

## **Explanatory report pursuant to Sections 289 (4) and (5) and Section 315 (4) of the Commercial Code (Handelsgesetzbuch, HGB)**

### **Disclosures Pursuant to Section 289 (4) and Section 315 (4) HGB and Explanatory Report**

#### **Composition of subscribed capital**

As of 31 December 2010, PAION AG had a subscribed capital of EUR 25,073,684.00, divided into 25,073,684 no-par value shares, each representing a notional share in the capital stock of EUR 1.00. The shares are issued to the bearer and are fully paid in. Shareholders are not entitled to demand share certificates for their shares under Art. 6 (2) of the Articles of Incorporation. All shares carry the same rights and duties. Each share carries the right to one vote at the Annual General Meeting and also forms the basis of the holder's share in profit. More information on the individual rights and duties of shareholders can be found in the German Stock Corporation Act (Aktengesetz, AktG), in particular Sections 12, 53a et seqq., 118 et seqq. and 186.

#### **Restrictions relating to voting rights or the transfer of shares**

Pursuant to German legislation and the Articles of Incorporation of PAION AG, no restrictions are imposed on the voting rights or transferability of the shares. The Management Board of PAION AG is also not aware of any voting rights or share transfer restrictions at shareholder level.

#### **Shareholdings which exceed 10% of voting rights**

The German Securities Trading Act (Wertpapierhandelsgesetz, WpHG) stipulates that any shareholder who achieves, exceeds or falls short of specific shares in the voting rights in the Company through the purchase or sale of shares or by other means, must notify the Company and the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) accordingly. The lowest threshold for this reporting obligation is 3%. The Company has been notified by Innoven Partenaires S.A., Paris, France, that the latter owns direct or indirect shares in the Company's capital that equal or exceed 10% of the voting rights. On 1 August 2008, Innoven Partenaires S.A., Paris, France, held 10.57% of the voting rights of PAION AG (equivalent to 2,602,953 voting rights).

#### **Shares with special rights conferring control**

The bearers of PAION AG shares have not been granted any special rights by the Company, in particular with regard to powers of control.

#### **Type of control of voting rights when employees are shareholders and do not directly exercise their control rights**

The share options issued to employees and members of the Management Board can be exercised once the defined vesting period has expired and the other conditions have been met by the beneficiaries. Shares acquired in this way give the beneficiaries the same rights as other shareholders and are not subject to any voting rights control.

#### **Legal provisions and provisions of the Articles of Incorporation on the appointment and removal of members of the Management Board and amendments to the Articles of Incorporation**

Members of the Management Board are appointed and removed in accordance with Sections 84 and 85 AktG and the supplementary provisions of the Supervisory Board's rules of procedure which stipulate an age limit of 65 years for Management Board members. Pursuant to Section 84 AktG, members of the Management Board can be elected for a maximum of five years by the Supervisory Board. Repeat appointments or extensions of the term of office for up to a maximum of five years at a time are permissible. Pursuant to Art. 8 (1) of the Articles of Incorporation, the Management Board must comprise at least two members. The Supervisory Board determines the number of members on the Management Board. Furthermore, pursuant to Section 84 (2) AktG and Art. 8 (2) of the Articles of Incorporation, the Supervisory Board may appoint a member of the Management Board as CEO.

Amendments to the Articles of Incorporation are effected in accordance with Sections 179 and 133 AktG in conjunction with Art. 27 of PAION AG's Articles of Incorporation. The shareholder resolution required for any amendment to the Articles of Incorporation can, under PAION AG's Articles of Incorporation, be adopted by a simple majority of the capital stock represented at the adoption of the resolution, provided this is permitted by law.

#### **Authority of the Management Board to issue or buy back shares**

The Management Board is authorised to increase the share capital on or prior to 25 May 2014, with the consent of the Supervisory Board, on one or more occasions, by up to EUR 12,300,000.00 in total by issuing up to

12,300,000 new no-par value bearer shares in return for cash contributions or contributions in kind (Authorised Capital 2009). In the case of capital increases against contributions in kind, the Management Board may also exclude subscription rights, subject to the Supervisory Board's consent. Shareholders must be granted subscription rights if the capital is to be increased against payments in cash. The new shares may also be taken by one or more financial institutions on condition that they offer them to shareholders. The Management Board may, subject to the Supervisory Board's consent, exclude peak amounts from shareholders' subscription rights. The Management Board is also authorised to exclude shareholders' subscription rights, subject to the consent of the Supervisory Board, if the issue price of the new shares is not significantly less than the market price and the shares issued in return for cash contributions with subscription rights excluded pursuant to Section 186 (3) Sentence 4 AktG do not exceed 10% of the share capital as of 25 May 2009. The Management Board is moreover authorised to exclude shareholders' subscription rights, subject to the consent of the Supervisory Board, to the extent necessary to grant subscription rights to holders of convertible bonds, participation rights or options as defined in Section 221 AktG. To date, 470,765 issued shares of the Authorised Capital 2009 have been used.

Furthermore, subject to the consent of the Supervisory Board, the Management Board is authorised to issue on or before 18 May 2015, on one or more occasions, bearer and/or registered convertible and/or warrant bonds of up to an aggregate of EUR 98,000,000.00 with a maximum term of 20 years and to grant the holders or beneficiaries of the bonds conversion rights or options to new shares in PAION AG with a share in share capital of up to EUR 9,800,000.00 in total (Conditional Capital 2010 II). Furthermore, the company is authorised to issue 858,121 shares (Conditional Capital 2004 II), 760,235 shares (Conditional Capital 2008 I) and 720,000 shares (Conditional Capital 2010 I) in connection with the Stock Option Plans 2005, 2008 and 2010.

#### **Material arrangements dependent on a change in control in the wake of a takeover bid**

The licence agreement reached with Lundbeck at the end of 2007 stipulates that Lundbeck, in certain circumstances, has the authorisation to limit PAION's information rights to a minimum in the event of a change of control at PAION, and, if required, to terminate all options exercised by PAION with regard to co-marketing. If Lundbeck exercises its termination right, PAION retains its claim to milestone payments and to a share in the joint marketing result.

Based on the agreement with H.E.A.T. Mezzanine S.A., Luxemburg regarding the subordinate loan of EUR 7,000,000, H.E.A.T. Mezzanine S.A. has the right, to terminate the loan ("extraordinary dismissal") following a change of control, if PAION after a change of control does not provide written evidence to the creditor, that as a consequence of the change of control the credit rating of PAION does not fall under a defined level.

#### **Compensation agreements entered into by the company with members of the Management Board and employees in the event of a takeover bid**

The terms of the Stock Option Plans 2008 and 2010 stipulate for both members of the Management Board and employees that in case of a change of control the vesting period for all options, whose two-year (Stock Option Plan 2008) or four-years (Stock Option Plan 2010) vesting period has expired the vesting period ends at the date of the change of control. For all options, whose two- or four-year vesting period has not expired yet at the date of the change of control, the entitlement to subscribe to shares is converted into an entitlement to a cash settlement based on the share price on the day the change of control comes into effect; the corresponding stock options lapse. The company may choose to grant listed shares in the acquiring company instead of the cash settlement.

For information on further existing compensation agreements with Management Board members, please refer to our comments in the section "Compensation Report".

#### **Accounting-Related Risk Management and Internal Control System (Disclosures Pursuant to Section 289 (5) HGB and Explanatory Report)**

The risk management system and the internal control system involve also the accounting-related processes and aim to ensure the compliance and the reliability of the financial statements and the management report and the released interim financial statements.

The accounting-related risk management and internal control system aim at the risk of significant misstatements in the financial reporting. Essential measures and controls in financial reporting are the clear assignment of responsibilities, four-eyes principle, the segregation of duties, the use of an appropriate financial accounting system with a corresponding authorisation concept as well as the use of checklists and work instructions. Furthermore, single and consolidated financial statements are prepared every month for internal purposes. The monthly, quarterly and annual financial statements are analysed by means of the Group-wide controlling with regard to plan/actual variances and implausibilities and inconsistencies in the accounting. The monthly financial

statements are forwarded to the Supervisory Board. The quarterly and annual financial statements are published. The quarterly and annual financial statements are discussed with the Supervisory Board prior to publication.

The risk management system is reviewed once per year and discussed with the Supervisory Board. The risk analysis is updated during the year and presented to the Supervisory Board; special risks are communicated ad-hoc. The internal control system is reviewed continuously with regard to the effectiveness of the controls and is adjusted if required. The risk management system and the internal control system are audited by Internal Audit in line with a multiyear audit plan.

Significant issues in context of the preparation of financial statements are discussed promptly with the audit committee. Furthermore, the audit committee determines additional audit topics and key audit procedures for the auditor.

In addition, the auditor is obligated to report to the Supervisory Board on accounting relevant risks and control deficiencies as well as other deficiencies of the risk management system and the internal control system that he becomes aware of in the course of his audit.

Aachen, Germany, 8 March 2011

PAION AG

Handwritten signature of Dr Wolfgang Söhngen in black ink.

Dr Wolfgang Söhngen

Handwritten signature of Bernhard Hofer in black ink.

Bernhard Hofer

Handwritten signature of Dr Mariola Söhngen in black ink.

Dr Mariola Söhngen

Handwritten signature of Dr Gavin Kilpatrick in black ink.

Dr Gavin Kilpatrick