Discounting the future cash flows for the variable rate mortgage notes receivable using an estimated market rate of 7.0%, management estimates the variable rate mortgage notes receivable s fair value to be approximately $128.6 million at June 30, 2009.

At June 30, 2009, the Company had a carrying value of $376.0 million in fixed rate mortgage notes receivable outstanding, including related accrued interest, with a weighted average interest rate of approximately 12.79%. The fixed rate mortgage notes bear interest at rates of 9.40% to 15.00%. Discounting the future cash flows for fixed rate mortgage notes receivable using an estimated weighted average market rate of 13.74%, management estimates the fixed rate mortgage notes receivable s fair value to be approximately $365.6 million at June 30, 2009.

Investment in a direct financing lease

The fair value of the Company s investment in a direct financing lease as of June 30, 2009 is estimated by discounting the future cash flows of the instrument using current market rates. At June 30, 2009, the Company had an investment in a direct financing lease with a carrying value of $167.9 million and a weighted average effective interest rate of 12.01%. The investment in direct financing lease bears interest at effective interest rates of 11.90% to 12.40%. Discounting the future cash flows for the investment in a direct financing lease using an estimated market rate of 13.01%, management estimates the investment in a direct financing lease s fair value to be approximately $155.7 million at June 30, 2009.

Cash and cash equivalents, restricted cash:

Due to the highly liquid nature of our short term investments, the carrying values of our cash and cash equivalents and restricted cash approximate the fair market values.

Accounts and notes receivable:

The carrying values of our accounts receivable approximate the fair market value at June 30, 2009.

The fair value of the Company s notes receivable as of June 30, 2009 is estimated by discounting the future cash flows of each instrument using current market rates. At June 30, 2009, the Company had a carrying value of $43.1 million in fixed rate notes receivable outstanding with a weighted average interest rate of approximately 10.64%. The fixed rate notes bear interest at rates

of 6.33% to 15.00%. Discounting the future cash flows for fixed rate notes receivable using an estimated market rate of 11.54%, management estimates the fixed rate notes receivable s fair value to be approximately $42.4 million at June 30, 2009.

Derivative instruments:

Derivative instruments are carried at their fair market value.

Debt instruments:

The fair value of the Company s debt as of June 30, 2009 is estimated by discounting the future cash flows of each instrument using current market rates. At June 30, 2009, the Company had a carrying value of $396.0 million in variable rate debt outstanding with an average weighted interest rate of approximately 5.39%. Discounting the future cash flows for variable rate debt using an estimated market rate of 5.56%, management estimates the variable rate debt s fair value to be approximately $387.2 million at June 30, 2009. As described in Note 8, $205.0 million of variable rate debt outstanding at June 30, 2009 has been converted to a fixed rate by interest rate swap agreements. At June 30, 2009, the Company had a carrying value of $829.4 million in fixed rate long-term debt outstanding with an average weighted interest rate of approximately 6.00%. Discounting the future cash flows for fixed rate debt using an estimated market rate of 5.90%, management estimates the fixed rate debt s fair value to be approximately $826.0 million at June 30, 2009.

Accounts payable and accrued liabilities:

The carrying value of accounts payable and accrued liabilities approximates fair value due to the short term maturities of these amounts.

Common and preferred dividends payable:

The carrying values of common and preferred dividends payable approximate fair value due to the short term maturities of these amounts.

11. Earnings Per Share

The following table summarizes the Company s common shares used for computation of basic and diluted earnings per share for the three and six months ended June 30, 2009 and 2008 (unaudited, amounts in thousands except per share information):

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	Three Months Ended June 30, 2009			Six Months Ended June 30, 2009		
	Income (numerator)	Shares (denominator)	Per Share Amount	Income (numerator)	Shares (denominator)	Per Share Amount
earnings:						
e from uing ions	$ 25,995	34,970	$ 0.74	$ 50,090	34,678	$ 1.44
net loss table to ntrolling sts	1,709		0.05	2,943		0.09
e from uing ions table to ainment rties	27,704		0.79	53,033		1.53
red nd ements	(7,552)		(0.21)	(15,103)		(0.44)

hel A. n	**39,500**	**182,570**	**64,082**	**50,000**	**336,152**
rt B.	**29,166**	**75,324**	**110,115**	**-**	**214,605**
h J. lka	**39,500**	**182,570**	**64,082**	**-**	**286,152**
topher ebler	**35,000**	**124,023**	**64,082**	**-**	**223,105**
Lerner	**32,000**	**124,023**	**64,082**	**-**	**220,105**
Lingnau	**12,500**	**15,255**	**12,383**	**-**	**40,138**
Wang	**44,667**	**73,846**	**64,082**	**-**	**182,595**

ield	**45,500**	**73,846**	**64,082**	-	**183,428**

(1) Amounts reported for Mr. Chess, our Chairman of the Board and former Acting President and Chief Executive Officer, represent the compensation earned in respect of his services as a non-employee director for the period in 2007 in which he was no longer an employee of us. The compensation earned or awarded to Mr. Chess in respect of his services as our Acting President and Chief Executive Officer is reported in the Summary Compensation Table and related supporting tables.

Dr. Patton, our Founder and Chief Research Fellow, is not included in this table as he was an employee of us in 2007 and thus received no compensation for his services in his capacity as a director.

Mr. Robin, our President and Chief Executive Officer is not included in this table as he was an employee of us in 2007 and thus received no compensation for his services in his capacity as a director.

(2) Amounts reported represent the dollar amount recognized for financial statement reporting purposes for the fiscal year ended December 31, 2007 in accordance with SFAS No. 123R. For purposes of this calculation, we have disregarded the estimate of forfeitures related to service-based vesting conditions. There were no forfeitures of restricted stock unit awards made by the non-employee directors during the year. For a complete description of the assumptions made in determining the SFAS No. 123R valuation, please refer to Note 2 (Share-Based Compensation) to our audited financial statements in our annual report on Form 10-K for the fiscal year ended December 31, 2007. As of December 31, 2007, each of our non-employee directors has the following number of outstanding restricted stock unit awards that were granted in respect of their services as

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directors: Michael A. Brown: 5,000; Robert B. Chess: 9,167: Joseph J. Krivulka: 5,000; Christopher Kuebler: 5,000; Irwin Lerner: 5,000; Lutz Lingnau: 5,000; Susan Wang: 5,000; and Roy A. Whitfield: 5,000.

(3) Amounts reported represent the dollar amount recognized for financial statement reporting purposes for the fiscal year ended December 31, 2007 in accordance with SFAS No. 123R. For purposes of this calculation, we have disregarded the estimate of forfeitures related to service-based vesting conditions. There were no forfeitures of stock option awards made by non-employee directors during the year. For a complete description of the assumptions made in determining the SFAS No. 123R valuation, please refer to Note 2 (Share-Based Compensation) to our audited financial statements in our annual report on Form 10-K for the fiscal year ended December 31, 2007. As of December 31, 2007, each of our non-employee directors has the following number of outstanding stock option awards that were granted in respect of their services as directors: Michael A. Brown: 122,500; Robert B. Chess: 27,500; Joseph J. Krivulka: 67,500; Christopher A. Kuebler: 120,000; Irwin Lerner: 165,000; Lutz Lingnau: 15,000; Susan Wang: 77,375; and Roy A. Whitfield: 155,000.

(4) The grant date fair value of the restricted stock unit awards granted to Mr. Chess during 2007 is $107,463. The grant date fair value of the restricted stock unit awards awarded to each other non-employee director during 2007 is $44,000. The grant date fair value of the stock options awarded to Mr. Chess during 2007 is $149,855. The grant date fair value of the stock options awarded to each other non-employee director during 2007 is $54,209.

(5) Represents a special payment recommended and approved by the board of directors for Mr. Brown s service as Chairman of our organization and compensation committee in connection with our Chief Executive Officer hiring process.

Under the Director Plan in effect for 2007, each non-employee director was eligible to receive an annual retainer of $25,000 for serving on the board of directors, an annual retainer of $25,000 for serving as the chair or lead director of the board of directors, an annual retainer of $7,500 for serving on the audit committee, an additional annual retainer of $7,500 for serving as chair of the audit committee, an annual retainer of $5,000 for serving on any other committee established by the board of directors and an additional annual retainer of $5,000 for serving as chair of any other such committee. In addition, if a non-employee director attended more than four (4) regularly scheduled board meetings then such non-employee director received an additional $2,000 per in person meeting and if the non-employee director attended more than four (4) telephonic board meetings then such non-employee director received an additional $1,000 per telephonic meeting. Similarly, if a non-employee director attended more than four (4) regularly scheduled committee meetings then such non-employee director received an additional $1,000 per in person meeting and if the non-employee director attended more than four (4) telephonic committee meetings then such non-employee director received an additional $500 per telephonic meeting.

In addition, under the Director Plan in effect for 2007, in September each non-employee director received equity awards under the 2000 Equity Incentive Plan with an aggregate value composed of fifty percent (50%) stock options at an exercise price equal to the closing price of our common stock on the grant date and fifty percent (50%) restricted stock unit awards. This annual equity compensation award was based on the approximate aggregate value of the median equity compensation for non-employee directors of comparable companies as determined annually by the board of directors. The value of stock options was determined based on the application of the Black-Scholes valuation method. Stock options and restricted stock unit awards granted to non-employee directors under the Director Plan vest over a period of one year following the date of grant and stock options have a term of eight (8) years. In the event of a change of control, the vesting of each option or restricted stock unit award will accelerate in full as of the closing of such transaction. Each option or restricted stock unit award will also accelerate in full upon the director s death.

In March 2008, the organization and compensation committee recommended, and the board of directors approved, an Amended and Restated Compensation Plan for Non-Employee Directors, effective as of January 1, 2008 (the 2008 Director Plan). The modifications were made to the Director Plan to adjust compensation to more closely approximate the median of non-employee director compensation of our peer group companies. The structure of the 2008 Director Plan is substantially similar to the Director Plan in effect for 2007, however, the following key changes were made. The annual retainers previously payable to directors for their service on committees of the board of directors were eliminated, and the meeting fees payable for attendance at committee meetings in person or telephonically were increased. Under the 2008 Director Plan, directors are entitled to receive

their board and committee meeting fees for all meetings attended, and not just for attending more than four (4) meetings. Changes were also made to the mix of equity awards, as we can elect to grant 100% of the annual equity award in the form of stock options (rather than 50% in stock options and 50% in restricted stock unit awards). While the 2008 Director Plan retains the flexibility to grant a mix of stock options and restricted stock unit awards, the board of directors determined that non-employee director equity compensation in 2008 would be in the form of stock options to be consistent with the type of recent equity incentives granted to the Named Executive Officers. In addition, the 2008 Director Plan now provides for an initial equity award that will be granted to new directors upon their appointment to the board of directors. The value of the initial equity award is equal to 150% of the annual equity award and will vest monthly over a period of three years or upon the occurrence of a change of control. New directors will also be entitled to a pro rata portion of the annual equity award if they are appointed following the grant date. The board of directors also decided to make a one-time equity award to Messrs. Lingnau and Huh in connection with their recent appointment to the board of directors which was consistent with the initial equity awards made to the other members of the board of directors in connection with their appointments to the board of directors. This appointment equity award for Messrs. Lingnau and Huh was made in March 2008 and therefore will be reported in our 2008 Director Compensation Table.

INFORMATION ABOUT THE EXECUTIVE OFFICERS

COMPENSATION DISCUSSION AND ANALYSIS

Introduction

The Compensation Discussion and Analysis is designed to provide stockholders with an understanding of our executive compensation philosophy and decision making process. It discusses the principles underlying the structure of the compensation arrangements for our Chief Executive Officer, our former Acting Chief Executive Officer, our Chief Financial Officer, two other persons that served as Chief Financial Officer during 2007, our other three most highly compensated executive officers who were serving as executive officers on December 31, 2007 and our former Senior Vice President Research and Development who would have been one of our other three most highly compensated executive officers had his employment not terminated prior to December 31, 2007 (the Named Executive Officers).

Our current compensation programs for the Named Executive Officers are determined and approved by the organization and compensation committee, although the full board of directors approves the compensation programs for our Chief Executive Officer based on the recommendations of the organization and compensation committee. None of the Named Executive Officers are members of the organization and compensation committee. As described in more detail above under the caption Information About the Board of Directors Organization and Compensation Committee, the organization and compensation committee takes into account our President and Chief Executive Officer s recommendations regarding the compensatory arrangements for our executive officers, although our President and Chief Executive Officer does not participate in the deliberations or determinations of his own compensation. For example, during 2007, the organization and compensation committee considered the President and Chief Executive Officer s recommendations regarding the appropriate equity awards to grant to our executive officers. The other Named Executive Officers do not currently have any role in determining or recommending the form or amount of compensation paid to our Named Executive Officers.

Compensation Program Objectives and Philosophy

In 2007, the Company began a significant transformation from a drug delivery service provider to a therapeutic drug development company. As a result, in 2007 the Company was in a turn-around position as it began execution of its strategy to develop and expand early research activities and its proprietary clinical development pipeline as well as continuing to execute on significant collaboration partnerships. During this critical transition year, we concluded that it was vital that we provide our experienced and skilled senior leadership with significant incentives and retention compensation. Our goal was to structure a substantial portion of this compensation such that it would only have value if the senior leadership was successful in building significant incremental value for the Company and its stockholders.

As such, our current executive compensation programs are intended to achieve the following four fundamental goals and objectives: (1) to attract and retain an experienced, highly qualified and motivated executive management team to lead our business, (2) to emphasize sustained performance by aligning significant elements of executive compensation with our stockholders interests, (3) to provide appropriate economic rewards for achieving high levels of Company performance and individual contribution and (4) to ensure we are paying competitively, taking into account the experience, skills and performance of the executive officers required to build our business in our turn-around position.

When structuring our current executive compensation programs to achieve our goals and objectives, we are guided by the following basic philosophies:

Pay for Performance and Alignment with Stockholders Interests. A pay for performance model that will deliver compensation significantly above our industry median for exceptional performance both for performance-based incentive compensation and potential equity value is an effective way both to attract and retain highly qualified and motivated executives.

Total Rewards Program. The total compensation program must balance pay for performance elements with static non-performance based elements in order to create a total rewards program that is competitive.

Flexible Approach. The level of compensation provided to executives must take into account each executive s role, experience, tenure and performance.

Focus on Achievement of Identified Business Goals. The compensation program should be structured so that executives are appropriately incentivized to achieve our short- and long-term goals.

We believe that each element of our executive compensation program helps us to achieve one or more of our compensation goals and objectives. For example, we believe that performance-based short-term cash incentive opportunities in combination with equity incentive awards that are earned over time and increase in value as the Company becomes more valuable is the best way to align our executives interests with those of our stockholders. Providing base salaries, occasional discretionary bonus opportunities and severance protections for certain terminations of employment helps us ensure that we are providing a competitive compensation package that will permit us to attract and retain qualified executives. We believe that we have created a total compensation program that combines short- and long-term components, cash and equity, and fixed and contingent payments, in proportions that are appropriate to achieve each of our four fundamental goals and objectives. We also believe that the structure of our compensation program provides appropriate incentives to reward our executive officers for achieving our long-term goals and objectives, some of the most important of which are building a successful product pipeline, encouraging collaboration with partners to build long-term business relationships, increasing the efficiency of our organization capabilities and infrastructure and continuously improving our financial performance.

Design and Elements of Our Compensation Program

As we describe in more detail below, the material elements of our current executive compensation programs for Named Executive Officers consist primarily of the following:

1. *Base Salary.* Each Named Executive Officer earned an annual base salary during 2007 for the period that he was employed.

2. *Short-Term Incentive Compensation and Discretionary Bonuses.* Each Named Executive Officer, other than Mr. Chess, was eligible to earn an incentive cash compensation payment based on the achievement of company-wide performance objectives and upon their individual performance. In addition, Messrs. Huh and Chess earned discretionary bonuses during 2007 based upon their performance.

3. *Long-Term Incentive Compensation.* Each Named Executive Officer received a grant of stock options during 2007, while Messrs. Nicholson, Chess and Harkness also received restricted stock unit awards (RSUs).

4. *Severance and Change of Control Benefits.* Each Named Executive Officer who remains one of our employees is offered severance benefits for certain actual or constructive terminations of employment, as well as enhanced severance benefits for certain actual or constructive terminations of employment occurring in connection with a change of control. Certain of our Named Executive Officers whose employment with us has terminated received severance benefits in connection with their termination of employment.

While we review peer group company data regarding the mix of current and long-term incentive compensation and between cash and non-cash compensation, we have not adopted any formal policies or guidelines for allocations among these various compensation elements. However, consistent with our philosophy of paying for performance, we believe that a greater component of overall cash compensation for the Named Executive Officers relative to other employees should be performance-based.

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Benchmarking of Compensation: Peer Companies

One important factor in our compensation decisions is information regarding compensation practices of similar public companies. When making compensation decisions during 2006 that affected compensation levels for 2007, and when making compensation decisions during the first portion of 2007, we reviewed compensation studies prepared by Towers Perrin as part of our decision process. The compensation studies provided by Towers Perrin provided data on base salary, total cash compensation (base salary plus actual annual incentives), target total cash compensation (base salary plus target annual incentives) and actual total direct compensation (actual total cash compensation plus expected value of long-term equity incentives). The compensation studies provided by Towers Perrin were based on a review of the following 28 publicly-held companies:

Alkermes, Inc.
Amylin Pharmaceuticals Inc.
Biosite Inc.
Celgene Corp.
Connetics Corp.
Cubist Pharmaceutical Inc.
CV Therapeutics Inc.
Enzon Pharmaceuticals Inc.
Eyetech Pharmaceuticals Inc.
Gen-Probe Inc.
Human Genome Sciences Inc.
ICOS Corp.
Intermune Inc.
Martek Biosciences Corp.
MGI Pharma Inc.
Nabi Biopharmaceuticals
Neurocrine Biosciences Inc.
OSI Pharmaceuticals Inc.
Pharmion Corp.
Protein Design Labs Inc.
Salix Pharmaceuticals
Sepracor Inc.
Serologics Corp.
Techne Corp.
United Therapeutics Corp.
Ventana Medical Systems Inc.
Vertex Pharmaceuticals Inc.
Zymogenetics Inc.

In July 2007, we undertook a review of our peer group companies and selected a smaller, more focused group that better fits our transition from a drug delivery company to a multi-product drug development company. In determining the appropriate peer companies, we considered the following factors: business model, business stage and complexity, product similarity and company size (both number of employees and market capitalization). We approved a new peer group in December 2007. Frederic W. Cook & Co. developed compensation studies that provided data on base salary, total cash compensation (base salary plus actual annual incentives), target total cash compensation (base salary plus target annual incentives) and actual total direct compensation (actual total cash compensation plus expected value of long-term equity incentives). This information was used in the deliberations when determining the structure and amounts of retention equity awards made to the Named Executive Officers in December 2007, and in determining total compensation for the Named Executive Officers as part of our annual compensation review in February 2008. The new peer companies included:

Alkermes, Inc.
Cubist Pharmaceutical Inc.
CV Therapeutics Inc.
Human Genome Sciences Inc.
Incyte Corporation
Medarex, Inc.
Onyx Pharmaceuticals Inc.
OSI Pharmaceuticals Inc.
PDL BioPharma, Inc.
Pharmion Corp.
United Therapeutics Corp.
Zymogenetics Inc.

The above selection of peer group companies was reviewed by the board of directors prior to approval. We recognize that given the fluctuation of our market capitalization in 2007 as a result of the business transition discussed above, it

was important to consider a wide range of factors in selecting an appropriate peer group. We concluded that we will again review the appropriateness of this selection of peer group companies in 2008.

We realize that benchmarking our executive compensation programs against compensation earned at peer group companies may not always be appropriate as a standalone tool for setting compensation due to the unique aspects of our business and the need to attract and retrain particular expert managers with unique experience, skills

and other individual circumstances. However, we generally believe that gathering this information is an important component of our executive compensation decision-making process.

Current Executive Compensation Program Elements

Base Salary

Base salary is an important element of compensation for the Named Executive Officers because it provides the executives with a specified minimum level of cash compensation for their services. Base salaries for those Named Executive Officers who were employed in February 2007 were reviewed by us at that time and were generally increased from between 5% to 16.5% relative to the base salaries earned during 2006. When determining the amount of each such Named Executive Officer s increase, we considered peer group company data, Radford executive survey data covering companies in the life sciences industry, individual performance, level and scope of responsibility, experience and internal pay equity considerations. In 2007, we believe that we both recruited and retained superior executive talent to guide the company through a period of significant transition. We also promoted three of our Named Executive Officers during 2007 based upon their exceptional performance in their prior roles and increased the base salary of Dr. Huh by 12.6% in connection with his promotion. Consistent with our objective of attracting and retaining highly qualified and motivated executives and given our turn-around position, we targeted the base salary for the newly hired and promoted executives between the 50th percentile and 75th percentile, with individual variations within this range determined based upon the executive s experience, past performance and expected role in the Company. The base salary earned by each Named Executive Officer during 2007 is reported below in the Summary Compensation Table.

Short-Term Incentive Compensation and Discretionary Bonuses

Incentive Compensation Policy. In December 2006, we approved the Incentive Compensation Policy as our short-term incentive compensation plan for the 2007 fiscal year. We adopted the Incentive Compensation Policy for all employees and all executive officers other than the Chief Executive Officer, who is subject to his own variable compensation arrangement with objectives established and evaluated by the full board of directors. However, because the Chief Executive Officer s variable compensation arrangement is structured to mirror the Incentive Compensation Policy in as many respects as are practical, we discuss the Chief Executive Officer s short-term incentive compensation opportunity as part of the discussion of the Incentive Compensation Policy. Consistent with our compensation philosophies of paying for performance and maintaining a flexible approach, we adopted the Incentive Compensation Policy to provide Named Executive Officers with an incentive to contribute to the achievement of corporate objectives and goals while at the same time encouraging and rewarding excellent individual performance and recognizing differences in performance between individuals.

Plan Design. The design approved for the Incentive Compensation Policy is to have a number of Company performance objectives, with defined deliverables, and predetermined weightings for each performance period. The targets for each of these Company performance objectives are established so that attainment of the objective is not assured and requires significant performance above the base-level plan to achieve the highest incentive compensation levels. After determination of the level of achievement of the Company performance objectives for the performance period, the board of directors will determine the percentage at which the Company met its performance objectives. Each Company performance objective may be met, exceeded or not satisfied, and as a result the Company s performance rating may range from 0% to 150% depending on our achievement of the performance objectives. We may, in our discretion, determine that our corporate performance for a performance period does not merit awarding any incentive compensation.

After the Company performance rating is determined by the board of directors, each Named Executive Officer s individual performance is reviewed by us in order to determine the appropriate percentage to be assigned to him based on an assessment of his individual performance for the performance period. Each Named Executive Officer s actual bonus payment is then determined based on both the level of attainment of the Company performance objectives and the Named Executive Officer s individual performance. The Incentive Compensation Policy does not provide for a specific allocation of each Named Executive Officer s actual

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bonus amount between attainment of the Company performance objectives and individual performance (e.g., a Named Executive Officer could earn his full target bonus if his individual performance percentage is 100%, even if we fail to achieve the Company performance objectives at the 100% level). The appropriate allocation for each Named Executive Officer is determined by us in our sole discretion. The maximum payout for each Named Executive Officer was determined to be 200% of his target annual incentive (with the actual award determined based on the corporate performance modifier and the individual performance modifier), although the maximum payout under Mr. Robin s variable compensation arrangement for 2007 was set at 150% of his target annual performance-based incentive compensation based on his offer letter agreement entered into in January 2007. The design of the Incentive Compensation Policy can be summarized as follows:

Target Annual Incentive (% of Base Salary)	X	Corporate Performance Modifier (0 – 150)%	X	Individual Performance Modifier (0 – 200%)

Target Annual Incentives for 2007. Except for Mr. Chess, who did not participate in the Incentive Compensation Policy, the Named Executive Officers who were employed by us during 2006 were each assigned a target annual incentive award for 2007 at the beginning of the year. Mr. Robin and the other Named Executive Officers who began employment during 2007 were also assigned a target incentive award that they were eligible to earn for the portion of 2007 following their start date although Mr. Robin who began employment in January 2007 was eligible for 100% of his incentive compensation target. Each Named Executive Officer s target annual incentive award was set as a specific percentage of base salary. For the participating Named Executive Officers other than Mr. Robin, the dollar amount of the annual incentive target was initially split between two semi-annual performance periods by dividing it equally into two parts (Mr. Robin s incentive target applied for the entire portion of 2007). For example, an executive with an initial target annual incentive equal of 50% of base salary would have had a target incentive equal to 50% of the base salary earned for the performance period from January 1, 2007 through June 30, 2007, and a target incentive equal to 50% of the base salary earned for the performance period from July 1, 2007 through December 31, 2007. Following the initial determination of target incentive awards, we decided to retroactively increase the target awards for Messrs. Elam, Huh and Patton. We increased Dr. Huh s target award in connection with his promotion to Chief Operating Officer and Head of the PEGylation Business Unit in June 2007. We increased Messrs. Elam s and Patton s target awards because, after reviewing peer group compensation information, we determined that their initial awards were not competitive with similar short-term incentive opportunities offered to comparable executives at our peer companies. The following table shows the target annual incentive award assigned to each Named Executive Officer for 2007 both as a dollar amount for the entire 2007 year and as a percentage of base salary for each semi-annual performance period. The amounts shown in the table reflect the retroactive adjustments described above, and the dollar amounts presented take into account the value of any pro-rata bonuses newly hired Named Executive Officers were entitled to receive for 2007.

Name	**Target Annual Incentive for Entire 2007 Year ($)**	**Target Annual Incentive for 1/1/07 through 6/30/07 (% of Base Salary)**	**Target Annual Incentive for 7/1/07 through 12/31/07 (% of Base Salary)**
Howard W. Robin	400,000	59%	59%

John Nicholson	53,125	N/A	50%
Hoyoung Huh	237,500	50%	50%
Nevan C. Elam	188,486	50%	50%
John S. Patton	141,663	43%	50%
Robert B. Chess	-	-	-
Timothy Harkness	78,958	N/A	50%
Louis Drapeau	64,772	35%	35%
David Johnston	142,498	35%	35%

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Company Performance Objectives. For the first semi-annual performance period from January 1, 2007 through June 30, 2007, the Company performance objectives and relative weightings assigned to each objective were as follows:

1. Improve leadership and management of the Company and make the Company a great place to work (10%).
2. Meet Exubera manufacturing commitments (20%).
3. Development objective related to a next-generation pulmonary device development program (15%).
4. Execute business transformation system and process changes (10%).
5. Development objective related to advancing our proprietary product portfolio (15%).
6. Development objective related to meeting partner development program commitments (10%).

7. Operating loss/income objective (20%).

For the second semi-annual performance period from July 1, 2007 through December 31, 2007, the Company performance objectives and relative weightings assigned to each objective were as follows:

1. An objective related to supporting the commercial success of Exubera (10%).
2. Development objective related to a next-generation pulmonary insulin development program (15%).
3. Clinical development objective related to NKTR-061 (inhaled amakacin) (10%).
4. Clinical development objective related to NKTR-118 (pegylated oral nalaxol) (10%).
5. Clinical development objective related to NKTR-102 (pegylated irinotecan) (20%).
6. Regulatory objective related to NKTR-203 (basal insulin) (5%).
7. A business development objective related to Nektar s PEGylation Technology platform (5%).
8. A business development objective related to Nektar s Pulmonary Technology platform (20%).
9. Financial objective related to reduction of ongoing annual cash expenditures (20%).
10. An organizational development objective (10%).
11. An objective related to corporate communications (5%).

These second half performance objectives also served as the performance objectives applicable to Mr. Robin s short-term incentive compensation opportunity for the 2007 calendar year. The aggregate weighting of the second half performance objectives was set at 130%, as they were designed to represent significant stretch goals. Our intent in establishing the weightings was that if we met our base-level plan for the performance period, we would achieve approximately 100% of the 130% aggregate weightings. Achievement of all of the performance objectives would

represent significant out-performance, and mean that we exceeded our base-level plan during the performance period. Similarly, out-performance with respect to any of the individual Company performance objectives would also mean that the Company exceeded the base-level plan with respect to that objective and contribute to a corporate performance rating greater than 130%. However, the maximum corporate performance modifier was 150% in any case in 2007.

Actual Annual Incentives Earned for 2007. Following the end of the first-half 2007 performance period, after review of the Company s achievement of the Company performance objectives we established for such semi-annual period, we concluded that the corporate performance rating would be set at 100%. This 100% corporate performance achievement rating was determined in our discretion based on a preliminary assessment that the actual achievement level based on a numerical scoring of the Company performance objectives would not have been less than 100%. In connection with this determination, we opted not to make any upward or downward adjustments for individual performance. We made the foregoing determinations for a number of reasons, including the following: (i) the transition of senior leadership of the Company with our appointment of Mr. Robin as President and Chief Executive Officer in January 2007, (ii) our desire to establish a different range of

performance objectives for the second-half 2007 performance period that reflected the comprehensive organization, strategic, operational and financial review conducted by Mr. Robin and his senior management team that, among other things, resulted in the approval of a new operational efficiency plan that included a work force reduction carried out on May 23, 2007, (iii) the fact that employees participating in the Incentive Compensation Policy who were terminated as part of the workforce reduction were awarded 100% of their target incentive compensation and (iv) the focus of our management team during a substantial majority of the first half 2007 performance period was on the significant effort that was necessary to plan and implement the operational efficiency program, work force reduction and establishment of the second half 2007 goals.

At the end of the first performance period, those Named Executive Officers who were eligible to receive a payment with respect to the first performance period were offered the opportunity to either receive their payment earned for the first performance period or to elect to have their entire 2007 incentive compensation payment based on our attainment of the performance objectives established for the second performance period and the executive s individual performance. We offered these Named Executive Officers this election option because although it has been our past practice to have short-term incentive compensation become earned based on performance during two semi-annual performance periods, we decided during 2007 to transition to one annual performance period, and wanted to give the Named Executive Officers the option of also having an annual performance period for 2007.

Following the end of the second performance period, the Company s attainment of quantitative performance objectives was reviewed by the Company s internal audit department and qualitative performance objectives were reviewed by the organization and compensation committee and the board of directors. As a result of these reviews, the board of directors determined that the Company performance objectives for the second period had been achieved at a 145% level. Following this determination, each Named Executive Officer s individual performance was reviewed and each Named Executive Officer s individual performance rating was determined by us (Mr. Robin s performance was assessed by, and incentive bonus determined by, the board of directors). Each Named Executive Officer s incentive bonus earned was then determined based on the attainment of the Company performance objectives and his individual performance. The following table lists the actual bonus earned by each Named Executive Officer as a percentage of his target bonus established for the entire 2007 fiscal year and for each semi-annual performance period, where applicable.

Name	Actual Bonus as a Percentage of Target for Entire 2007 Year (%)	Actual Bonus as a Percentage of Target for First Performance Period (%)	Actual Bonus as a Percentage of Target for Second Performance Period (%)
Howard W. Robin[(1)]	150%	N/A	N/A
John Nicholson	155%	N/A	N/A
Hoyoung Huh	145%	N/A	N/A
Nevan C. Elam	150%	N/A	N/A

John S. Patton[(2)]	116%	100%	130%
Robert B. Chess[(3)]	N/A	N/A	N/A
Tim Harkness[(4)]	N/A	N/A	N/A
Louis Drapeau[(4)]	N/A	100%	N/A
David Johnston[(4)]	N/A	100%	N/A

(1) The bonus award represented the maximum bonus achievement under the terms of Mr. Robin s January 2007 offer letter agreement.

(2) Mr. Patton elected to receive variable compensation separately for the two semi-annual performance periods.

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(3) Mr. Chess did not participate.

(4) Messrs. Harkness, Drapeau and Johnston each had employment termination dates prior to December 31, 2007.

Changes to Incentive Compensation Policy for 2008. In February 2008, we approved an amendment to the Incentive Compensation Policy to increase the maximum amount of the corporate performance modifier to 200% from 150%. However, the maximum payout of 200% for any individual Named Executive Officer, including Mr. Robin, remains intact. We determined to increase Mr. Robin s maximum payout from 150% of his target annual incentive to 200% of his target annual incentive in order to make Mr. Robin s target short-term incentive compensation opportunity consistent with the opportunities provided to the other Named Executive Officers. We also approved an amendment to the Incentive Compensation Policy where the plan will be based upon annual performance, with the performance period running from January 1 to December 31 of each year. This amendment eliminates the semi-annual incentive compensation payments and was approved to continue to promote a pay-for-performance culture at the Company.

Discretionary Bonuses Paid in 2007. Each of Messrs. Huh, Chess, Patton and Johnston were awarded and paid discretionary bonuses during 2007 that were not paid pursuant to the Incentive Compensation Policy. We determined to pay Mr. Chess his bonus for the following reasons: (i) to recognize his willingness to put aside other personal priorities and opportunities to serve as our acting President and Chief Executive Officer during the search for a new President and Chief Executive Officer for a much longer period of time than originally anticipated (until Mr. Robin s appointment in January 2007), (ii) his outstanding leadership during a year in which Exubera manufacturing ramped to commercial scale and we made advances in our proprietary and partner research and development programs and (iii) for his key role in the critical transition period from the retirement of our former President and Chief Executive Officer, Ajit S. Gill, to the successful recruitment and appointment of Mr. Robin. We determined to pay Dr. Huh his bonus to recognize his outstanding performance in 2006. We determined to pay Messrs. Patton and Johnston their bonuses in order to compensate them for losses they incurred as a result of an administrative delay in the delivery of shares of common stock by the Company in respect of outstanding restricted stock units that vested during 2007.

The amount of the actual incentive bonus, if any, earned by each Named Executive Officer under the Incentive Compensation Policy for the 2007 fiscal year, and the amounts of the discretionary bonuses paid to Messrs. Huh, Chess, Patton and Johnston, are reported in the Summary Compensation Table below.

Equity Awards

In accordance with our objective of aligning executive compensation with our stockholders interests, our current long-term incentive program for the Named Executive Officers consists solely of the award of equity compensation subject to a vesting schedule. We believe that equity compensation is an effective tool to align the interests of Named Executive Officers who have significant responsibility for driving our success with the interests of our stockholders and also provides the executives with an opportunity to increase their share ownership. We have historically awarded equity compensation in the form of stock options and restricted stock unit awards (RSUs). During 2007, we determined that Named Executive Officers would be granted primarily stock options, and each Named Executive Officer received at least one grant of stock options during 2007. Stock options were and continue to be our preferred equity award because the options will only have value if the shares of our common stock appreciate following the grant date and further align the interests of the Named Executive Officers with those of our stockholders. While we granted RSU awards to Messrs. Chess, Nicholson and Harkness during 2007, these awards were either made in connection with the executive s commencement of employment (Mr. Harkness), in connection with a promotion (Mr. Nicholson) or to reward outstanding performance under special circumstances (Mr. Chess).

Stock Options. As in past years, the Named Executive Officers who were employed by us during the prior year received an annual equity award during the first portion of the calendar year in connection with the annual performance review process. We considered a number of factors when determining the size of each Named Executive Officer s annual performance grant of stock options, with some of the most important factors being individual performance, peer group company comparisons for long-term compensation for similar executive

positions, overall contribution to the Company, internal pay equity, executive officer retention, carried-interest ownership, the Black-Scholes valuation of the stock options, potential wealth creation analysis, the number of unvested stock options held by the executive officer and their exercise price(s), the total number of stock options and RSUs to be awarded and the effects on stockholder dilution. These annual performance grants become vested in substantially equal monthly installments over a four-year period, subject to the Named Executive Officer s continued employment or service through each vesting date. In 2007, we changed our standard vesting period for stock options to a four-year vesting period instead of the five-year vesting period that was used previously to be consistent with companies in our industry.

We also granted stock option awards to Messrs. Robin, Nicholson, Huh and Harkness in connection with either their commencement of employment or promotion. The primary factors that we considered when determining the size of these grants were the need to offer a competitive and above median equity compensation package that would attract or retain these executives in our turn-around position, peer group company comparisons for long-term compensation for similar executive positions, the Black-Scholes valuation of the stock options, each executive s experience and past performance, and the carried-interest ownership and potential for future gain for each executive. With the exception of Mr. Robin s grant, these grants vest over a four-year period like annual performance grants. However there is no monthly vesting during the first year because an annual cliff vesting hurdle is used instead. Mr. Robin s initial stock option grant vests over a five-year period because his stock options were granted before we determined it was appropriate to utilize a four-year vesting period for stock option awards.

As discussed above, the Company s strategy significantly changed during the course of 2007 under Mr. Robin s leadership as the Company began its transformation into a drug development company. During this critical transition period, we believed it was vital that we retain and motivate our senior leaders responsible for the execution of the Company s therapeutic drug development business plan and closely align their financial success with the interests of our stockholders. As a result, we determined that it was appropriate to award a special retention grant of stock options to each of the Named Executive Officers who remained employed by us at the time of grant. We did not believe that stockholder interests would be served by granting full value RSU awards for retention purposes and elected instead to grant stock options that would only have value if the price of the Company s stock increased after the grant date. We determined that a special grant of stock options was necessary for several reasons, the most important of which are the following:

Past stock option grants offered minimal retentive value because of our stock price performance.

Our belief that the new management team in place as of December 2007 had performed well under Mr. Robin s leadership, and that we were not satisfying our compensation objective of providing appropriate rewards for high levels of individual contributions.

Our determination that existing outstanding equity awards were not meeting our objective of providing competitive compensation based on comparative peer company long-term incentive information provided by Frederic W. Cook & Co.

The proportion and importance of equity compensation as an element of our total compensation program and the need to ensure that it remained so.

Our belief that it was important to provide a compelling retention compensation element for the Named Executive Officers.

In order to determine the size of each Named Executive Officer s special retention grant, we considered each executive s current stock award holdings, the average exercise price of stock options held by each executive,

competitive benchmark data for similar executive roles at peer group companies, individual executive skills, experience and performance, and a carried-interest ownership analysis. Like the new hire and promotion grants, these retention grants vest over a four-year period with no portion of the option vesting unless the Named Executive Officer continues to provide service to the Company for at least one year following the stock option grant (i.e., one year cliff vesting for the first 25% of the shares subject to the stock option).

Restricted Stock Units. RSU awards granted to Messrs. Nicholson and Harkness vest over a period of four years, with an annual cliff vesting hurdle used for these awards as well.

The stock option and RSU awards granted to Mr. Chess have a different vesting schedule because they were granted in recognition of Mr. Chess services as our Acting President and Chief Executive Officer on a temporary basis.

The grant date for equity awards is typically the date of approval by the organization and compensation committee or the board of directors, as the case may be, or the date an executive officer commences employment for new hire grants. To streamline the administration of our equity plans, the organization and compensation committee or board of directors, as applicable, will generally approve equity awards to newly hired executives at the time their other compensation arrangements are approved, but provide that the grant date will be the later date that they actually begin employment with us. This approach also permits us to match the grant date with the service period of the option recipient. We do not have any programs, plans or practices with respect to the timing of stock option grants in coordination with the release of material nonpublic information with the intent to provide value to option recipients. Accordingly, we do not time the release of material nonpublic information for the purpose of affecting the value of equity or other compensation granted to our executive officers. We believe that the grant of equity awards should be made in the normal course of business aligning the interests of the stock option recipients with those of the stockholders rather than seeking to provide an immediate benefit to option recipients through the timing of stock option grants.

The number of shares of common stock subject to stock options and RSUs granted to each Named Executive Officer during 2007, and the grant-date fair value of these awards as determined under FAS 123R for purposes of our financial statements, is presented in the Grants of Plan Based Awards table below. A description of the material terms of the 2007 stock option and RSU awards is presented in the narrative section following that table.

Severance and Change of Control Benefits

Named Executive Officers who are Current Employees. If the employment of each of Messrs. Robin, Nicholson, Patton and Elam is terminated by us without cause or by the executive for a designated good reason outside of a change of control context, he will be entitled to severance benefits. Messrs. Robin and Nicholson entered into offer letter agreements providing for severance protections in connection with their commencement of employment and Messrs. Patton and Elam entered into letter agreements providing for severance protections during 2007. Severance benefits are based on a 1x multiple, and include a cash severance payment based on the executive s base salary and the amount of his target annual incentive bonus, payment of COBRA premiums for one year, an additional twelve or eighteen month period to exercise vested options (including any options granted prior to the agreements being entered into) and pro-rata option vesting for Messrs. Robin and Nicholson if their employment terminates within their first year of employment. In order to attract and retain these Named Executive Officers in a competitive environment for highly skilled senior executive talent in the biotechnology and pharmaceutical industry, we determined it was necessary to offer each of them severance benefits for terminations resulting from a termination without cause or constructive termination of employment outside of a change of control situation. Many of our peer companies provide severance benefits for similar types of terminations of employment, and we believe that it is important for us to offer these severance benefits in order to continue to provide a competitive total compensation program. These Named Executive Officers would also be entitled to certain termination benefits upon a termination of employment because of death or disability outside of a change of control context.

We also have a Change of Control Severance Benefit Plan (the CIC Plan) that would provide Messrs. Robin, Nicholson, Patton and Elam with certain severance benefits if their employment is terminated in connection with a change of control. Severance benefits under the CIC Plan are structured on a double-trigger basis, meaning that the executive must experience a termination without cause or resign for a designated and specifically defined good reason

in connection with the change of control in order for severance benefits to become due under the CIC Plan. Like the severance benefits under the letter agreements, we believe that these change of control severance benefits are an important element of a competitive total compensation program. Additionally, we believe that providing change of control benefits should eliminate, or at least reduce, the reluctance of our Named Executive Officers and

other key employees covered by the CIC Plan to diligently consider and pursue potential change of control opportunities that may be in the best interests of our stockholders. At the same time, by providing change of control benefits only upon the occurrence of an additional triggering event occurring in connection with the change of control transaction resulting in a job loss, we believe that this CIC Plan helps preserve the value of our key personnel for any potential acquiring company.

Severance benefits under the CIC Plan are generally similar to the severance benefits under the letter agreements, however Mr. Robin s cash payments and COBRA period would be increased and all executives would be entitled to full equity vesting, and a gross up payment for any excise taxes imposed under Section 4999 of the Internal Revenue Code once a 10% cutback threshold is exceeded and outplacement benefits. We determined that the Chief Executive Officer s cash severance payments should be increased to an amount equivalent to annual base salary and target bonus compensation for two years in connection with a change of control because of his role in the Company and the likelihood that a change of control would result in his termination of employment. The excise tax gross-up is intended to make the Named Executive Officers whole for any adverse tax consequences to which they may become subject under Section 4999 of the Internal Revenue Code and to preserve the level of change of control severance protections that we have determined to be appropriate.

Named Executive Officers who are Former Employees. Each of Messrs. Chess, Huh, Drapeau, Harkness and Johnston are no longer employees of us. Messrs. Chess and Huh did not receive any severance or other termination benefits in connection with their resignations, and each is currently a non-employee member of our board of directors. We entered into separation agreements with each of Messrs. Drapeau, Harkness and Johnston in connection with their terminations of employment whereby each executive received severance benefits in exchange for agreeing to release all potential claims they may have against us. The severance benefits for Messrs. Drapeau and Johnston were determined based on similar benefit arrangements provided to senior executives of the Company during the past few years. The severance benefits for Mr. Harkness were determined substantially in accordance with his offer letter agreement.

The Potential Payments Upon Termination or Change of Control section below describes and quantifies the severance and other benefits paid or payable to the Named Executive Officers.

Other Benefits

We believe that establishing competitive benefit packages for employees is an important factor in attracting and retaining highly-qualified personnel, including the Named Executive Officers. The Named Executive Officers are eligible to participate in all of our employee benefit plans, such as medical, dental, vision, group life, disability insurance and the 401(k) plan, in each case generally on the same basis as other employees. We do not offer a tax-qualified defined-benefit pension plan or any non-qualified defined benefit retirement plans.

Perquisites

We do not believe that perquisites constitute a material element of our total compensation program for the Named Executive Officers. A substantial portion of the perquisites provided to Named Executive Officers during 2007 included life insurance premiums paid by us. The perquisites and other personal benefits provided to the Named Executive Officers during 2007 are reported in footnote 5 to the Summary Compensation Table below.

Section 162(m) Policy

Section 162(m) of the U.S. Internal Revenue Code limits our deduction for federal income tax purposes to $1 million of compensation paid to certain Named Executive Officers in a taxable year. Compensation above $1 million may be

deducted if it is performance-based compensation within the meaning of Section 162(m). While we consider the compensation limits of Section 162(m) when designing our executive compensation programs, we have from time to time granted compensation that may not be deductible under the Section 162(m) limits in situations where we have determined the compensation to be appropriate to satisfy our compensation and other objectives. We intend to continue to evaluate the effects of the compensation limits of Section 162(m) and to grant compensation awards in the future in a manner consistent with the best interests of our stockholders.

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Compensation Committee Report

The material in this report is being furnished and shall not be deemed filed with the SEC for purposes of Section 18 of the Exchange Act or otherwise subject to the liability of that section, nor shall the material in this section be deemed to be incorporated by reference in any registration statement or other document filed with the SEC under the Securities Act of 1933, as amended (the Securities Act), or the Exchange Act, except as otherwise expressly stated in such filing.

The organization and compensation committee has reviewed the Compensation Discussion and Analysis and discussed it with management. Based on its review and discussions with management, the committee recommended to our board of directors that the Compensation Discussion and Analysis be included in our annual report on Form 10-K for the fiscal year ended December 31, 2007 and in our 2008 proxy statement. This report is provided by the following independent directors, who comprise the committee:

Michael A. Brown – Chairman
Christopher A. Kuebler
Lutz Lingnau

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Summary Compensation Table

The following table shows, for the fiscal year ended December 31, 2007, compensation awarded to or earned by our Chief Executive Officer, our former Acting Chief Executive Officer, our Chief Financial Officer, two other persons that served as Chief Financial Officer during 2007, our other three most highly compensated executive officers who were serving as executive officers on December 31, 2007 and our former Senior Vice President Research and Development who would have been one of our other three most highly compensated executive officers had his employment not terminated prior to December 31, 2007 (the Named Executive Officers). To the extent any Named Executive Officers were also named executive officers for the fiscal year ended December 31, 2006, compensation information for our 2006 fiscal year is also presented for such executives.

and Principal Position (a)	Year (b)	Salary ($) (c)	Bonus ($)(1) (d)	Stock Awards ($)(2)(3) (e)	Option Awards ($)(2)(3) (f)	Non-Equity Incentive Plan Compensation ($)(4) (g)	All Other Compensation ($)(5) (i)	Tot
l W. Robin nt and Chief ve Officer	2007	654,243			967,644	601,800	4,083	2,2
cholson Vice President, e and inancial Officer (7)	2007	104,641		1,055	54,289	82,300	31,185	2
g Huh M.D., Ph.D. perating Officer and Gylation Business Unit	2007	451,153	20,000		407,447	344,000	9,182	1,2
Patton, Ph.D. esearch Fellow	2007	303,214	86,256	70,875	174,539	164,500	33,833	8
	2006	286,534		292,289	103,412	131,060	9,071	8
C. Elam Vice President and the ary Business Unit	2007	372,638			274,740	282,800	2,886	9
	2006	321,332		35,911	176,970	114,804	582	6
B. Chess Acting President and	2007	100,000	317,000	339,753	703,264		8,734	1,4

ve Officer(9)								
	2006	**418,459**		**716,224**	**1,011,709**	**262,718**	**8,040**	**2,4**
y Harkness								
Senior Vice								
nt, Finance and Chief								
al Officer (10)	**2007**	**141,094**		**6,581**	**50,046**		**739,445**	**9**
rapeau								
Senior Vice								
nt, Finance								
ief Financial Officer								
	2007	**252,399**			**159,880**	**64,772**	**404,367**	**8**
	2006	**336,589**		**-**	**201,459**	**119,968**	**11,355**	**6**
ohnston								
Senior Vice President								
h and Development								
	2007	**390,831**	**42,028**	**18,266**	**127,800**	**71,248**	**528,870**	**1,1**
	2006	**335,910**		**71,157**	**165,547**	**119,574**	**9,759**	**7**

(1) Amounts reported represent discretionary bonus amounts paid to Messrs. Huh and Chess during 2007 that were not paid pursuant to our Incentive Compensation Policy. Amounts reported for Messrs. Patton and Johnston were payments in compensation for administrative delay in the delivery of vested common stock under outstanding restricted stock units in 2007.

(2) Amounts reported represent the dollar amount recognized for financial statement reporting purposes with respect to the indicated fiscal year in accordance with SFAS No. 123R. For purposes of this calculation, we have disregarded the estimate of forfeitures related to service-based vesting conditions, and have only taken into account actual forfeitures to the extent permitted under SEC rules. Except as described below for Messrs. Drapeau, Harkness and Johnston, there were no forfeitures made during the year. For a complete description of the assumptions made in determining the SFAS No. 123R valuation, please refer to Note 2 (Share-Based Compensation) to our audited financial statements in our annual report on Form 10-K for the indicated fiscal year.

(3) In connection with their terminations of employment during 2007, Messrs. Drapeau, Harkness and Johnston each forfeited the following number of unvested stock options and restricted stock units; Mr. Drapeau: 130,000 stock options; Mr. Harkness: 187,500 stock options and 10,000 restricted stock units; and Mr. Johnston: 81,251 stock options and 13,500 restricted stock units.

(4) Amounts reported for 2007 represent amounts earned under the Incentive Compensation Policy (or for Mr. Robin, under his letter agreement). Amounts reported for 2006 represent amounts earned under the predecessor Variable Compensation Plan.

(5) Amounts reported in 2007 for the Named Executive Officers generally include life insurance premiums paid by us and matching contributions under our 401(k) plan. In addition to these benefits, certain Named Executive Officers received other compensation in 2007 having a value in excess of $10,000 or that are otherwise required to be individually identified. In connection with his commencement of employment, Mr. Nicholson received reimbursements for his temporary housing having a total value of $26,947. Dr. Patton received $15,137 of premium life insurance benefits. Amounts reported for Messrs. Harkness ($735,924), Drapeau ($376,980) and Johnston ($539,102) reflect the full amounts of all cash severance payments, group health, life and disability insurance premiums under COBRA and other reimbursements payable by us to each executive in connection with his termination of employment. Please see the Potential Payments Upon Termination or Change of Control section below for a more detailed description of these payments and benefits.

(6) Amounts reported reflect the amounts earned by Mr. Robin during 2007 following his commencement of employment on January 15, 2007.

(7) Amounts reported reflect the amounts earned by Mr. Nicholson during 2007 following his commencement of employment on October 2, 2007.

(8) On February 11, 2008, Dr. Huh resigned from his position as our Chief Operating Officer and Head of the PEGylation Business Unit with effect from February 29, 2008. Dr. Huh was appointed as a member of the board of directors effective as of February 11, 2008.

(9) In connection with Mr. Robin s commencement of employment on January 15, 2007, Mr. Chess stepped down from his position as our Acting President and Chief Executive Officer. The compensation reported above represents the compensation earned by Mr. Chess in respect of the services he performed for us as our Acting

President and Chief Executive Officer through a transition period following the appointment of Mr. Robin as President and Chief Executive Officer. Any compensation earned by Mr. Chess during 2007 in respect of his services as a non-employee member of our board of directors is reported in the Director Compensation Table elsewhere in this proxy statement.

(10) Amounts reported reflect the compensation earned by Mr. Harkness during the period of 2007 that he was employed by us, including certain benefits he became entitled to in connection with his termination of employment.

(11) Amounts reported reflect the compensation earned by Mr. Drapeau during 2007 prior to his termination of employment on September 7, 2007, including certain benefits he was entitled to in connection with his termination of employment.

(12) Amounts reported reflect the compensation earned by Mr. Johnston during 2007 prior to his termination of employment on November 2, 2007, including certain benefits he was entitled to in connection with his termination of employment.

Description of Base Salary and Bonus Amounts

Base Salaries. Each of the Named Executive Officers previously entered into our standard form employment agreement and an offer letter. The form employment agreement provides for protective covenants with respect to confidential information, intellectual property and assignment of inventions and also sets forth other standard terms and conditions of employment. The offer letters generally establish each Named Executive Officer s minimum base salary and target annual short-term compensation amounts, as well as other additional terms and conditions of the executive s employment. For example, Mr. Robin s offer letter provides for an initial base salary of $680,000 per year. Mr. Robin s base salary may be increased by us from time to time in the discretion of the board of directors, but may not be decreased below the initial amount specified in his offer letter. The offer letters entered into with the other Named Executive Officers work similarly, in that each specify an initial base salary that may be increased in our discretion, but which may not be decreased. As discussed in more detail in the Compensation Discussion and Analysis, we review each Named Executive Officer s base salary on at least an annual basis to determine whether any increase in base salary is warranted. In making our determination, we consider the factors discussed above under the caption Compensation Discussion and Analysis Current Executive Compensation Program Elements Base Salary. Each Named Executive Officer s base salary paid in our 2007 fiscal year was the amount reported for the officer in the Summary Compensation Table above. Amounts reported for Messrs. Robin, Nicholson, Chess, Harkness, Drapeau and Johnston reflect the pro-rated base salary amounts earned by each executive during the portion of 2007 that they were employed by us.

Bonuses. As described in more detail under the caption Compensation Discussion and Analysis Current Executive Compensation Program Elements Short-Term Incentive Compensation and Discretionary Bonuses, Messrs. Huh, Chess, Patton and Johnston were awarded and paid discretionary bonuses during 2007. Dr. Huh was awarded a special discretionary cash bonus of $20,000 in 2007 based on his performance, and Mr. Chess was awarded a discretionary cash bonus of $317,000 in 2007 in recognition of his successful performance in leading the Company through the transition to Mr. Robin s appointment in January 2007. Messrs. Patton and Johnston were awarded their discretionary bonuses in order to compensate them for losses they incurred as a result of an administrative delay in the delivery of shares of common stock in respect of outstanding restricted stock units that vested during 2007.

The amount of Messrs. Robin s, Nicholson s, Huh s, Patton s, Elam s, Chess , Harkness , Drapeau s and Johnston s 200 base salaries plus bonuses represented 29%, 38%, 38%, 47%, 40%, 28%, 15%, 29% and 37% of their respective total compensation amounts reported in the Summary Compensation Table. These percentages would be higher if payments in respect of short-term incentive compensation amounts reported as non-equity incentive plan compensation were also included.

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GRANTS OF PLAN BASED AWARDS IN 2007

The following table shows, for the fiscal year ended December 31, 2007, certain information regarding grants of plan-based awards to the Named Executive Officers.

			Estimated Possible Payouts Under Non-Equity Incentive Plan Awards (3)(4)						
ame a)	Grant Date (b(1)	Date of Board or Committee Approval(2)	Threshold ($) (c)	Target ($) (d)	Maximum ($) (e)	All Other Stock Awards: Number of Shares of Stock or Units (#) (i)	All Other Option Awards: Number of Securities Underlying Options (#) (j)	Exercise or Base Price of Option Awards ($/sh)(5) (k)	Gran Fair of S and (Aw ($ (
l W.									
			0	400,000	601,800				
	1/16/2007	12/21/2006					34,435	14.52	2
	1/16/2007	12/21/2006					565,565	14.52	4,6
	12/21/2007						700,000	6.98	2,3
cholson			0	53,125	106,250				
	10/2/2007	9/1/2007					45,092	8.87	1
	10/2/2007	9/1/2007					154,908	8.87	6
	12/10/2007	12/06/2007				10,000			
	12/21/2007						100,000	6.98	3

g Huh, h.D.		**0**	**237,500**	**475,000**			
	4/2/2007				**40,000**	**13.02**	**2**
	6/6/2007				**100,000**	**10.84**	**5**
	9/18/2007				**40,000**	**13.02**	
	9/18/2007				**20,000**	**15.25**	
	9/18/2007				**10,000**	**17.39**	
	9/18/2007				**100,000**	**10.84**	
	9/18/2007				**70,000**	**15.25**	
	12/21/2007				**250,000**	**6.98**	**8**
C. Elam		**0**	**188,486**	**376,972**			
	4/2/2007				**40,000**	**13.02**	**2**
	9/18/2007				**12,000**	**17.39**	
	9/18/2007				**80,000**	**18.61**	
	9/18/2007				**40,000**	**13.02**	
	12/21/2007				**150,000**	**6.98**	**4**
Patton,		**0**	**141,663**	**250,575**			
	4/2/2007				**30,000**	**13.02**	**1**
	9/18/2007				**23,000**	**7.775**	
	9/18/2007				**2,450**	**13.8125**	
	9/18/2007				**15,989**	**27.6875**	
	9/18/2007				**7,016**	**14.25**	
	9/18/2007				**7,000**	**7.775**	

9/18/2007	**30,000**	**13.02**
9/18/2007	**6,504**	**15.375**
9/18/2007	**3,611**	**27.6875**
9/18/2007	**20,984**	**14.25**
9/18/2007	**332**	**15.375**
9/18/2007	**10,413**	**27.875**
9/18/2007	**3,587**	**27.875**
9/18/2007	**12,000**	**15.375**
9/18/2007	**20,000**	**18.54**
9/18/2007	**14,000**	**7.15**
9/18/2007	**97,550**	**13.8125**

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ame (a)	Grant Date (b(1)	Date of Board or Committee Approval(2)	Estimated Possible Payouts Under Non-Equity Incentive Plan Awards (3)(4) Threshold ($) (c)	Target ($) (d)	Maximum ($) (e)	All Other Stock Awards: Number of Shares of Stock or Units (#) (i)	All Other Option Awards: Number of Securities Underlying Options (#) (j)	Exercise or Base Price of Option Awards ($/sh)(5) (k)
	9/18/2007						21,164	15.375
	12/21/2007						100,000	6.98
. Chess(7)	1/3/2007	12/7/2006					17,000	15.24
	1/3/2007	12/7/2006				8,333		
Harkness	8/23/07	8/22/2007	0	78,958	157,916		47,960	8.34
	8/23/07	8/22/2007					152,040	8.34
	8/23/07	8/22/2007				10,000		
apeau			0	64,772	97,158			
	4/2/2007						40,000	13.02
hnston			0	142,498	249,371			
	4/2/2007						40,000	13.02

10/5/2007	**40,000**	**$**	**13.02**
10/5/2007	**20,000**	**$**	**17.39**

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