

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

/X/ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934.

For the quarterly period ended June 30, 1996

or,
/ / TRANSITION REPORTS PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934.

For the transition period from _____ to _____.

COMMISSION FILE NUMBER: 0-23556

INHALE THERAPEUTIC SYSTEMS
(Exact name of registrant as specified in its charter)

CALIFORNIA 94-3134940
(State of other jurisdiction of (IRS Employer Identification No.)
incorporation or organization)

1060 EAST MEADOW CIRCLE
PALO ALTO, CALIFORNIA 94303
(Address of principal executive offices)

415-354-0700
(Registrant's telephone number, including area code)

1001 East Meadow Circle, Palo Alto, California 94303
(Former name, former address and former fiscal year, if changed since last
report)

Indicate by check mark whether the registrant (1) has filed all reports required
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. /X/ Yes / / No

The number of outstanding shares of the registrant's Common Stock, no par value,
was 11,532,262 as of July 16, 1996.

INHALE THERAPEUTIC SYSTEMS

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Item 1.

INHALE THERAPEUTIC SYSTEMS

Condensed Balance Sheets
(in thousands)

	June 30, 1996 ----- (unaudited)	December 31, 1995 -----
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 7,951	\$ 3,834
Short-term investments	26,343	16,093
Other current assets	1,157	487
	-----	-----
Total current assets	35,451	20,414
Property and equipment, net	3,112	2,660
Deposits and other assets	165	174
	-----	-----

\$ 38,728 \$ 23,248
=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:			
Accounts payable and accrued liabilities	\$ 1,610	\$ 1,616	
Other current liabilities	973	519	
Deferred revenue - current portion	470	578	
Total current liabilities	3,053	2,713	
Equipment financing obligations	256	353	
Stockholders' equity:			
Common stock, no par value: 30,000 shares authorized, 11,532 shares and 10,142 shares issued and outstanding at June 30, 1996 and December 31, 1995, respectively	57,744	38,202	
Deferred compensation	(169)	(250)	
Deficit accumulated during the development stage	(22,156)	(17,770)	
Total shareholders' equity	35,419	20,182	
	\$38,728	\$23,248	
	=====	=====	

Note: The balance sheet at December 31, 1995 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

See accompanying notes.

INHALE THERAPEUTIC SYSTEMS

Condensed Statements of Operations
(in thousands, except per share information)
(unaudited)

	Three Months Ended June 30, -----		Six Months Ended June 30, -----	
	1996 ----	1995 ----	1996 ----	1995 ----
Contract research revenue	\$ 1,448	\$ 1,021	\$ 2,930	\$ 1,609
Costs and expenses:				
Research and development	3,516	2,174	6,433	4,135
General and administrative	854	782	1,555	1,795
	-----	-----	-----	-----
Total operating costs and expenses	4,370	2,956	7,988	5,930
	-----	-----	-----	-----
Loss from operations	(2,922)	(1,935)	(5,058)	(4,321)
Interest income, net	437	351	672	561
	-----	-----	-----	-----
Net loss	\$ (2,485)	\$ (1,584)	\$ (4,386)	\$ (3,760)
	=====	=====	=====	=====
Net loss per share	\$ (0.22)	\$ (0.16)	\$ (0.41)	\$ (0.39)
	=====	=====	=====	=====

Shares used in computing net loss per share	11,387 =====	10,120 =====	10,769 =====	9,546 =====
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See accompanying notes.

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INHALE THERAPEUTIC SYSTEMS

Condensed Statements of Cash Flows
(in thousands)
(unaudited)
Increase Decrease in Cash and Cash Equivalents

	Six Months Ended June 30, -----	
	1996 ----	1995 ----
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash used in operations	\$ (4,077)	\$ (2,480)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available for sale securities	(29,751)	(28,027)
Sales of available for sale securities	1,421	5,565
Maturities of available for sale securities	18,080	9,826
Purchases of property and equipment, net	(955)	(631)
	-----	-----
Net cash used in investing activities	(11,205)	(13,267)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments of equipment loan and capital lease obligations		
Issuance of common stock, net of issuance costs	(143)	(106)
	19,542	12,243
	-----	-----
Net cash provided by financing activities	19,399	12,137
	-----	-----
Net increase (decrease) in cash and cash equivalents	4,117	(3,610)
Cash and cash equivalents at beginning of period	3,834	10,510
Cash and cash equivalents at end of period	\$ 7,951 =====	\$ 6,900 =====

See accompanying notes.

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INHALE THERAPEUTIC SYSTEMS

NOTES TO CONDENSED FINANCIAL STATEMENTS
June 30, 1996
(unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed financial statements of Inhale Therapeutic Systems ("Inhale" or the "Company") have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. The balance sheet as of June 30, 1996, the related statements of operations for the three and six month periods ended June 30, 1996 and 1995 and cash flows for the six month period ended June 30, 1996 and 1995 are unaudited but include all adjustments (consisting of normal recurring adjustments) which the Company considers necessary for a fair presentation of the financial position at such

dates and the operating results and cash flows for those periods. Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information normally included in financial statements and related footnotes prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (the "Commission"). The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K filed with the Commission.

Results for any interim period are not necessarily indicative of results for any other interim period or for the entire year.

2. REVENUE RECOGNITION

Contract revenue from collaborative research agreements is recorded when earned and as the related costs are incurred. Payments received which are related to future performance are deferred and recognized as revenue when earned over future performance periods. In accordance with contract terms, up-front and milestone payments from collaborative research agreements are considered reimbursements for costs incurred under the agreements, and accordingly, are generally recognized based on actual efforts expended over the terms of the agreements. Further, the Company defers recognition of revenue earned under arrangements with related parties that grant the Company an option to reacquire technology rights until such option expires. The Company's research revenue is derived primarily from clients in the pharmaceutical and biotechnology industries. All of the Company's research and development agreements are generally cancelable by the partner without significant penalty to the partner.

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Contract research revenue from two partners represented 73% and 14% of the Company's revenue in the six month period ended June 30, 1996. Contract revenue from two partners represented 69% and 20% of the Company's revenue in the same period last year. Costs of contract research revenue approximate such revenue and are included in research and development expenses.

3. NET LOSS PER SHARE

Net loss per share is computed using the weighted average number of shares of common stock outstanding. Common equivalent shares from stock options, and a warrant are excluded from the computation as their effect is antidilutive.

4. COLLABORATIVE AGREEMENT

On March 1, 1996, the Company signed a collaboration agreement with Baxter Healthcare Corporation (a subsidiary of Baxter International) ("Baxter") to use Inhale's dry powder pulmonary delivery system as a technology platform for developing and launching therapeutic products. On April 9, 1996, Baxter purchased \$20.0 million of Inhale Common Stock at a 25% market premium, based on the average market price prior to the signing of the agreement. Baxter will receive worldwide commercialization rights in exchange for making up to an estimated \$60 million in research and development funding and milestone payments for the first four molecules, assuming successful development and continuation of the program by Baxter. Baxter also has an option to add molecules to the collaboration that could result in additional funding and milestone payments to Inhale. Inhale will receive royalties and manufacturing payments on sales of products developed through the collaboration. Additionally, under the terms of the agreement, Inhale has an option to reacquire technology rights.

Inhale has primary responsibility for development of the selected therapeutics. Inhale will develop dry powder formulations for use with its portable inhalation device, and will process and package powders for clinical supplies and marketed products. Clinical trials also will be managed by Inhale. Baxter will be responsible for the worldwide commercialization of the products resulting from the collaboration.

Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis of Financial Condition and

Results of Operations for the three and six months ended June 30, 1996 and 1995, should be read in conjunction with the Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's Annual Report on Form 10-K.

The discussion in this Form 10-Q contains forward-looking statements that involve risks and uncertainties. The Company's actual results could differ materially from those discussed herein. Factors that could cause or contribute to such differences include, but are not limited to, those discussed herein as well as those discussed under the caption "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 1995. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's analysis only as of the date hereof. The Company undertakes no obligation to publicly release the results of any revision to these forward-looking statements which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

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OVERVIEW

Since its inception in July 1990, Inhale has been a development stage company engaged in the development of a pulmonary system for the delivery of macromolecule drugs for systemic and local lung applications. The Company has been unprofitable since inception and expects to incur significant and increasing additional operating losses over the next several years primarily due to increasing research and development expenditures and expansion of manufacturing facilities. To date, Inhale has not sold any products and does not anticipate receiving revenue from product sales or royalties in the near future. For the period from inception through June 30, 1996, the Company incurred a cumulative net loss of approximately \$22.2 million. Inhale's sources of working capital have been equity financings, financings of equipment acquisitions, interest earned on investments of cash, and revenues from short-term research and feasibility agreements and development contracts.

Inhale typically has been compensated for research and development expenses during initial feasibility work performed under collaborative arrangements. Inhale's strategy is to enter into development contracts with pharmaceutical and biotechnology corporate partners after feasibility is demonstrated. Partners that enter into collaborative agreements will pay for research and development expenses and will make payments to Inhale as it achieves certain key milestones. Inhale expects to receive royalties from its partners based on revenues received from product sales, and to receive revenue from the manufacturing of powders and the supply of devices. To date, one up-front signing payment and one milestone and no royalty payments have been received by the Company under its collaborative agreements. In certain cases, the Company may enter into collaborative agreements under which the Company's partners would manufacture or package powders or supply inhalation devices, thereby potentially limiting one or more sources of revenue for the Company. To achieve and sustain profitable operations, the Company, alone or with others, must successfully develop, obtain regulatory approval for, manufacture, introduce, market and sell products utilizing its pulmonary drug delivery system. There can be no assurance that the Company can generate sufficient product or contract research revenue to become profitable or to sustain profitability.

RESULTS OF OPERATIONS

Revenues in the second quarter in 1996 were \$1,448,000 compared to \$1,021,000 in the second quarter of 1995, an increase of 42%. Revenues for the six months ended June 30, 1996 were \$2,930,000 compared to \$1,609,000 for the six months ended June 30, 1995, an increase of 82%. The increase in revenues was primarily due to revenue recognized under the Company's collaborative agreement entered into with Pfizer, Inc. ("Pfizer") on January 18, 1995. Such revenue was comprised of reimbursed research and development expenses and the amortization of the pro-rata portion of the up-front signing payment based on actual efforts expended. The collaboration covers the development of insulin products using Inhale's non-invasive pulmonary drug delivery system for macromolecules. Costs of contract research revenue approximate such revenue and are included in

research and development expense.

Research and development expenses increased to approximately \$3,516,000 in the second quarter of 1996 from \$2,174,000 in the second quarter of 1995, an increase of 62%. Research and development expenses for the six months ended

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June 30, 1996 were \$6,433,000 compared to \$4,135,000 for the six months ended June 30, 1995, an increase of 56%. The increase is primarily attributed to continued expansion of research activities resulting from an increase in the number of projects, additional hiring of scientific personnel and increased costs of laboratory supplies and consulting services. The Company expects research, development and process development spending to increase significantly over the next few years as the Company continues to expand its research and development and commence its manufacturing efforts.

General and administrative expenses increased to \$854,000 in the second quarter of 1996 from \$782,000 in the second quarter of 1995, an increase of 9%. The increase in the second quarter 1996 was due primarily to increased marketing consulting costs associated with collaborative agreements, and increased administrative staffing and support of the Company's increased research efforts. General and administrative expenses for the six months ended June 30, 1996 were \$1,555,000 compared to \$1,795,000 for the six months ended June 30, 1995, a decrease of 13%. Marketing consulting costs associated with the Company's collaborative agreements that were incurred in the first quarter of 1995 were not experienced at the same level in the same period this year. General and administrative expenses are expected to continue to increase to support increased levels of research, development and manufacturing activities and to cover the costs of being a public company.

Net interest income increased to \$437,000 in the second quarter of 1996 compared to \$351,000 in the second quarter of 1995. Net interest income increased to \$672,000 for the six months ended June 30, 1996 compared to \$561,000 for the six months ended June 30, 1995. Interest income was earned on larger cash and investment balances held by the Company in the three and six month periods ended June 30, 1996, compared to the same period last year. The higher cash balance a result of the \$20.0 million equity investment by Baxter on April 9, 1996.

LIQUIDITY AND CAPITAL RESOURCES

The Company has financed its operations primarily through private placements of its equity securities, public offerings, contract research revenues, interest income earned on its investments of cash and financing of equipment acquisitions. On April 9, 1996, Baxter made a \$20.0 million equity investment in Inhale at a 25% premium to market price in conjunction with an agreement the Company signed with Baxter in March 1996 to develop products using Inhale's non-invasive pulmonary drug delivery system for macromolecules. At June 1996, the Company had cash, cash equivalents and short-term investments of approximately \$34.3 million.

The Company's operations used cash of \$4.1 million in the six months ended June 30, 1996, as compared to \$2.5 million for the six months ended June 30, 1995. The increase in cash usage was due to increased operating expenses in the six month period ended June 30, 1996 as compared to the same period last year. These amounts differed from the Company's net operating losses in these periods due principally to depreciation expenses, and increases in accounts payable and accrued liabilities.

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The Company expects its cash requirements to increase due to expected increases in expenses related to the further research and development of its technologies resulting from a larger number of projects, development of drug

formulations, process development for the manufacture and filling of powders and devices, marketing, and general and administrative costs. These expenses include, but are not limited to, increases in personnel and personnel related costs, capital equipment, inhalation device prototype construction and facilities expansion, including the planning and building of a late-stage clinical and early-stage commercial manufacturing facility.

The Company believes that its cash, cash equivalents and short-term investments as of June 30, 1996 of approximately \$34.3 million, together with the: i) potential future \$5.0 million equity investment by Pfizer; and ii) interest income and possible additional equipment financing, will be sufficient to meet its operating expense and capital expenditure requirements at least through 1997. However, the Company's capital needs will depend on many factors, including continued scientific progress in its research and development arrangements, progress with pre-clinical and clinical trials, the time and costs involved in obtaining regulatory approvals, the costs of developing and the rate of scale-up of the Company's powder processing and packaging technologies, the timing and cost of its late-stage clinical and early commercial production facility, the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims, the need to acquire licenses to new technologies and the status of competitive products. To satisfy its long-term needs, the Company intends to seek additional funding, as necessary, from corporate partners and from the sale of securities. There can be no assurance that additional funds, if and when required, will be available to the Company on favorable terms, if at all.

INHALE THERAPEUTIC SYSTEMS

PART II: OTHER INFORMATION

- Item 1. Legal Proceedings - Not applicable
- Item 2. Changes in Securities - None
- Item 3. Defaults upon Senior Securities - None
- Item 4. Submission of Matters to a Vote of Security Holders
 - (a) The Annual Meeting of Shareholders of Inhale Therapeutic Systems was held on May 15, 1996.
 - (b) Robert B. Chess, John S. Patton, Terry L. Opdendyk, Mark J. Gabrielson, James B. Glavin and Melvin Perelman, Ph.d. were each elected to the Board of Directors to hold office until the next annual meeting of shareholders and until his successor is elected and has qualified, or until such director's earlier death, resignation or removal.
 - (c) The matters voted upon at the meeting and the voting of shareholders with respect thereto are as follows:
 - 1. The election of Robert B. Chess, John S. Patton, Terry L. Opdendyk, Mark J. Gabrielson, James B. Glavin and Melvin Perelman, Ph.d. to the Board of Directors to hold office until the next annual meeting of shareholders and until his successor is elected and has qualified, or until such director's earlier death, resignation or removal:

	For ---	Withheld -----
Robert B. Chess	10,734,723	3,150
John S. Patton	10,734,723	3,150
Terry L. Opdendyk	10,734,723	3,150
Mark J. Gabrielson	10,727,223	10,650
James B. Glavin	10,727,223	10,650

2. The amendment of the Company's 1994 Equity Incentive Plan to increase the aggregate number of shares of Common Stock authorized for issuance under such plan by 1,500,000 shares from 2,400,000 shares to 3,900,000 shares:
 - For: 8,627,636
 - Against: 1,606,412
 - Broker non-vote: 495,309
 - Abstain: 8,516

3. The amendment of the Company's 1994 Non-Employee Directors' Stock Option Plan to: (i) increase the initial grant thereunder from 7,200 shares to 14,400 shares; (ii) change from an annual option grant thereunder of 7,200 shares to a biennial grant of 14,400 shares; and (iii) change the vesting of options granted thereunder from 12 months to 24 months:
 - For: 9,889,830
 - Against: 242,085
 - Broker non-vote: 594,770
 - Abstain: 11,188

4. The ratification of the selection of Ernst & Young, LLP as independent auditors of the Company for its fiscal year ending December 31, 1996:

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For: 10,735,473 Against: 700 Abstain: 1,700
 Broker non-vote: 0

- Item 5. Other Information - None
- Item 6. Exhibits and Reports on Form 8-K
- (a) Exhibits

EXHIBIT -----	EXHIBIT TITLE -----
3.1(3)	Restated Articles of Incorporation of the Registrant.
3.2(1)	Bylaws of the Registrant.
4.1	Reference is made to Exhibits 3.1 through 3.2.
4.2(1)	Restated Investor Rights Agreement among the Registrant and certain other persons named therein, dated April 29, 1993, as amended October 29, 1993.
4.3(1)	Stock Purchase Agreement between the Registrant and Robert M. Platz, dated August 2, 1990.
4.4(1)	Stock Purchase Agreement between the Registrant and John S. Patton, dated August 2, 1990.
4.5(1)	Warrant to purchase 18,182 Shares of Series C Preferred Stock between the Registrant and Phoenix leasing Incorporated, dated October 29, 1993.
4.6(1)	Specimen stock certificates.
4.7(1)	Stock Restriction Agreement between the Registrant and Robert M. Platz, dated September 13, 1991.
4.8(1)	Stock Restriction Agreement between the Registrant and John S. Patton, Dated September 13, 1991.
4.9(2)	Stock Purchase Agreement between the Registrant and Pfizer Inc., dated January 18, 1995.
10.1(4)	Registrant's 1994 Equity Incentive Plan, as amended (the "Equity Incentive Plan").
10.2(1)	Form of Incentive Stock Option under the Equity Incentive Plan.
10.3(1)	Form of Nonstatutory Stock Option under the Equity Incentive Plan.
10.4	Registrant's 1994 Non-Employee Directors' Stock Option Plan, as amended.
10.5(1)	Registrant's 1994 Employee Stock Purchase Plan.
10.6(1)	Standard Industrial Lease between the Registrant and W.F. Batton & Co., Inc., dated September 17, 1992, as amended September 18, 1992.
10.7(1)	Master Equipment Lease between the Registrant and Phoenix Leasing Incorporated, dated August 15, 1992, and Schedules 1 to 4 thereto.

10.8(1)	Senior Loan and Security Agreement between the Registrant and Phoenix Leasing Incorporated, dated September 15, 1993.
10.9(1)	Sublease Agreement between the Registrant and John S. Patton, dated September 13, 1991.
10.10(2)	Offer Letter, dated September 16, 1994, from the Registrant to Jack M. Anthony.
10.11(2)	Addendum to Lease dated September 17, 1992, between the Registrant and W.F. Batton & Marie A. Batton.
10.12(6)	Lease dated May 31, 1995, between the Registrant and W.F. Batton & Marie A. Batton.
10.13(6)	Addendum Number One to Lease dated September 17, 1992, between the Registrant and W.F. Batton & Marie A. Batton.
10.14(6)	Addendum to Lease dated May 31, 1995 between the Registrant and W.F. Batton & Marie A. Batton.
10.15(6)	Addendum Number Two to Lease dated September 17, 1992, between the Registrant and W.F. Batton & Marie A. Batton.
10.16(5)	Stock Purchase Agreement between the Registrant and Baxter World Trade Corporation, dated March 1, 1996.
27.1	Financial Data Schedule

-
- (1) Incorporated by reference from the Company's Registration Statement on Form S-1 (No. 33-75924), as amended.
 - (2) Incorporated by reference from the Company's Registration Statement on Form S-1 (No. 33-89502), as amended.
 - (3) Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 1994.
 - (4) Incorporated by reference from the Company's Registration Statement on Form S-8 (No. 333-07969).
 - (5) Incorporated by reference from the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 1996.
 - (6) Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 1995.

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Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto.

INHALE THERAPEUTIC SYSTEMS

DATE: August 13, 1996

BY: /S/ Robert B. Chess

Robert B. Chess

President, Chief Executive Officer and
Director

DATE: August 13, 1996

BY: /S/ Ajit Gill

Ajit S. Gill
Chief Financial Officer
(Principal Financial and Accounting
Officer)

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INHALE THERAPEUTIC SYSTEMS

1994 NON-EMPLOYEE DIRECTORS' STOCK OPTION PLAN

ADOPTED ON FEBRUARY 10, 1994

APPROVED BY THE SHAREHOLDERS

ON FEBRUARY 18, 1994

AMENDED ON MARCH 27, 1996

APPROVED BY THE SHAREHOLDERS

ON MAY 15, 1996

1. PURPOSE.

(a) The purpose of the 1994 Non-Employee Directors' Stock Option Plan (the "Plan") is to provide a means by which each director of Inhale Therapeutic Systems (the "Company") who is not otherwise an employee of the Company or of any Affiliate of the Company (each such person being hereafter referred to as a "Non-Employee Director") will be given an opportunity to purchase stock of the Company.

(b) The word "Affiliate" as used in the Plan means any parent corporation or subsidiary corporation of the Company as those terms are defined in Sections 424(e) and (f), respectively, of the Internal Revenue Code of 1986, as amended from time to time (the "Code").

(c) The Company, by means of the Plan, seeks to retain the services of persons now serving as Non-Employee Directors of the Company, to secure and retain the services of persons capable of serving in such capacity, and to provide incentives for such persons to exert maximum efforts for the success of the Company.

2. ADMINISTRATION.

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(a) The Plan shall be administered by the Board of Directors of the Company (the "Board") unless and until the Board delegates administration to a committee, as provided in subparagraph 2(b).

(b) The Board may delegate administration of the Plan to a committee composed of not fewer than two (2) members of the Board (the "Committee"). If administration is delegated to a Committee, the Committee shall have, in connection with the administration of the Plan, the powers theretofore possessed by the Board, subject, however, to such resolutions, not inconsistent with the provisions of the Plan, as may be adopted from time to time by the Board. The Board may abolish the Committee at any time and revert in the Board the administration of the Plan.

3. SHARES SUBJECT TO THE PLAN.

(a) Subject to the provisions of paragraph 10 relating to adjustments upon changes in stock, the stock that may be sold pursuant to options granted under the Plan shall not exceed in the aggregate Two Hundred Thousand (200,000) shares of the Company's common stock. If any option granted under the Plan shall for any reason expire or otherwise terminate without having been exercised in full, the stock not purchased under such option shall again become available for the Plan.

(b) The stock subject to the Plan may be unissued shares or reacquired shares, bought on the market or otherwise.

4. ELIGIBILITY.

Options shall be granted only to Non-Employee Directors of the Company.

5. NON-DISCRETIONARY GRANTS.

2.

(a) On June 1 of every other year, commencing June 1, 1996, each person who is then a Non-Employee Director shall be granted an option to purchase Fourteen Thousand Four Hundred (14,400) shares of common stock of the Company on the terms and conditions set forth herein.

(b) Each person who was not previously an employee of the Company and who becomes a Non-Employee Director after March 27, 1996 shall be granted an option on the date such person becomes a Non-Employee Director (the "Appointment Date") to purchase that number of shares equal to 14,400 multiplied by a fraction, the numerator of which is the number of full months between the Appointment Date and the following June 1 of the next even numbered year, and the denominator of which is twenty-four (24).

6. OPTION PROVISIONS.

Each option shall contain the following terms and conditions:

(a) The term of each option commences on the date it is granted and, unless sooner terminated as set forth herein, expires on the date ("Expiration Date") ten (10) years from the date of grant. If the optionee's service as a Director of the Company terminates for any reason or for no reason, the option shall terminate on the earlier of the Expiration Date or the date three (3) months following the date of termination of service; provided, however, that if such termination of service is due to the optionee's death, the option shall terminate on the earlier of the Expiration Date or twelve (12) months following the date of the optionee's death. In any and all circumstances, an option may be exercised following termination of the optionee's service as a Non-Employee Director of the Company only as to that number of shares as to which it was exercisable on the date of termination of such service under the provisions of subparagraph 6(e). (b) The exercise

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price of each option shall be one hundred percent (100%) of the fair market value of the stock subject to such option on the date such option is granted.

(b) Payment of the exercise price of each option is due in full in cash upon any exercise. Notwithstanding the foregoing, this option may be exercised pursuant to a program developed under Regulation T as promulgated by the Federal Reserve Board which results in the receipt of cash (or check) by the Company prior to the issuance of shares of the Company's common stock.

(c) An option shall not be transferable except by will or by the laws of descent and distribution, and shall be exercisable during the lifetime of the person to whom the option is granted only by such person or by his guardian or legal representative.

(d) Each option granted under the Plan shall become exercisable in twenty four (24) equal monthly installments beginning with the first day of the first month following the date of grant, provided that the optionee has, during the entire period prior to such vesting date, continuously served as a Non-Employee Director or as an employee of or consultant to the Company or any Affiliate of the Company, whereupon such option shall become fully exercisable in accordance with its terms with respect to that portion of the shares represented by that installment.

(e) The Company may require any optionee, or any person to whom an option is transferred under subparagraph 6(d), as a condition of exercising any such option: (i) to give written assurances satisfactory to the Company as to the optionee's knowledge and experience in financial and business matters; and (ii) to give written assurances satisfactory to the Company stating that such person is acquiring the stock subject to the option for such person's own account

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and not with any present intention of selling or otherwise distributing the stock. These requirements, and any assurances given pursuant to such requirements, shall be inoperative if (i) the issuance of the shares upon the exercise of the option has been registered under a then-currently-effective registration statement under the Securities Act of 1933, as amended (the "Securities Act"), or (ii), as to any particular requirement, a determination is

made by counsel for the Company that such requirement need not be met in the circumstances under the then-applicable securities laws.

(f) Notwithstanding anything to the contrary contained herein, an option may not be exercised unless the shares issuable upon exercise of such option are then registered under the Securities Act or, if such shares are not then so registered, the Company has determined that such exercise and issuance would be exempt from the registration requirements of the Securities Act.

7. COVENANTS OF THE COMPANY.

(a) During the terms of the options granted under the Plan, the Company shall keep available at all times the number of shares of stock required to satisfy such options.

(b) The Company shall seek to obtain from each regulatory commission or agency having jurisdiction over the Plan such authority as may be required to issue and sell shares of stock upon exercise of the options granted under the Plan; provided, however, that this undertaking shall not require the Company to register under the Securities Act either the Plan, any option granted under the Plan, or any stock issued or issuable pursuant to any such option. If the Company is unable to obtain from any such regulatory commission or agency the authority which counsel for the Company deems necessary for the lawful issuance and sale of stock under the Plan, the

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Company shall be relieved from any liability for failure to issue and sell stock upon exercise of such options.

8. USE OF PROCEEDS FROM STOCK.

Proceeds from the sale of stock pursuant to options granted under the Plan shall constitute general funds of the Company.

9. MISCELLANEOUS.

(a) Neither an optionee nor any person to whom an option is transferred under subparagraph 6(d) shall be deemed to be the holder of, or to have any of the rights of a holder with respect to, any shares subject to such option unless and until such person has satisfied all requirements for exercise of the option pursuant to its terms.

(b) Throughout the term of any option granted pursuant to the Plan, the Company shall make available to the holder of such option, not later than one hundred twenty (120) days after the close of each of the Company's fiscal years during the option term, upon request, such financial and other information regarding the Company as comprises the annual report to the stockholders of the Company provided for in the Bylaws of the Company and such other information regarding the Company as the holder of such option may reasonably request.

(c) Nothing in the Plan or in any instrument executed pursuant thereto shall confer upon any Non-Employee Director any right to continue in the service of the Company or any Affiliate or shall affect any right of the Company, its Board or stockholders or any Affiliate to terminate the service of any Non-Employee Director with or without cause.

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(d) No Non-Employee Director, individually or as a member of a group, and no beneficiary or other person claiming under or through him, shall have any right, title or interest in or to any option reserved for the purposes of the Plan except as to such shares of common stock, if any, as shall have been reserved for him pursuant to an option granted to him.

(e) In connection with each option made pursuant to the Plan, it shall be a condition precedent to the Company's obligation to issue or transfer shares to a Non-Employee Director, or to evidence the removal of any restrictions on transfer, that such Non-Employee Director make arrangements satisfactory to the Company to insure that the amount of any federal or other withholding tax required to be withheld with respect to such sale or transfer, or such removal or lapse, is made available to the Company for timely payment of such tax.

10. ADJUSTMENTS UPON CHANGES IN STOCK.

(a) If any change is made in the stock subject to the Plan, or subject to any option granted under the Plan (through merger, consolidation, reorganization, recapitalization, stock dividend, dividend in property other than cash, stock split, liquidating dividend, combination of shares, exchange of shares, change in corporate structure or otherwise), the Plan and outstanding options will be appropriately adjusted in the type of security and maximum number of shares subject to the Plan and the type of security and number of shares and price per share of stock subject to outstanding options.

(b) In the event of: (1) a merger or consolidation in which the Company is not the surviving corporation; (2) a reverse merger in which the Company is the surviving corporation but

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the shares of the Company's common stock outstanding immediately preceding the merger are converted by virtue of the merger into other property, whether in the form of securities, cash or otherwise; or (3) any other capital reorganization in which more than fifty percent (50%) of the shares of the Company entitled to vote are exchanged the time during which options outstanding under the Plan may be exercised shall be accelerated and the options terminated if not exercised prior to such event.

11. AMENDMENT OF THE PLAN.

(a) The Board at any time, and from time to time, may amend the Plan, provided, however, that the Board shall not amend the plan more than once every six months, with respect to the provisions of the plan which relate to the amount, price and timing of grants, other than to comport with changes in the Code, the Employee Retirement Income Security Act of 1974, as amended, or the rules thereunder. Except as provided in paragraph 10 relating to adjustments upon changes in stock, no amendment shall be effective unless approved by the stockholders of the Company within twelve (12) months before or after the adoption of the amendment, where the amendment will:

(i) Increase the number of shares which may be issued under the Plan;

(ii) Modify the requirements as to eligibility for participation in the Plan (to the extent such modification requires stockholder approval in order for the Plan to comply with the requirements of Rule 16b-3); or

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(iii) Modify the Plan in any other way if such modification requires stockholder approval in order for the Plan to comply with the requirements of Rule 16b-3.

(b) Rights and obligations under any option granted before any amendment of the Plan shall not be altered or impaired by such amendment unless (i) the Company requests the consent of the person to whom the option was granted and (ii) such person consents in writing.

12. TERMINATION OR SUSPENSION OF THE PLAN.

(a) The Board may suspend or terminate the Plan at any time. Unless sooner terminated, the Plan shall terminate on February 1, 2004. No options may be granted under the Plan while the Plan is suspended or after it is terminated.

(b) Rights and obligations under any option granted while the Plan is in effect shall not be altered or impaired by suspension or termination of the Plan, except with the consent of the person to whom the option was granted.

(c) The Plan shall terminate upon the occurrence of any of the events described in Section 10(b) above.

13. EFFECTIVE DATE OF PLAN; CONDITIONS OF EXERCISE.

(a) The Plan shall become effective upon adoption by the Board of Directors, subject to the conditions subsequent that the Plan is approved by the shareholders of the Company and the Company completes its initial public

offering of shares of its Common Stock.

(b) No option granted under the Plan shall be exercised or exercisable unless and until the condition of subparagraph 13(a) above has been met.

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