

IRONWOOD PHARMACEUTICALS INC

Form 10-Q

November 05, 2015

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2015

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-34620

## IRONWOOD PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**04-3404176**

(I.R.S. Employer  
Identification Number)

**301 Binney Street**

**Cambridge, Massachusetts**

(Address of Principal Executive Offices)

**02142**

(Zip Code)

**(617) 621-7722**

(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  No

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

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. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company)

Smaller reporting company

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

As of October 30, 2015, there were 126,987,217 shares of Class A common stock outstanding and 15,795,479 shares of Class B common stock outstanding.



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**NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q, including the sections titled Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors, contains forward-looking statements. All statements contained in this Quarterly Report on Form 10-Q other than statements of historical fact are forward-looking statements. Forward-looking statements include statements regarding our future financial position, business strategy, budgets, projected costs, plans and objectives of management for future operations. The words may, continue, estimate, intend, plan, will, believe, project, expect, seek, anticipate and similar expressions may identify forward-looking statements. The absence of these words does not necessarily mean that a statement is not forward-looking. These forward-looking statements include, among other things, statements about:

- the demand and market potential for linaclotide in the United States, or the U.S. (LINZESS®), in the European Union, or the E.U. (CONSTELLA®), and in other countries where it is approved for marketing;
- the timing, investment and associated activities involved in commercializing LINZESS by us and Allergan plc in the U.S.;
- the timing and execution of the launches and commercialization of CONSTELLA in the E.U.;
- the timing, investment and associated activities involved in developing, launching, and commercializing linaclotide by us and our partners worldwide;
- our ability and the ability of our partners to secure and maintain adequate reimbursement for linaclotide;
- the ability of our partners and third-party manufacturers to manufacture and distribute sufficient amounts of linaclotide on a commercial scale;
- our expectations regarding U.S. and foreign regulatory requirements for linaclotide and our product candidates, including our post-approval, nonclinical and clinical post-marketing plan with the Food and Drug Administration, or the FDA;

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- our partners' ability to obtain foreign regulatory approval of linaclotide and the ability of all of our product candidates to meet existing or future regulatory standards;
- the safety profile and related adverse events of linaclotide and our product candidates;
- the therapeutic benefits and effectiveness of linaclotide and our product candidates and the potential indications and market opportunities therefor;
- our ability to obtain and maintain intellectual property protection for linaclotide and our product candidates and the strength thereof;
- the ability of our partners to perform their obligations under our collaboration and license agreements with them;
- our plans with respect to the development, manufacture or sale of our product candidates and the associated timing thereof, including the design and results of pre-clinical and clinical studies;
- the in-licensing or acquisition of externally discovered businesses, products or technologies;
- our expectations as to future financial performance, expense levels, payments, tax obligations, capital raising and liquidity sources, and real estate needs, as well as the timing thereof;
- our ability to repay our outstanding indebtedness when due, or redeem or repurchase all or a portion of such debt, as well as the potential benefits of the note hedge transactions described herein;
- inventory levels and write downs and the drivers thereof;
- our ability to compete with other companies that are or may be developing or selling products that are competitive with our products and product candidates;

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- the status of government regulation in the life sciences industry, particularly with respect to healthcare reform;
- trends and challenges in our potential markets;
- our ability to attract and motivate key personnel; and
- other factors discussed elsewhere in this Quarterly Report on Form 10-Q.

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Any or all of our forward-looking statements in this Quarterly Report on Form 10-Q may turn out to be inaccurate. These forward-looking statements may be affected by inaccurate assumptions or by known or unknown risks and uncertainties, including the risks, uncertainties and assumptions identified under the heading "Risk Factors" in this Quarterly Report on Form 10-Q. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this Quarterly Report on Form 10-Q may not occur as contemplated, and actual results could differ materially from those anticipated or implied by the forward-looking statements.

You should not unduly rely on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. Unless required by law, we undertake no obligation to publicly update or revise any forward-looking statements to reflect new information or future events or otherwise. You should, however, review the factors and risks we describe in the reports we will file from time to time with the U.S. Securities and Exchange Commission, or the SEC, after the date of this Quarterly Report on Form 10-Q.

**NOTE REGARDING TRADEMARKS**

LINZESS® and CONSTELLA® are trademarks of Ironwood Pharmaceuticals, Inc. Any other trademarks referred to in this Quarterly Report on Form 10-Q are the property of their respective owners. All rights reserved.

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**IRONWOOD PHARMACEUTICALS, INC.**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 30, 2015**

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****Ironwood Pharmaceuticals, Inc.****Condensed Consolidated Balance Sheets****(In thousands, except share and per share amounts)****(unaudited)**

	September 30, 2015	December 31, 2014
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 248,077	\$ 74,297
Available-for-sale securities	214,229	174,037
Accounts receivable	2,570	10
Related party accounts receivable, net	34,401	25,829
Inventory		4,954
Prepaid expenses and other current assets	6,502	9,180
Total current assets	505,779	288,307
Restricted cash	8,747	8,147
Property and equipment, net	23,183	29,826
Convertible note hedges	72,494	
Other assets	3,223	3,042
Total assets	\$ 613,426	\$ 329,322
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable and related party accounts payable, net	\$ 5,904	\$ 9,762
Accrued research and development costs	2,635	3,574
Accrued expenses and other current liabilities	24,578	22,612
Current portion of capital lease obligations	2,325	1,152
Current portion of deferred rent	5,026	4,992
Current portion of deferred revenue	7,191	7,191
Current portion of PhaRMA notes payable	20,121	11,258
Total current liabilities	67,780	60,541
Capital lease obligations, net of current portion	1,068	2,571
Deferred rent, net of current portion	7,714	10,522
Deferred revenue, net of current portion	3,596	8,989
Note hedge warrants	62,976	
Convertible senior notes	217,408	
PhaRMA notes payable, net of current portion	141,781	158,147
Other liabilities	10,645	
Commitments and contingencies		
Stockholders' equity:		

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Preferred stock, \$0.001 par value, 75,000,000 shares authorized, no shares issued and outstanding			
Class A common stock, \$0.001 par value, 500,000,000 shares authorized and 126,820,615 and 124,915,658 shares issued and outstanding at September 30, 2015 and December 31, 2014, respectively		127	125
Class B common stock, \$0.001 par value, 100,000,000 shares authorized and 15,841,444 and 15,907,272 shares issued and outstanding at September 30, 2015 and December 31, 2014, respectively		16	16
Additional paid-in capital		1,196,345	1,055,876
Accumulated deficit		(1,096,078)	(967,446)
Accumulated other comprehensive income (loss)		48	(19)
Total stockholders' equity		100,458	88,552
Total liabilities and stockholders' equity	\$	613,426	\$ 329,322

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents**Ironwood Pharmaceuticals, Inc.****Condensed Consolidated Statements of Operations****(In thousands, except per share amounts)****(unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Collaborative arrangements revenue	\$ 39,572	\$ 16,918	\$ 96,248	\$ 38,363
Cost and expenses:				
Cost of revenue			12	3,548
Write-down of inventory to net realizable value and loss on non-cancellable purchase commitments	9,488		17,638	8,894
Research and development	25,830	25,122	81,119	74,408
Selling, general and administrative	30,439	28,535	93,740	87,758
Total cost and expenses	65,757	53,657	192,509	174,608
Loss from operations	(26,185)	(36,739)	(96,261)	(136,245)
Other (expense) income:				
Interest expense	(10,021)	(5,320)	(21,115)	(15,906)
Interest and investment income	156	71	292	180
Loss on derivatives	(11,340)		(11,548)	
Other expense, net	(21,205)	(5,249)	(32,371)	(15,726)
Net loss	\$ (47,390)	\$ (41,988)	\$ (128,632)	\$ (151,971)
Net loss per share - basic and diluted	\$ (0.33)	\$ (0.30)	\$ (0.91)	\$ (1.12)
Weighted average number of common shares used in net loss per share basic and diluted:	142,473	139,234	141,954	135,799

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**Ironwood Pharmaceuticals, Inc.**

**Condensed Consolidated Statements of Comprehensive Loss**

**(In thousands)**

**(unaudited)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Net loss	\$ (47,390)	\$ (41,988)	\$ (128,632)	\$ (151,971)
<b>Other comprehensive income:</b>				
Unrealized gains on available-for-sale securities	26	22	67	23
Total other comprehensive income	26	22	67	23
Comprehensive loss	\$ (47,364)	\$ (41,966)	\$ (128,565)	\$ (151,948)

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents**Ironwood Pharmaceuticals, Inc.****Condensed Consolidated Statements of Cash Flows****(In thousands)****(unaudited)**

	<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2014</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (128,632)	\$ (151,971)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>		
Depreciation and amortization	8,831	9,379
Share-based compensation expense	18,969	17,622
Change in fair value of note hedge warrants	(7,873)	
Change in fair value of convertible note hedges	19,421	
Write-down of inventory to net realizable value and loss on non-cancellable purchase commitments	17,638	8,894
Loss on facility subleases		2,573
Accretion of discount/premium on investment securities	722	824
Non-cash interest expense	4,599	1,201
<b>Changes in assets and liabilities:</b>		
Accounts receivable and related party accounts receivable	(11,132)	(12,527)
Restricted cash	(600)	
Prepaid expenses and other current assets	2,722	(5,329)
Inventory		224
Other assets	(181)	(240)
Accounts payable, related party accounts payable and accrued expenses	(2,946)	2,820
Accrued research and development costs	(939)	(1,356)
Deferred revenue	(5,393)	(2,752)
Deferred rent	(2,774)	(2,146)
Net cash used in operating activities	(87,568)	(132,784)
<b>Cash flows from investing activities:</b>		
Purchases of available-for-sale securities	(252,865)	(240,864)
Sales and maturities of available-for-sale securities	212,018	148,483
Purchases of property and equipment	(3,256)	(2,499)
Proceeds from sale of property and equipment	37	
Net cash used in investing activities	(44,066)	(94,880)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of convertible senior notes	335,699	
Proceeds from issuance of common stock		190,428
Proceeds from issuance of note hedge warrants	70,849	
Purchase of convertible note hedges	(91,915)	
Costs associated with issuance of convertible senior notes	(11,682)	
Proceeds from exercise of stock options and employee stock purchase plan	11,874	13,805
Payments on capital leases	(964)	(790)
Principal payments on PhaRMA notes	(8,447)	
Net cash provided by financing activities	305,414	203,443
Net increase (decrease) in cash and cash equivalents	173,780	(24,221)
Cash and cash equivalents, beginning of period	74,297	75,490
Cash and cash equivalents, end of period	\$ 248,077	\$ 51,269

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The accompanying notes are an integral part of these condensed consolidated financial statements.

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**Ironwood Pharmaceuticals, Inc.**

**Notes to Condensed Consolidated Financial Statements**

**(unaudited)**

**1. Nature of Business**

*Overview*

Ironwood Pharmaceuticals, Inc. (the Company) is an entrepreneurial pharmaceutical company focused on creating medicines that make a difference for patients, building value to earn the continued support of its fellow shareholders, and empowering its team to passionately pursue excellence. The Company's core strategy is to establish a leading gastrointestinal (GI) therapeutics company, leveraging its development and commercial capabilities in addressing GI disorders as well as its pharmacologic expertise in guanylate cyclase (GC) pathways.

The Company has one marketed product, linaclotide, which is available in the United States (U.S.) and Mexico under the trademarked name LINZESS® and is available in certain European countries and Canada under the trademarked name CONSTELLA®. Linaclotide is also being developed and commercialized in other parts of the world by certain of the Company's partners.

In August 2012, the U.S. Food and Drug Administration (FDA) approved LINZESS as a once-daily treatment for adult men and women suffering from irritable bowel syndrome with constipation (IBS-C) or chronic idiopathic constipation (CIC). The Company and Allergan plc (together with its affiliates, Allergan), formerly Actavis plc, began commercializing LINZESS in the U.S. in December 2012.

In November 2012, the European Commission granted marketing authorization to CONSTELLA for the symptomatic treatment of moderate to severe IBS-C in adults. CONSTELLA is the first, and to date, only drug approved in the European Union (E.U.) for IBS-C. The Company's former European partner, Almirall, S.A. (Almirall), began commercializing CONSTELLA in Europe in the second quarter of 2013. In October 2015, Almirall transferred its exclusive license to develop and commercialize linaclotide in Europe to Allergan. Currently, CONSTELLA is commercially available in certain European countries, including the United Kingdom, Italy and Spain. In May 2014, Almirall suspended commercialization of CONSTELLA in Germany following an inability to reach agreement with the German National Association of Statutory Health Insurance Funds on a reimbursement price that reflects the innovation and value of CONSTELLA. Allergan is assessing all possibilities to facilitate continued access to CONSTELLA for appropriate patients in Germany.

In December 2013 and February 2014, linaclotide was approved in Canada and Mexico, respectively, as a treatment for adult women and men suffering from IBS-C or CIC. Allergan has exclusive rights to commercialize linaclotide in Canada as CONSTELLA and, through a sublicense from Allergan, Almirall had exclusive rights to commercialize linaclotide in Mexico as LINZESS. In May 2014, Allergan began commercializing CONSTELLA in Canada and in June 2014, Almirall began commercializing LINZESS in Mexico. In October 2015, Almirall and Allergan terminated the sublicense arrangement with respect to Mexico, returning the exclusive rights to commercialize linaclotide in Mexico to Allergan.

Astellas Pharma Inc. ( Astellas ), the Company's partner in Japan, is developing linaclotide for the treatment of patients with IBS-C and chronic constipation in its territory. In October 2014, Astellas initiated a double-blind, placebo-controlled Phase III clinical trial of linaclotide in adult patients with IBS-C. In October 2012, the Company entered into a collaboration agreement with AstraZeneca AB ( AstraZeneca ) to co-develop and co-commercialize linaclotide in China, Hong Kong and Macau, with AstraZeneca having primary responsibility for the local operational execution. In July 2015, the Company and AstraZeneca reported positive top-line data from a double-blind, placebo-controlled Phase III clinical trial of linaclotide in adult patients with IBS-C. The Company continues to assess alternatives to bring linaclotide to IBS-C and CIC sufferers in the parts of the world outside of its partnered territories.

The Company and Allergan are also exploring development opportunities to enhance the clinical profile of LINZESS by seeking to expand its utility in its indicated populations, as well as studying linaclotide in additional indications and populations and in new formulations to assess its potential to treat various GI conditions. In October 2015, as part of this strategy, the Company and Allergan reported positive top-line results from a Phase III clinical trial in the U.S. evaluating a 72 mcg dose of linaclotide in adult patients with CIC. If approved, the 72 mcg dose and the currently approved 145 mcg dose would provide a broader range of treatment options to physicians and adult CIC patients in the U.S. In addition to linaclotide-based opportunities, the Company is advancing multiple GI development programs as well as further leveraging the pharmacological expertise in GC pathways that it established through the development of linaclotide, a guanylate cyclase type-C agonist, to advance a second GC program targeting soluble guanylate cyclase ( sGC ). sGC is a validated mechanism with the potential for broad therapeutic utility and multiple opportunities for product development in cardiovascular disease and other indications.



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In June 2015, the Company issued approximately \$335.7 million in aggregate principal amount of 2.25% Convertible Senior Notes due 2022 (the 2022 Notes ). The Company received net proceeds of approximately \$324.0 million from the sale of the 2022 Notes, after deducting fees and expenses of approximately \$11.7 million (Note 9).

***Basis of Presentation***

The accompanying condensed consolidated financial statements and the related disclosures are unaudited and have been prepared in accordance with accounting principles generally accepted in the U.S. ( U.S. GAAP ). Certain financial statement items have been reclassified to conform to the current period presentation. Additionally, certain information and footnote disclosures normally included in the Company s annual financial statements have been condensed or omitted. Accordingly, these interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2014, which was filed with the Securities and Exchange Commission on February 18, 2015 (the 2014 Annual Report on Form 10-K ).

The unaudited interim condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and, in the opinion of management, reflect all normal recurring adjustments considered necessary for a fair presentation of the Company s financial position as of September 30, 2015, and the results of its operations for the three and nine months ended September 30, 2015 and 2014 and its cash flows for the nine months ended September 30, 2015 and 2014. The results of operations for the three and nine months ended September 30, 2015 are not necessarily indicative of the results that may be expected for the full year or any other subsequent interim period.

***Principles of Consolidation***

The accompanying condensed consolidated financial statements include the accounts of Ironwood Pharmaceuticals, Inc. and its wholly owned subsidiaries, Ironwood Pharmaceuticals Securities Corporation and Ironwood Pharmaceuticals GmbH. All intercompany transactions and balances are eliminated in consolidation.

***Use of Estimates***

The preparation of condensed consolidated financial statements in accordance with U.S. GAAP requires the Company s management to make estimates and judgments that may affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company s management evaluates its estimates, including those related to revenue recognition, available-for-sale securities, inventory valuation and related reserves, impairment of long-lived assets, initial valuation procedures for the issuance of convertible notes, fair value of derivatives, balance sheet classification of notes payable and convertible notes, income taxes including the valuation allowance for deferred tax assets, research and development expense, contingencies and share-based compensation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under

different assumptions or conditions. Changes in estimates are reflected in reported results in the period in which they become known.

*Summary of Significant Accounting Policies*

The Company's significant accounting policies are described in Note 2, Summary of Significant Accounting Policies, in the Company's 2014 Annual Report on Form 10-K.

Deferred Financing Costs

On April 7, 2015, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2015-03, *Simplifying the Presentation of Debt Issuance Costs* ( ASU 2015-03 ). ASU 2015-03 requires debt issuance costs to be presented in an entity's balance sheet as a direct deduction from the associated debt liability. While the standard is retrospectively effective for annual reporting periods beginning after December 15, 2015, early adoption is permitted for any annual reporting period or interim period for which the entity's financial statements have not yet been issued.

The Company elected early adoption in the three months ended June 30, 2015, which resulted in a balance sheet reclassification of issuance costs in connection with the 11% PhaRMA Notes due 2024 (the PhaRMA Notes ) of approximately \$1.4 million recorded in prepaid expenses and other current assets and approximately \$2.8 million in other assets to a reduction in PhaRMA notes payable as of December 31, 2014. The financing costs incurred in connection with the issuance of the Company's 2022 Notes were

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recorded as a reduction in the carrying value of such debt. The Company's adoption of this standard did not have a significant impact on its results of operations or cash flows for the three or nine months ended September 30, 2015.

Derivative Assets and Liabilities

In June 2015, in connection with the issuance of the 2022 Notes, the Company entered into convertible note hedge transactions (the Convertible Note Hedges). Concurrently with entering into the Convertible Note Hedges, the Company also entered into certain warrant transactions in which it sold note hedge warrants (the Note Hedge Warrants) to the Convertible Note Hedge counterparties to acquire 20,249,665 shares of the Company's Class A common stock, subject to customary anti-dilution adjustments (Note 9). These instruments were assessed by the Company to be derivative financial instruments, as it was determined that the instruments meet the criteria for classification as derivatives under Accounting Standards Codification (ASC) Topic 815, *Derivatives and Hedging* (ASC 815).

The derivatives are recorded as assets or liabilities at fair value using the Black-Scholes option pricing model, and the changes in fair value are immediately recorded as a component of other (expense) income in the Condensed Consolidated Statements of Operations, as the derivatives had not been formally designated as hedges for accounting purposes in accordance with ASC 815.

***New Accounting Pronouncements***

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09), which supersedes the revenue recognition requirements in ASC Topic 605, *Revenue Recognition*, and most industry-specific guidance. The new standard requires that an entity recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. The update also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. ASU 2014-09 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017 and should be applied retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application. Early adoption is permitted beginning after December 15, 2016, including interim reporting periods within those years. The Company is currently evaluating the potential impact that ASU 2014-09 may have on its financial position and results of operations.

In April 2015, the FASB issued ASU No. 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*, which amends ASC Topic 350, *Intangibles - Goodwill and Other - Internal Use Software*. Under this standard, if a cloud computing arrangement includes a software license, the software license element of the arrangement should be accounted for consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the arrangement should be accounted for as a service contract. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2015 and may be applied on either a prospective or retrospective basis. Early adoption is not permitted. The Company does not expect adoption of this standard to have a significant impact on the Company's financial position or results of operations.

The Company did not adopt any other new accounting pronouncements during the three or nine months ended September 30, 2015 that had a material effect on the Company's condensed consolidated financial statements.

## 2. Net Loss Per Share

Basic and diluted net loss per common share is computed by dividing net loss by the weighted average number of common shares outstanding during the period.

In June 2015, in connection with the issuance of approximately \$335.7 million in aggregate principal amount of the 2022 Notes, the Company entered into the Convertible Note Hedges. The Convertible Note Hedges are generally expected to reduce the potential dilution to the Company's Class A common stockholders upon conversion of the 2022 Notes and/or offset any cash payments the Company is required to make in excess of the principal amount of converted 2022 Notes in the event that the market price per share of the Company's Class A common stock, as measured under the terms of the Convertible Note Hedges, is greater than the conversion price of the 2022 Notes (Note 9). The Convertible Note Hedges are not considered for purposes of calculating the number of diluted weighted average shares outstanding, as their effect would be antidilutive.

Concurrently with entering into the Convertible Note Hedges, the Company also entered Note Hedge Warrants to the Convertible Note Hedge counterparties to acquire 20,249,665 shares of the Company's Class A common stock, subject to customary

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anti-dilution adjustments. The Note Hedge Warrants could have a dilutive effect on the Class A common stock to the extent that the market price per share of the Class A common stock exceeds the applicable strike price of such warrants (Note 9).

The following table sets forth potential common shares subject to repurchase and issuable upon the exercise of outstanding options, the exercise of the Note Hedge Warrants, the vesting of restricted stock units and the conversion of the 2022 Notes, all of which have been excluded from the computation of diluted weighted average shares outstanding as their effect would be anti-dilutive (in thousands):

	Nine Months Ended September 30,	
	2015	2014
Options to purchase common stock	20,936	20,732
Shares subject to repurchase	112	148
Restricted stock units	532	
Note hedge warrants	20,250	
2022 Notes	20,250	
	62,080	20,880

The number of shares issuable under the Company's employee stock purchase plan that were excluded from the calculation of diluted weighted average shares outstanding because their effects would be anti-dilutive was insignificant.

### 3. Collaboration and License Agreements

At September 30, 2015, the Company had linaclotide collaboration agreements with Allergan and AstraZeneca, and linaclotide license agreements with Almirall and Astellas. The Company also had a co-promotion agreement with Exact Sciences Corp. (Exact Sciences) to co-promote Cologuard® and a separate co-promotion agreement with Allergan to co-promote VIBERZI. The following table provides amounts included in the Company's consolidated statements of operations as collaborative arrangements revenue attributable to transactions from these arrangements (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Allergan plc	\$ 35,083	\$ 13,523	\$ 84,790	\$ 23,748
AstraZeneca AB	474	1,959	2,170	2,645
Almirall, S.A.	143	158	360	7,473
Astellas Pharma Inc.	1,806	1,278	5,886	4,497
Exact Sciences Corp.	2,066		3,042	
Total collaborative arrangements revenue	\$ 39,572	\$ 16,918	\$ 96,248	\$ 38,363

#### Allergan plc

In September 2007, the Company entered into a collaboration agreement with Allergan to develop and commercialize linaclotide for the treatment of IBS-C, CIC and other GI conditions in North America. Under the terms of this collaboration agreement, the Company shares equally with Allergan all development costs as well as net profits or losses from the development and sale of linaclotide in the U.S. The Company receives royalties in the mid-teens percent based on net sales in Canada and Mexico. Allergan is solely responsible for the further development, regulatory approval and commercialization of linaclotide in those countries and funding any costs. In September 2012, Allergan sublicensed its commercialization rights in Mexico to Almirall. In October 2015, Almirall and Allergan terminated the sublicense arrangement with respect to Mexico, returning the exclusive rights to commercialize linaclotide in Mexico to Allergan. Allergan made non-refundable, up-front payments totaling \$70.0 million to the Company in order to obtain rights to linaclotide in North America. Because the license to jointly develop and commercialize linaclotide did not have a standalone value without research and development activities provided by the Company, the Company recorded the up-front license fee as collaborative arrangements revenue on a straight-line basis through September 30, 2012, the period over which linaclotide was jointly developed under the collaboration. The collaboration agreement for North America also includes contingent milestone payments, as well as a contingent equity investment, based on the achievement of specific development and commercial milestones. At September 30, 2015, \$205.0 million in license fees and development milestone payments had been received by the Company, as well as a \$25.0 million

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equity investment in the Company's capital stock. The Company can also achieve up to \$100.0 million in a sales-related milestone if certain conditions are met.

The collaboration agreement for North America included a contingent equity investment, in the form of a forward purchase contract, which required Allergan to purchase shares of the Company's convertible preferred stock upon achievement of a specific development milestone. At the inception of the arrangement, the Company valued the contingent equity investment and recorded an approximately \$9.0 million asset and incremental deferred revenue. The \$9.0 million of incremental deferred revenue was recognized as collaborative arrangements revenue on a straight-line basis over the period of the Company's continuing involvement through September 30, 2012. In July 2009, the Company achieved the development milestone triggering the equity investment and reclassified the forward purchase contract as a reduction to convertible preferred stock. On September 1, 2009, the Company issued 2,083,333 shares of convertible preferred stock to Allergan (Note 11).

The Company achieved all six development milestones under this agreement totaling \$135.0 million, which were recognized through September 2012. The remaining milestone payment that could be received from Allergan upon the achievement of sales targets will be recognized as collaborative arrangements revenue as earned.

As a result of the research and development cost-sharing provisions of the collaboration, the Company offset approximately \$2.9 million and approximately \$14.8 million against research and development costs during the three and nine months ended September 30, 2015, respectively, and approximately \$1.2 million and approximately \$3.3 million during the three and nine months ended September 30, 2014, respectively, to reflect each Company's obligation under the collaboration to bear half of the development costs incurred. In addition, in March 2015, the Company and Allergan agreed to share certain costs relating to the manufacturing of linaclotide active pharmaceutical ingredient (API) and certain other manufacturing activities. This arrangement resulted in net amounts received from Allergan of approximately \$4.3 million for costs incurred in prior periods, which were recorded by the Company as a reduction in research and development expenses during the three months ended March 31, 2015.

The Company receives 50% of the net profits and bears 50% of the net losses from the commercial sale of LINZESS in the U.S.; provided, however, that if either party provides fewer calls on physicians in a particular year than it is contractually required to provide, such party's share of the net profits will be adjusted as stipulated by the collaboration agreement. Certain of the adjustments to the share of the net profits may be reduced or eliminated in connection with the co-promotion activities under the Company's agreement with Allergan to co-promote VIBERZI. Net profits or net losses consist of net sales to third-party customers and sublicense income in the U.S. less cost of goods sold as well as selling, general and administrative expenses. Net sales are calculated and recorded by Allergan and may include gross sales net of discounts, rebates, allowances, sales taxes, freight and insurance charges, and other applicable deductions. The Company records its share of the net profits or net losses from the sale of LINZESS on a net basis and presents the settlement payments to and from Allergan as collaboration expense or collaborative arrangements revenue, as applicable. The Company and Allergan began commercializing LINZESS in the U.S. in December 2012.

The following table presents the amounts recorded by the Company for commercial efforts related to LINZESS in the U.S. in the three and nine months ended September 30, 2015 and 2014 (in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015		2014		2015		2014	
Collaborative arrangements revenue (1) (2)	\$	34,750	\$	13,510	\$	84,162	\$	23,735
		(8,645)		(8,187)		(24,648)		(23,992)

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Selling, general and administrative costs  
incurred by the Company (1)

The Company's share of net profit	\$	26,105	\$	5,323	\$	59,514	\$	(257)
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(1) Includes only collaborative arrangement revenue or selling, general and administrative costs attributable to the cost-sharing arrangement with Allergan.

(2) Includes a net profit share adjustment payable to Allergan of approximately \$2.4 million recorded during the nine months ended September 30, 2015. Also includes a net profit share adjustment received from Allergan of approximately \$2.3 million recorded during the nine months ended September 30, 2014, as described above.

The collaborative arrangements revenue recognized in the three and nine months ended September 30, 2015 and 2014 primarily represents the Company's share of the net profits and net losses on the sale of LINZESS in the U.S.

In May 2014, Allergan began commercializing CONSTELLA in Canada and in June 2014, Almirall began commercializing LINZESS in Mexico. In October 2015, Almirall and Allergan terminated the sublicense arrangement with respect to Mexico, returning the exclusive rights to commercialize linaclotide in Mexico to Allergan. The Company records royalties on sales of CONSTELLA in Canada and LINZESS in Mexico one quarter in arrears as it does not have access to the royalty reports from its partners or the ability to estimate the royalty revenue in the period earned. The Company recognized approximately \$0.3 million and approximately \$0.6



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million of royalty revenues in Canada and Mexico during the three and nine months ended September 30, 2015, respectively. The Company recognized an insignificant amount of royalty revenue in Canada and Mexico during the three and nine months ended September 30, 2014.

*VIBERZI Co-promotion Agreement*

In August 2015, the Company and Allergan entered into an agreement for the co-promotion of VIBERZI (eluxadoline) in the U.S., Allergan's treatment for adults suffering from irritable bowel syndrome with diarrhea ( IBS-D ) (the VIBERZI Co-promotion Agreement ). Under the terms of the VIBERZI Co-promotion Agreement, the Company's clinical sales specialists will detail VIBERZI to the approximately 25,000 health care practitioners to whom they detail LINZESS. Allergan will be responsible for all costs and activities relating to the commercialization of VIBERZI outside of the co-promotion.

Under the terms of the VIBERZI Co-promotion Agreement, the Company's promotional efforts will be compensated based on the volume of calls delivered by the Company's sales force, as well as agreed upon performance metrics, including the potential to achieve milestone payments up to \$20.0 million based on the net sales of VIBERZI in 2017 and 2018. The terms of the agreement reduce or eliminate certain of the adjustments to the share of net profits stipulated by the collaboration agreement with Allergan for North America, provided that the Company provides a minimum number of calls on physicians. The Company will also be compensated via reimbursements for medical education initiatives.

The agreement provides that the non-exclusive co-promotion will begin when VIBERZI becomes commercially available, and will continue until December 31, 2017, unless earlier terminated by either party pursuant to the provisions of the agreement. Either party may also terminate the VIBERZI Co-promotion Agreement in the event of an uncured material breach by the other party, withdrawal of necessary approvals by the FDA, for convenience, or bankruptcy or insolvency of the other party. Allergan may terminate the VIBERZI Co-promotion Agreement if the Company does not provide the minimum number of calls.

Activities under the VIBERZI Co-promotion Agreement were evaluated in accordance with ASC 605-25 to determine if they represented a multiple element revenue arrangement. The Company concluded that the VIBERZI Co-promotion Agreement does not represent a material modification to the collaboration agreement with Allergan for North America, as it is not material to the total arrangement consideration under the collaboration agreement, does not significantly modify the existing deliverables, and does not significantly change the term of the agreement. The Company identified the following deliverables in the agreement: second position sales detailing of VIBERZI, and medical education services. Each of the deliverables was deemed to have standalone value based on their nature and all deliverables met the criteria to be accounted for as separate units of accounting under ASC 605-25. The Company determined the best estimate of selling price for each of the deliverables approximated the value allocated to the deliverables under the agreement. As consideration is earned over the term of the agreement, the revenue will be allocated to each deliverable based on the relative selling price, using management's best estimate of selling price, and recognized as collaborative arrangements revenue in the Company's condensed consolidated statement of operations, in accordance with ASC 605-25, during the quarter earned.

**Almirall, S.A.**

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In April 2009, the Company entered into a license agreement with Almirall to develop and commercialize linaclotide in Europe (including the Commonwealth of Independent States and Turkey) for the treatment of IBS-C, CIC and other GI conditions. Under the terms of the license agreement, Almirall is responsible for the expenses associated with the development and commercialization of linaclotide in the European territory and the Company is required to participate on a joint development committee over linaclotide's development period and a joint commercialization committee while the product is being commercialized.

In May 2009, the Company received an approximately \$38.0 million payment from Almirall representing a \$40.0 million non-refundable up-front payment net of foreign withholding taxes. The Company elected to record the non-refundable up-front payment net of taxes withheld. The license agreement also included a \$15.0 million contingent equity investment, in the form of a forward purchase contract, which required Almirall to purchase shares of the Company's convertible preferred stock upon achievement of a specific development milestone. At the inception of the arrangement, the Company valued the contingent equity investment at approximately \$6.0 million. The Company recognized the up-front license fee and the value of the contingent equity investment totaling approximately \$6.0 million as collaborative arrangements revenue on a straight-line basis through September 30, 2012, the period over which linaclotide was developed under the license agreement. In November 2009, the Company achieved the development milestone triggering the equity investment and on November 13, 2009, the Company received \$15.0 million from Almirall for the purchase of 681,819 shares of convertible preferred stock (Note 11).

The original license agreement also included contingent milestone payments that could total up to \$40.0 million upon achievement of specific development and commercial launch milestones. In November 2010, the Company achieved a development milestone, which resulted in an approximately \$19.0 million payment, representing a \$20.0 million milestone, net of foreign withholding taxes. This development milestone was recognized as collaborative arrangements revenue through September 2012. Commercial milestone payments under the original license agreement consisted of \$4.0 million due upon the first commercial launch in each of the five major E.U. countries set forth in the agreement.

In June 2013 and February 2014, the Company and Almirall amended the original license agreement. Pursuant to the terms of the amendments, (i) the commercial launch milestones were reduced to \$17.0 million; (ii) new sales-based milestone payments were

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added to the agreement; and (iii) the escalating royalties based on sales of linaclotide were modified such that they begin in the low-twenties percent and escalate to the mid-forties percent through April 2017, and thereafter begin in the mid-twenties percent and escalate to the mid-forties percent at lower sales thresholds. In each case, these royalty payments are reduced by the transfer price paid for the API included in the product actually sold in the Almirall territory and other contractual deductions. The Company concluded that the amendments were a modification under ASU No. 2009-13, *Multiple-Deliverable Revenue Arrangements* ( ASU No. 2009-13 ), but the modification did not have a material impact on the Company's consolidated financial statements. The commercial launch and sales-based milestones are recognized as revenue as earned. The Company records royalties on sales of CONSTELLA one quarter in arrears as it does not have access to the royalty reports from Almirall or the ability to estimate the royalty revenue in the period earned.

During the second quarter of 2013, the Company achieved two milestones under the amended Almirall license agreement, which resulted in payments of approximately \$1.9 million from Almirall to the Company related to the commercial launches in two of the five major E.U. countries, the United Kingdom and Germany. The approximately \$1.9 million payment represented the two \$1.0 million milestones, net of foreign tax withholdings. During the first and second quarters of 2014, the Company achieved two milestones under the amended Almirall license agreement triggering payments of approximately \$1.0 million each related to the commercial launches in two additional major E.U. countries, Italy and Spain. Each approximately \$1.0 million payment represents the \$1.0 million milestone, net of foreign tax withholdings.

In October 2015, Almirall transferred its exclusive license to develop and commercialize linaclotide in Europe to Allergan. Concurrently, Almirall and Allergan terminated the sublicense arrangement with respect to Mexico, returning the exclusive rights to commercialize linaclotide in Mexico to Allergan. Additionally, in October 2015, the Company and Allergan separately entered into an amendment to the license agreement relating to the development and commercialization of linaclotide in Europe. Pursuant to the terms of the amendment, (i) the remaining sales-based milestones payable by Allergan to the Company under the license agreement were modified such that, when aggregated with the remaining commercial launch milestones, they could total up to \$42.5 million, (ii) the royalties payable to the Company during the term of the license agreement were modified such that the royalties based on sales volume in Europe begin in the mid-single digit percent effective immediately and escalate to the upper-teens percent by calendar year 2019, and (iii) Allergan assumed responsibility for the manufacturing of linaclotide API for Europe from the Company, as well as the associated costs. With the Company no longer responsible for the manufacturing of linaclotide API for Europe, the royalties under the license agreement will no longer be reduced by the transfer price paid for the API included in the product actually sold by Allergan in Europe in any given period.

The Company recognized an insignificant amount and approximately \$0.4 million of collaborative arrangements revenue, comprised of royalty revenue, from the European license agreement during the three and nine months ended September 30, 2015, respectively. The Company recognized approximately \$0.2 million and approximately \$7.5 million in total collaborative arrangements revenue from the European license agreement during the three and nine months ended September 30, 2014, respectively, including approximately \$0.2 million in royalty revenue during the three months ended September 30, 2014, and approximately \$5.1 million from the sale of API to Almirall, approximately \$1.9 million in commercial launch milestones, and approximately \$0.5 million in royalty revenue during the nine months ended September 30, 2014.

**Astellas Pharma Inc.**

In November 2009, the Company entered into a license agreement with Astellas to develop and commercialize linaclotide for the treatment of IBS-C, CIC and other GI conditions in Japan, South Korea, Taiwan, Thailand, the Philippines and Indonesia. As a result of an amendment executed in March 2013, the Company regained rights to linaclotide in South Korea, Taiwan, Thailand, the Philippines and Indonesia. The Company concluded that the amendment was not a material modification of the license agreement. Astellas continues to be responsible for all activities relating to development, regulatory approval and commercialization in Japan as well as funding any costs and the Company is required

to participate on a joint development committee over linaclotide's development period.

In 2009, Astellas paid the Company a non-refundable, up-front licensing fee of \$30.0 million, which is being recognized as collaborative arrangements revenue on a straight-line basis over the Company's estimate of the period over which linaclotide will be developed under the license agreement. In March 2013, the Company revised its estimate of the development period from 115 months to 85 months based on the Company's assessment of regulatory approval timelines for Japan. During the three and nine months ended September 30, 2015 and 2014, the Company recognized approximately \$1.3 million and approximately \$3.8 million of revenue related to the up-front licensing fee, respectively, including approximately \$0.5 million and approximately \$1.5 million of revenue in each period attributable to the March 2013 revision to the estimated development period. At September 30, 2015, approximately \$7.6 million of the up-front license fee remained deferred.

The agreement also includes three additional development milestone payments that could total up to \$45.0 million, none of which the Company considers substantive. The first milestone payment consists of \$15.0 million upon enrollment of the first study subject in a Phase III study for linaclotide in Japan, which was achieved in November 2014 and for which approximately

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\$11.8 million was recognized as revenue through September 30, 2015, including approximately \$0.5 million and approximately \$1.6 million recognized during the three and nine months ended September 30, 2015, respectively. The remaining approximately \$3.2 million of this milestone payment will be recognized over the remaining development period. The two additional milestone payments consist of \$15.0 million upon filing of the Japanese equivalent of an NDA with the relevant regulatory authority in Japan and \$15.0 million upon approval of such equivalent by the relevant regulatory authority. In addition, the Company will receive royalties which escalate based on sales volume, beginning in the low-twenties percent, less the transfer price paid for the API included in the product actually sold and other contractual deductions.

During the three and nine months ended September 30, 2015, the Company recognized approximately \$1.8 million and approximately \$5.9 million, respectively, in collaborative arrangements revenue from the Astellas license agreement, including an insignificant amount and approximately \$0.5 million, respectively, from the sale of API to Astellas. During the three and nine months ended September 30, 2014, the Company recognized approximately \$1.3 million and approximately \$4.5 million, respectively, in collaborative arrangements revenue from the Astellas license agreement, including an insignificant amount and approximately \$0.7 million during the three and nine months ended September 30, 2014, respectively, from the sale of API to Astellas.

**AstraZeneca AB**

In October 2012, the Company entered into a collaboration agreement with AstraZeneca (the AstraZeneca Collaboration Agreement) to co-develop and co-commercialize linaclotide in China, Hong Kong and Macau (the License Territory). The collaboration provides AstraZeneca with an exclusive nontransferable license to exploit the underlying technology in the License Territory. The parties share responsibility for continued development and commercialization of linaclotide under a joint development plan and a joint commercialization plan, respectively, with AstraZeneca having primary responsibility for the local operational execution.

The parties agreed to an Initial Development Plan (IDP) which includes the planned development of linaclotide in China, including the lead responsibility for each activity and the related internal and external costs. The IDP indicates that AstraZeneca is responsible for a multinational Phase III clinical trial (the Phase III Trial), the Company is responsible for nonclinical development and supplying clinical trial material and both parties are responsible for the regulatory submission process. The IDP indicates that the party specifically designated as being responsible for a particular development activity under the IDP shall implement and conduct such activities. The activities are governed by a Joint Development Committee (JDC), with equal representation from each party. The JDC is responsible for approving, by unanimous consent, the joint development plan and development budget, as well as approving protocols for clinical studies, reviewing and commenting on regulatory submissions, and providing an exchange of data and information.

The AstraZeneca Collaboration Agreement will continue until there is no longer a development plan or commercialization plan in place, however, it can be terminated by AstraZeneca at any time upon 180 days prior written notice. Under certain circumstances, either party may terminate the AstraZeneca Collaboration Agreement in the event of bankruptcy or an uncured material breach of the other party. Upon certain change in control scenarios of AstraZeneca, the Company may elect to terminate the AstraZeneca Collaboration Agreement and may re-acquire its product rights in a lump sum payment equal to the fair market value of such product rights.

In connection with the AstraZeneca Collaboration Agreement, the Company and AstraZeneca also executed a co-promotion agreement (the Co-Promotion Agreement), pursuant to which the Company utilized its existing sales force to co-promote NEXIUM® (esomeprazole magnesium), one of AstraZeneca's products, in the U.S. The Co-Promotion Agreement expired in May 2014.

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There are no refund provisions in the AstraZeneca Collaboration Agreement and the Co-Promotion Agreement (together, the AstraZeneca Agreements ).

Under the terms of the AstraZeneca Collaboration Agreement, the Company received a \$25.0 million non-refundable upfront payment upon execution. The Company is also eligible for \$125.0 million in additional commercial milestone payments contingent on the achievement of certain sales targets. The parties will also share in the net profits and losses associated with the development and commercialization of linaclotide in the License Territory, with AstraZeneca receiving 55% of the net profits or incurring 55% of the net losses until a certain specified commercial milestone is achieved, at which time profits and losses will be shared equally thereafter.

Activities under the AstraZeneca Agreements were evaluated in accordance with ASC Topic 605-25, *Revenue Recognition - Multiple-Element Arrangements* ( ASC 605-25 ), to determine if they represented a multiple element revenue arrangement. The Company identified the following deliverables in the AstraZeneca Agreements:

- an exclusive license to develop and commercialize linaclotide in the License Territory (the License Deliverable ),
- research, development and regulatory services pursuant to the IDP, as modified from time to time (the R&D Services ),
- JDC services,

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- obligation to supply clinical trial material, and
- co-promotion services for AstraZeneca's product (the Co-Promotion Deliverable).

The License Deliverable is nontransferable and has certain sublicense restrictions. The Company determined that the License Deliverable had standalone value as a result of AstraZeneca's internal product development and commercialization capabilities, which would enable it to use the License Deliverable for its intended purposes without the involvement of the Company. The remaining deliverables were deemed to have standalone value based on their nature and all deliverables met the criteria to be accounted for as separate units of accounting under ASC 605-25. Factors considered in this determination included, among other things, whether any other vendors sell the items separately and if the customer could use the delivered item for its intended purpose without the receipt of the remaining deliverables.

The Company identified the supply of linaclotide drug product for commercial requirements and commercialization services as contingent deliverables because these services are contingent upon the receipt of regulatory approval to commercialize linaclotide in the License Territory, and there were no binding commitments or firm purchase orders pending for commercial supply. As these deliverables are contingent, and are not at an incremental discount, they are not evaluated as deliverables at the inception of the arrangement. These contingent deliverables will be evaluated and accounted for separately as each related contingency is resolved. As of September 30, 2015, no contingent deliverables were provided by the Company under the AstraZeneca Agreements.

In August 2014, the Company and AstraZeneca, through the JDC, modified the IDP and development budget to include approximately \$14.0 million in additional activities over the remaining development period, to be shared by the Company and AstraZeneca under the terms of the AstraZeneca Collaboration Agreement. These additional activities serve to support the continued development of linaclotide in the Licensed Territory, including the Phase III Trial. Pursuant to the terms of the modified IDP and development budget, certain of the Company's deliverables were modified, specifically the R&D Services and the obligation to supply clinical trial material. The Company determined that the 2014 modification to the IDP and development budget should be accounted for as a modification to the AstraZeneca Collaboration Agreement. However, this modification did not have a material impact on the Company's consolidated financial statements as there was an insignificant amount of deferred revenue associated with the AstraZeneca Collaboration Agreement as of the date of the modification. In accordance with ASU No. 2009-13, the Company reallocated the arrangement consideration to all of the identified deliverables in the arrangement (both delivered and undelivered) based on the information available as of the date of the modification. During the three months ended June 30, 2015, the Company and AstraZeneca modified the expected development timeline due to a lengthened review timeline in China as a result of recent changes made by the China Food and Drug Administration (CFDA) to the approval process. No changes were made to the development budget. This lengthened timeline did not impact the Company's allocation of the Arrangement Consideration, and had an insignificant impact on the Company's consolidated financial statements, including the amounts recognized for the R&D Services and JDC services deliverables.

The total amount of the non-contingent consideration allocable to the AstraZeneca Agreements of approximately \$34.0 million (Arrangement Consideration) includes the \$25.0 million non-refundable upfront payment and 55% of the costs for clinical trial material supply services and research, development and regulatory activities allocated to the Company in the IDP or as approved by the JDC in subsequent periods, or approximately \$9.0 million.

The Company allocated the Arrangement Consideration of approximately \$34.0 million to the non-contingent deliverables based on management's best estimate of selling price (BESP) of each deliverable using the relative selling price method as the Company did not have vendor-specific objective evidence or third-party evidence of selling price for such deliverables. The Company estimated the BESP for the License Deliverable using a multi-period excess-earnings method under the income approach which utilized cash flow projections, the key assumptions of which included the following market conditions and entity-specific factors: (a) the specific rights provided under the license to develop and commercialize linaclotide; (b) the potential indications for linaclotide pursuant to the license; (c) the likelihood linaclotide will be

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developed for more than one indication; (d) the stage of development of linaclotide for IBS-C and CIC and the projected timeline for regulatory approval; (e) the development risk by indication; (f) the market size by indication; (g) the expected product life of linaclotide assuming commercialization; (h) the competitive environment, and (i) the estimated development and commercialization costs of linaclotide in the License Territory. The Company utilized a discount rate of 11.5% in its analysis, representing the weighted average cost of capital derived from returns on equity for comparable companies. The Company determined its BESP for the remaining deliverables based on the nature of the services to be performed and estimates of the associated effort and cost of the services adjusted for a reasonable profit margin such that they represented estimated market rates for similar services sold on a standalone basis. The Company concluded that a change in key assumptions used to determine BESP for each deliverable would not have a significant effect on the allocation of the Arrangement Consideration, as the estimated selling price of the License Deliverable significantly exceeds the other deliverables.

Of the approximately \$34.0 million of Arrangement Consideration, approximately \$29.7 million was allocated to the License Deliverable, approximately \$1.8 million to the R&D Services, approximately \$0.1 million to the JDC services, approximately \$0.3 million to the clinical trial material supply services, and approximately \$2.1 million to the Co-Promotion Deliverable in the relative selling price model, at the time of the material modification.



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Because the Company shares development costs with AstraZeneca, payments from AstraZeneca with respect to both research and development and selling, general and administrative costs incurred by the Company prior to the commercialization of linaclotide in the License Territory are recorded as a reduction in expense, in accordance with the Company's policy, which is consistent with the nature of the cost reimbursement. Development costs incurred by the Company that pertain to the joint development plan and subsequent amendments to the joint development plan, as approved by the JDC, are recorded as research and development expense as incurred. Payments to AstraZeneca are recorded as incremental research and development expense.

The Company completed its obligations related to the License Deliverable upon execution of the AstraZeneca Agreements; however, the revenue recognized in the statement of operations was limited to the non-contingent portion of the License Deliverable consideration in accordance with ASC 605-25. During the three and nine months ended September 30, 2015, and as a result of the modification to the IDP and development budget in August 2014, the Company recognized approximately \$0.4 million and approximately \$2.0 million, respectively, as collaborative arrangements revenue related to this deliverable as this portion of the Arrangement Consideration was no longer contingent. During the three and nine months ended September 30, 2014, the Company recognized approximately \$1.8 million as collaborative arrangements revenue related to the License Deliverable.

The Company also performs R&D Services and JDC services, and supplies clinical trial materials during the estimated development period. All Arrangement Consideration allocated to such services is being recognized as a reduction of research and development costs, using the proportional performance method, by which the amounts are recognized in proportion to the costs incurred. As a result of the cost-sharing arrangements under the collaboration, the Company recognized an insignificant amount and approximately \$0.7 million, respectively, in incremental research and development costs during the three and nine months ended September 30, 2015, and approximately \$0.5 million and approximately \$1.8 million in incremental research and development costs during the three and nine months ended September 30, 2014, respectively.

The amount allocated to the Co-Promotion Deliverable was recognized as collaborative arrangements revenue using the proportional performance method, which approximates recognition on a straight-line basis beginning on the date that the Company began to co-promote AstraZeneca's product, through December 31, 2013 (the earliest cancellation date). As of December 31, 2013, the Company completed its obligation related to the Co-Promotion Deliverable; however, the revenue recognized in the statement of operations was limited to the non-contingent consideration in accordance with ASC 605-25. During the three and nine months ended September 30, 2015, the Company recognized an insignificant amount as collaborative arrangements revenue related to this deliverable as this portion of the Arrangement Consideration was no longer contingent. During the three and nine months ended September 30, 2014, the Company recognized an insignificant amount and approximately \$0.8 million, respectively, in collaborative arrangements revenue related to this deliverable.

The Company reassesses the periods of performance for each deliverable at the end of each reporting period.

Milestone payments received from AstraZeneca upon the achievement of sales targets will be recognized as earned.

**Exact Sciences Corp.**

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In March 2015, the Company entered into an agreement to co-promote Exact Sciences' Cologuard®, the first and only FDA-approved noninvasive stool DNA screening test for colorectal cancer (the Exact Sciences Co-promotion Agreement). Under the terms of the Exact Sciences Co-promotion Agreement, the Company's sales team is promoting and educating health care practitioners regarding Cologuard, with LINZESS remaining the Company's first-position product. The companies are also collaborating on medical education initiatives to support more in-depth understanding of Cologuard and the importance of colorectal cancer screening. Exact Sciences maintains responsibility for all other aspects of the commercialization of Cologuard outside of the co-promotion.

Under the terms of the Exact Sciences Co-promotion Agreement, the Company will be compensated via reimbursements for sales detailing, promotional support services and medical education initiatives. During the initial one-year term of the agreement, the Company could receive up to a maximum reimbursement of approximately \$4.8 million. Royalties are earned on the net sales of Cologuard generated from the healthcare practitioners on whom the Company calls less the sales promotion reimbursement to the Company. The Company will also be compensated via royalties during the term and for one year following the termination of the Company's co-promotion efforts. There are no refund provisions in the Exact Sciences Co-promotion Agreement.

The non-exclusive Exact Sciences Co-promotion Agreement covers an initial one-year term, and renews automatically for successive one month periods unless and until terminated by either party. Either party may terminate the agreement in the event of an uncured material breach by the other party, withdrawal of Cologuard from the U.S. market, restriction on the indications for Cologuard by the FDA, imposition of restrictive federal or state price controls, change of control of the other party, or bankruptcy or insolvency of the other party.

Activities under the Exact Sciences Co-promotion Agreement were evaluated in accordance with ASC 605-25, to determine if they represented a multiple element revenue arrangement. The Company identified the following deliverables in the Exact Sciences Co-promotion Agreement: second position sales detailing, promotional support services, and medical education services. Each of the deliverables was deemed to have standalone value based on their nature and all deliverables met the criteria to be accounted for as

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separate units of accounting under ASC 605-25. The Company determined that the best estimate of selling price for each of the three deliverables approximated the value allocated to the deliverables under the agreement. The revenue related to each deliverable will be recognized as collaborative arrangements revenue in the Company's condensed consolidated statement of operations, in accordance with ASC 605-25, during the quarter earned. During the three and nine months ended September 30, 2015, the Company recognized approximately \$2.0 million and approximately \$3.0 million, respectively, as collaborative arrangements revenue related to this arrangement.

**Other Collaboration and License Agreements**

The Company has other collaboration and license agreements that are not individually significant to its business. In connection with entering into these agreements, the Company made aggregate up-front payments of approximately \$5.8 million, which were expensed as research and development expense. Pursuant to the terms of one agreement, the Company may be required to pay \$7.5 million for development milestones, of which approximately \$2.5 million had been paid as of September 30, 2015, and \$18.0 million for regulatory milestones, none of which had been paid as of September 30, 2015. In addition, pursuant to the terms of another agreement, the contingent milestones could total up to \$114.5 million per product to one of the Company's collaboration partners, including \$21.5 million for development milestones, \$58.0 million for regulatory milestones and \$35.0 million for sales-based milestones. Further, under such agreements, the Company is also required to fund certain research activities and, if any product related to these collaborations is approved for marketing, to pay significant royalties on future sales. During the three and nine months ended September 30, 2015, the Company did not incur any research and development expense associated with the Company's other collaboration and license agreements. During the nine months ended September 30, 2014, the Company incurred approximately \$1.0 million in research and development expense associated with the Company's other collaboration and license agreements.

**4. Fair Value of Financial Instruments**

The tables below present information about the Company's assets that are measured at fair value on a recurring basis as of September 30, 2015 and December 31, 2014 and indicate the fair value hierarchy of the valuation techniques the Company utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize observable inputs such as quoted prices in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs utilize data points that are either directly or indirectly observable, such as quoted prices, interest rates and yield curves. Fair values determined by Level 3 inputs utilize unobservable data points in which there is little or no market data, which require the Company to develop its own assumptions for the asset or liability.

The Company's investment portfolio includes many fixed income securities that do not always trade on a daily basis. As a result, the pricing services used by the Company apply other available information as applicable through processes such as benchmark yields, benchmarking of like securities, sector groupings and matrix pricing to prepare valuations. In addition, model processes were used to assess interest rate impact and develop prepayment scenarios. These models take into consideration relevant credit information, perceived market movements, sector news and economic events. The inputs into these models may include benchmark yields, reported trades, broker-dealer quotes, issuer spreads and other relevant data.

The following tables present the assets and liabilities the Company has measured at fair value on a recurring basis (in thousands):

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	Fair Value Measurements at Reporting Date Using			
	September 30, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Cash and cash equivalents:				
Money market funds	\$ 239,871	\$ 239,871	\$	\$
U.S. government-sponsored securities	7,033		7,033	
Available-for-sale securities:				
U.S. Treasury securities	50,220	50,220		
U.S. government-sponsored securities	164,009		164,009	
Convertible note hedges	72,494			72,494
<b>Total assets</b>	<b>533,627</b>	<b>290,091</b>	<b>171,042</b>	<b>72,494</b>
<b>Liabilities:</b>				
Note hedge warrants	62,976			62,976
<b>Total liabilities</b>	<b>62,976</b>			<b>62,976</b>
<b>Total assets and liabilities measured at fair value</b>	<b>\$ 596,603</b>	<b>\$ 290,091</b>	<b>\$ 171,042</b>	<b>\$ 135,470</b>

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	December 31, 2014	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Cash and cash equivalents:				
Money market funds	\$ 60,966	\$ 60,966	\$	\$
Available-for-sale securities:				
U.S. Treasury securities	24,005	24,005		
U.S. government-sponsored securities	150,032		150,032	
Total assets measured at fair value	\$ 235,003	\$ 84,971	\$ 150,032	\$

There were no transfers between fair value measurement levels during the three or nine months ended September 30, 2015 or 2014.

Cash equivalents, accounts receivable, related party accounts receivable, prepaid expenses and other current assets, accounts payable, related party accounts payable, accrued expenses and the current portion of capital lease obligations at September 30, 2015 and December 31, 2014 are carried at amounts that approximate fair value due to their short-term maturities.

The non-current portion of the capital lease obligations at September 30, 2015 and December 31, 2014 approximates fair value as it bears interest at a rate approximating a market interest rate.

The Company classifies its derivative financial instruments as Level 3 under the fair value hierarchy. The Company's Convertible Note Hedges and the Note Hedge Warrants are recorded as derivative assets and liabilities because they do not qualify for equity classification. In addition, the derivative assets and liabilities do not qualify for hedge accounting. These derivatives are not actively traded and are valued using the Black-Scholes option-pricing model which requires the use of subjective assumptions. Significant inputs used to determine fair value as of September 30, 2015 included the price per share of the Company's Class A common stock, time to maturity of the derivative instruments, the strike prices of the derivative instruments, the risk-free interest rate, and the historical and implied volatility of the Company's Class A common stock. Changes to these inputs could materially affect the valuation of the Convertible Note Hedges and Note Hedge Warrants.

The following inputs were used in the fair market valuation of the Convertible Note Hedges and Note Hedge Warrants as of September 30, 2015:

	Convertible Note Hedges	Note Hedge Warrants
Risk-free interest rate (1)	1.7%	1.8%
Time to maturity	6.7	7.3
Stock price (2)	\$ 10.42	\$ 10.42
Strike price (3)	\$ 16.58	\$ 21.50
Common stock volatility (4)	45.0%	45.0%
Dividend yield	%	%

- (1) Based on U.S. Treasury Curve.
- (2) The closing price of the Company's common stock on the last trading day of the quarter.
- (3) As per agreement.
- (4) Selected volatility based on historical volatility and implied volatility.

The Convertible Note Hedges and the Note Hedge Warrants are recorded at fair value at each reporting period and changes in fair value are recorded immediately in the Company's Condensed Consolidated Statements of Operations, and reported in other expense, net. Gains and losses for these derivative financial instruments are presented separately in the Company's Condensed Consolidated Statements of Cash Flows.

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The following table reflects the change in the Company's Level 3 convertible note derivatives from their initial value at issuance through September 30, 2015:

	Convertible Note Hedges	Note Hedge Warrants
Balance at December 31, 2014	\$	\$
Issuance of note hedge warrants		(70,849)
Purchase of convertible note hedges	91,915	
Change in fair value, recorded as a component of loss on derivatives	(19,421)	7,873
Balance at September 30, 2015	\$ 72,494	\$ (62,976)

### 11% Pharma Notes

In January 2013, the Company closed a private placement of \$175.0 million in aggregate principal amount of notes due on or before June 15, 2024 (the Pharma Notes). The estimated fair value of the Pharma Notes was approximately \$171.2 million and approximately \$182.5 million as of September 30, 2015 and December 31, 2014, respectively, and was determined using Level 3 inputs, including a quoted rate.

### 2.25% Convertible Senior Notes

In June 2015, the Company issued approximately \$335.7 million of its 2022 Notes. The Company separately accounted for the liability and equity components of the 2022 Notes by allocating the proceeds between the liability component and equity component (Note 9). The fair value of the 2022 Notes, which differs from their carrying value, is influenced by interest rates, the Company's stock price and stock price volatility, and is determined by reference to prices for the 2022 Notes observed in market trading, which are Level 2 inputs. The estimated fair value of the 2022 Notes as of September 30, 2015 was approximately \$302.7 million.

### 5. Available-for-Sale Securities

The following tables summarize the available-for-sale securities held at September 30, 2015 and December 31, 2014 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>September 30, 2015</b>				
U.S. Treasury securities	\$ 50,193	\$ 27	\$	\$ 50,220
U.S. government-sponsored securities	163,988	28	(7)	164,009
Total	\$ 214,181	\$ 55	\$ (7)	\$ 214,229

Amortized Cost

Fair Value

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			Gross Unrealized Gains		Gross Unrealized Losses	
<b>December 31, 2014</b>						
U.S. Treasury securities	\$	24,001	\$	4	\$	24,005
U.S. government-sponsored securities		150,055		2	(25)	150,032
Total	\$	174,056	\$	6	(25)	174,037

The contractual maturities of all securities held at September 30, 2015 are one year or less. There were 9 and 27 available-for-sale securities in an unrealized loss position at September 30, 2015 and December 31, 2014, respectively, none of which had been in an unrealized loss position for more than twelve months. The aggregate fair value of these securities at September 30, 2015 and December 31, 2014 was approximately \$41.8 million and approximately \$101.9 million, respectively. The Company reviews its investments for other-than-temporary impairment whenever the fair value of an investment is less than amortized cost and evidence indicates that an investment's carrying amount is not recoverable within a reasonable period of time. To determine whether an impairment is other-than-temporary, the Company considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. The Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity. The Company did not hold any securities with other-than-temporary impairment at September 30, 2015.



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There were no sales of available-for-sale securities during the three or nine months ended September 30, 2015 or 2014. Gross realized gains and losses on the sales of available-for-sale securities that have been included in other (expense) income, net unrealized holding gains or losses for the period that have been included in accumulated other comprehensive income as well as gains and losses reclassified out of accumulated other comprehensive income into other (expense) income were not material to the Company's consolidated results of operations. The cost of securities sold or the amount reclassified out of the accumulated other comprehensive income into other (expense) income is based on the specific identification method for purposes of recording realized gains and losses.

**6. Inventory**

Inventory consisted of the following (in thousands):

	September 30, 2015	December 31, 2014
Raw materials	\$	\$ 4,954

Inventory represents linaclotide API that is available for commercial sale. The Company evaluates inventory levels quarterly and any inventory that has a cost basis in excess of its expected net realizable value, inventory that becomes obsolete, inventory in excess of expected sales requirements, inventory that fails to meet commercial sale specifications or is otherwise impaired is written down with a corresponding charge to the statement of operations in the period that the impairment is first identified.

The Company has entered into multiple commercial supply agreements for the purchase of linaclotide API, as the Company is responsible for supplying API to its collaboration partners outside of North America and Europe. Two of the Company's API supply agreements contain minimum purchase commitments. In addition, the Company and Allergan are jointly obligated to make minimum purchases of linaclotide API for the territories covered by the Company's collaboration with Allergan in North America. Currently, Allergan fulfills all such minimum purchase commitments. As part of the Company's net realizable value assessment of its inventory, the Company assesses whether it has any excess non-cancelable purchase commitments resulting from its two minimum supply agreements with its suppliers of linaclotide API outside of North America.

In July 2015 and August 2015, the Company entered into amendments to its agreements with two of its suppliers of linaclotide API. One amendment reduced the Company's non-cancelable purchase commitments and the other increased the Company's non-cancelable purchase commitments, but extended the timeframe over which the Company must purchase the API. The amended contracts include total non-cancelable commercial supply purchase obligations of approximately \$34.9 million through 2023.

The determination of the net realizable value of inventory and non-cancelable purchase commitments is based on demand forecasts from the Company's partners, that are received quarterly, to project the next 24 months of demand and the Company's internal forecast for projected demand in subsequent years. During the three months ended June 30, 2015, Ammirall reduced its forecasted purchases of linaclotide API for Europe for the subsequent 18 months. In addition, the CFDA recently made regulatory changes to the marketing approval process in China which resulted in a lengthened approval timeline for linaclotide. The reduced demand from Ammirall and the extended timeline for commercialization of linaclotide in China resulted in lower projected sales of linaclotide API to the Company's partners in Europe and China during the years included in the assessment. As a result, during the three months ended June 30, 2015, the Company wrote-down the balance of its inventory of approximately \$5.0 million to zero and accrued approximately \$3.2 million for excess non-cancelable inventory purchase commitments.

The Company's loss on non-cancelable API purchase commitments for the three months ended September 30, 2015 was approximately \$9.4 million, which primarily relates to the amendment to the license agreement with Allergan pertaining to the development and commercialization of linaclotide for Europe executed in October 2015. Pursuant to the terms of the amendment, Allergan assumed responsibility for the manufacturing of linaclotide API for Europe from the Company, as well as the associated costs (Note 3), which resulted in the Company accruing for the loss on the non-cancelable inventory purchase commitments under one of its API supply agreements covering commercial supply of linaclotide API for the European market. The Company has evaluated all remaining minimum purchase commitments under its API supply agreements for territories outside of North America and concluded that the approximately \$22.3 million of purchase commitments from the second API supply agreement covering the Japan, China, Hong Kong and Macau markets are realizable.

The write-down of inventory to net realizable value and the loss on non-cancelable inventory purchase commitments is recorded as a separate line item in the Company's Condensed Consolidated Statement of Operations. As of September 30, 2015, the accrual for excess purchase commitments is recorded as approximately \$2.5 million in accrued expenses and other current liabilities and approximately \$10.1 million in other liabilities in the Company's Condensed Consolidated Balance Sheet.

During the three months ended June 30, 2014, Almirall reduced its inventory demand forecast, mainly due to the suspension of the commercialization of CONSTELLA in Germany, which led the Company to write down approximately \$8.9 million of inventory to net realizable value.

## **7. Property and Equipment**

Property and equipment, net consisted of the following (in thousands):

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	September 30, 2015	December 31, 2014
Manufacturing equipment	\$ 3,747	\$ 3,623
Laboratory equipment	14,229	15,126
Computer and office equipment	5,220	5,185
Furniture and fixtures	2,093	2,093
Software	14,168	13,921
Construction in process	169	1,457
Leased vehicles	4,531	4,472
Leasehold improvements	38,475	36,928
	82,632	82,805
Less accumulated depreciation and amortization	(59,449)	(52,979)
	\$ 23,183	\$ 29,826

In the third quarter of 2014, the Company entered into arrangements, with the landlord's consent, to sublease a portion of its Cambridge, Massachusetts corporate headquarters as it does not intend to use the space for its operations. During the three months ended September 30, 2014, the Company recorded aggregated charges of approximately \$2.6 million, which represented its obligations to the landlord associated with the sublet space, net of sublease income due to the Company under the subleases, and a partial write-down of leasehold improvement assets not utilized by the Company under the terms of the subleases.

**8. Accrued Expenses and Other Current Liabilities**

Accrued expenses and other current liabilities consisted of the following (in thousands):

	September 30, 2015	December 31, 2014
Salaries and benefits	\$ 16,139	\$ 16,582
Professional fees	626	574
Accrued interest	3,012	850
Accrued loss on non-cancellable purchase commitments	2,510	
Other	2,291	4,606
	\$ 24,578	\$ 22,612

**9. Notes Payable****2.25% Convertible Senior Notes due 2022**

In June 2015, the Company issued approximately \$335.7 million aggregate principal amount of the 2022 Notes. The Company received net proceeds of approximately \$324.0 million from the sale of the 2022 Notes, after deducting fees and expenses of approximately \$11.7 million. The Company used approximately \$21.1 million of the net proceeds from the sale of the 2022 Notes to pay the net cost of the Convertible Note Hedges (after such cost was partially offset by the proceeds to the Company from the sale of the Note Hedge Warrants), as described below.

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The 2022 Notes are governed by an indenture (the "Indenture") between the Company and U.S. Bank National Association, as the trustee. The 2022 Notes are senior unsecured obligations and bear cash interest at the annual rate of 2.25%, payable on June 15 and December 15 of each year, beginning on December 15, 2015. The 2022 Notes will mature on June 15, 2022, unless earlier converted or repurchased. The Company may settle conversions of the 2022 Notes through payment or delivery, as the case may be, of cash, shares of Class A common stock of the Company or a combination of cash and shares of Class A common stock, at the Company's option (subject to, and in accordance with, the settlement provisions of the Indenture). The initial conversion rate for the 2022 Notes is 60.3209 shares of Class A common stock (subject to adjustment as provided for in the Indenture) per \$1,000 principal amount of the 2022 Notes, which is equal to an initial conversion price of approximately \$16.58 per share and 20,249,665 shares. Holders of the 2022 Notes may convert their 2022 Notes at their option at any time prior to the close of business on the business day immediately preceding December 15, 2021 in multiples of \$1,000 principal amount, only under the following circumstances:

- during any calendar quarter commencing after the calendar quarter ending on September 30, 2015 (and only during such calendar quarter), if the last reported sale price of the Company's Class A common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price for the 2022 Notes on each applicable trading day;
- during the five business day period after any five consecutive trading day period (the "measurement period") in which the trading price (as defined in the Indenture) per \$1,000 principal amount of the 2022 Notes for each trading day of the measurement period was less than 98% of the product of the last reported sale price of the Company's Class A common stock and the conversion rate for the 2022 Notes on each such trading day; or
- upon the occurrence of specified corporate events described in the Indenture.

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On or after December 15, 2021, until the close of business on the second scheduled trading day immediately preceding June 15, 2022, holders may convert their 2022 Notes, in multiples of \$1,000 principal amount, at the option of the holder regardless of the foregoing circumstances.

If a make-whole fundamental change, as described in the Indenture, occurs and a holder elects to convert its 2022 Notes in connection with such make-whole fundamental change, such holder may be entitled to an increase in the conversion rate as described in the Indenture. The Company may not redeem the 2022 Notes prior to the maturity date and no sinking fund is provided for the 2022 Notes, which means that the Company is not required to periodically redeem or retire the 2022 Notes. Upon the occurrence of certain fundamental changes involving the Company, holders of the 2022 Notes may require the Company to repurchase for cash all or part of their 2022 Notes at a repurchase price equal to 100% of the principal amount of the 2022 Notes to be repurchased, plus accrued and unpaid interest.

The Indenture does not contain any financial covenants or restrict the Company's ability to repurchase the Company's securities, pay dividends or make restricted payments in the event of a transaction that substantially increases the Company's level of indebtedness. The Indenture provides for customary events of default. In the case of an event of default with respect to the 2022 Notes arising from specified events of bankruptcy or insolvency, all outstanding 2022 Notes will become due and payable immediately without further action or notice. If any other event of default with respect to the 2022 Notes under the Indenture occurs or is continuing, the trustee or holders of at least 25% in aggregate principal amount of the then outstanding 2022 Notes may declare the principal amount of the 2022 Notes to be immediately due and payable. Notwithstanding the foregoing, the Indenture provides that, upon the Company's election, and for up to 180 days, the sole remedy for an event of default relating to certain failures by the Company to comply with certain reporting covenants in the Indenture consists exclusively of the right to receive additional interest on the 2022 Notes.

In accordance with accounting guidance for debt with conversion and other options, the Company separately accounted for the liability and equity components of the 2022 Notes by allocating the proceeds between the liability component and the embedded conversion option, or equity component, due to the Company's ability to settle the 2022 Notes in cash, its Class A common stock, or a combination of cash and Class A common stock at the option of the Company. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The allocation was performed in a manner that reflected the Company's non-convertible debt borrowing rate for similar debt. The equity component of the 2022 Notes was recognized as a debt discount and represents the difference between the gross proceeds from the issuance of the 2022 Notes and the fair value of the liability of the 2022 Notes on their respective dates of issuance. The excess of the principal amount of the liability component over its carrying amount, or debt discount, is amortized to interest expense using the effective interest method over seven years, or the life of the 2022 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

The Company's outstanding Convertible Note balances as of September 30, 2015 consisted of the following (in thousands):

Liability component:	
Principal	\$ 335,699
Less: unamortized debt discount	(110,703)
Net carrying amount	\$ 224,996
Equity component	\$ 114,199

In connection with the issuance of the 2022 Notes, the Company incurred approximately \$11.7 million of debt issuance costs, which primarily consisted of initial purchaser discounts, legal and other professional fees. The Company allocated these costs to the liability and equity components based on the allocation of the proceeds. The portion of these costs allocated to the equity components totaling approximately \$4.0 million were recorded as a reduction to additional paid-in capital. The portion of these costs allocated to the liability components totaling

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approximately \$7.7 million were recorded as a reduction in the carrying value of the debt on the balance sheet and are amortized to interest expense using the effective interest method over the expected life of the 2022 Notes.

The Company determined the expected life of the 2022 Notes was equal to its seven-year term. The effective interest rate on the liability components of the 2022 Notes for the period from the date of issuance through September 30, 2015 was 9.34%. The following table sets forth total interest expense recognized related to the 2022 Notes during the three and nine months ended September 30, 2015 (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30, 2015</b>		<b>September 30, 2015</b>	
Contractual interest expense	\$	1,888	\$	2,181
Amortization of debt issuance costs		137		160
Amortization of debt discount		3,001		3,496
Total interest expense	\$	5,026	\$	5,837

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*Convertible Note Hedge and Warrant Transactions with Respect to 2022 Notes*

To minimize the impact of potential dilution to the Company's Class A common stockholders upon conversion of the 2022 Notes, the Company entered into the Convertible Note Hedges covering 20,249,665 shares of the Company's Class A common stock in connection with the issuance of the 2022 Notes. The Convertible Note Hedges have an exercise price of approximately \$16.58 per share and are exercisable when and if the 2022 Notes are converted. If upon conversion of the 2022 Notes, the price of the Company's Class A common stock is above the exercise price of the Convertible Note Hedges, the counterparties are obligated to deliver shares of the Company's Class A common stock and/or cash with an aggregate value approximately equal to the difference between the price of the Company's Class A common stock at the conversion date and the exercise price, multiplied by the number of shares of the Company's Class A common stock related to the Convertible Note Hedge being exercised.

Concurrently with entering into the Convertible Note Hedges, the Company also sold Note Hedge Warrants to the Convertible Note Hedge counterparties to acquire 20,249,665 shares of the Company's Class A common stock, subject to customary anti-dilution adjustments. The strike price of the Note Hedge Warrants is initially \$21.50 per share, subject to adjustment, and such warrants are exercisable over the 150 trading day period beginning on September 15, 2022. The Note Hedge Warrants could have a dilutive effect on the Class A common stock to the extent that the market price per share of the Company's Class A common stock exceeds the applicable strike price of such warrants.

The Convertible Note Hedges and the Note Hedge Warrants are separate transactions entered into by the Company and are not part of the terms of the 2022 Notes. Holders of the 2022 Notes and the Note Hedge Warrants do not have any rights with respect to the Convertible Note Hedges. The Company paid approximately \$91.9 million for the Convertible Note Hedges and recorded this amount as a long-term asset on the condensed consolidated balance sheet. The Company received approximately \$70.8 million for the Note Hedge Warrants and recorded this amount as a long-term liability, resulting in a net cost to the Company of approximately \$21.1 million.

**11% PharMA Notes due 2024**

In January 2013, the Company closed a private placement of \$175.0 million in aggregate principal amount of notes due on or before June 15, 2024. The PharMA Notes bear an annual interest rate of 11%, with interest payable March 15, June 15, September 15 and December 15 of each year (each a Payment Date) beginning June 15, 2013. On March 15, 2014, the Company began making quarterly payments on the PharMA Notes equal to the greater of (i) 7.5% of net sales of LINZESS in the U.S. for the preceding quarter (the Synthetic Royalty Amount) and (ii) accrued and unpaid interest on the PharMA Notes (the Required Interest Amount). Principal on the PharMA Notes will be repaid in an amount equal to the Synthetic Royalty Amount minus the Required Interest Amount, when this is a positive number, until the principal has been paid in full. Given the principal payments on the PharMA Notes are based on the Synthetic Royalty Amount, which will vary from quarter to quarter, the PharMA Notes may be repaid prior to June 15, 2024, the final legal maturity date. The Company made principal payments of approximately \$9.6 million through September 30, 2015, and expects to pay approximately \$20.1 million of the principal within twelve months following September 30, 2015.

The PharMA Notes are secured solely by a security interest in a segregated bank account established to receive the required quarterly payments. Up to the amount of the required quarterly payments under the PharMA Notes, Allergan will deposit its quarterly profit (loss) sharing payments due to the Company under the collaboration agreement for North America, if any, into the segregated bank account. If the funds deposited by Allergan into the segregated bank account are insufficient to make a required payment of interest or principal on a particular Payment Date, the Company is obligated to deposit such shortfall out of the Company's general funds into the segregated bank account.

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The PhaRMA Notes may be redeemed at any time prior to maturity, in whole or in part, at the option of the Company. The Company will pay a redemption price equal to the percentage of outstanding principal balance of the PhaRMA Notes being redeemed specified below for the period in which the redemption occurs (plus the accrued and unpaid interest to the redemption date on the PhaRMA Notes being redeemed):

<b>Payment Dates</b>	<b>Redemption Percentage</b>
From and including January 1, 2015 to and including December 31, 2015	105.50%
From and including January 1, 2016 to and including December 31, 2016	102.75%
From and including January 1, 2017 and thereafter	100.00%



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The PhaRMA Notes contain certain covenants related to the Company's obligations with respect to the commercialization of LINZESS and the related collaboration agreement with Allergan for North America, as well as certain customary covenants, including covenants that limit or restrict the Company's ability to incur certain liens, merge or consolidate or make dispositions of assets. The PhaRMA Notes also specify a number of events of default (some of which are subject to applicable cure periods), including, among other things, covenant defaults, other non-payment defaults, and bankruptcy and insolvency defaults. Upon the occurrence of an event of default, subject to cure periods in certain circumstances, all amounts outstanding may become immediately due and payable.

The upfront cash proceeds of \$175.0 million, less a discount of approximately \$0.4 million for payment of legal fees incurred on behalf of the noteholders, were recorded as notes payable at issuance. The Company also capitalized approximately \$7.3 million of debt issuance costs in connection with the PhaRMA Notes. During the three months ended June 30, 2015, the Company early adopted ASU 2015-03, which requires debt issuance costs to be presented in an entity's balance sheet as a direct deduction from the associated debt liability (Note 1). The Company's adoption of ASU 2015-03 resulted in a balance sheet reclassification of issuance costs in connection with the PhaRMA Notes of approximately \$1.4 million of prepaid expenses and other current assets and approximately \$2.8 million of other assets to a reduction in PhaRMA notes payable as of December 31, 2014. The PhaRMA Notes issuance costs and discount are being amortized over the estimated term of the obligation using the effective interest method. The repayment provisions represent embedded derivatives that are clearly and closely related to the PhaRMA Notes and as such do not require separate accounting treatment.

The accounting for the PhaRMA Notes requires the Company to make certain estimates and assumptions about the future net sales of LINZESS in the U.S. LINZESS has been marketed since December 2012 and the estimates of the magnitude and timing of LINZESS net sales are subject to significant variability due to the recent product launch and the extended time period associated with the PhaRMA Notes, and thus subject to significant uncertainty. Therefore, these estimates and assumptions are likely to change as the Company gains additional experience marketing LINZESS, which may result in future adjustments to the portion of the PhaRMA Notes that is classified as a current liability, the amortization of debt issuance costs and discounts as well as the accretion of the interest expense. Any such adjustments could be material to the Company's condensed consolidated financial statements.

## 10. Employee Stock Benefit Plans

The Company has several share-based compensation plans under which stock options, restricted stock awards, restricted stock units (RSUs), and other share-based awards are available for grant to employees, directors and consultants of the Company.

The following table summarizes share-based compensation expense reflected in the condensed consolidated statements of operations for the three and nine months ended September 30, 2015 and 2014 (in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015		2014		2015		2014	
Research and development	\$	2,662	\$	2,151	\$	7,407	\$	7,112
Selling, general and administrative		3,978		3,385		11,562		10,510
	\$	6,640	\$	5,536	\$	18,969	\$	17,622

A summary of stock option activity for the nine months ended September 30, 2015 is as follows:

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	Number of Shares (in thousands)	Weighted-Average Exercise Price
Outstanding at December 31, 2014	19,957	\$ 10.07
Granted	3,145	15.14
Exercised	(1,538)	6.35
Cancelled	(628)	12.98
Outstanding at September 30, 2015	20,936	\$ 11.02

The weighted-average assumptions used to estimate the fair value of the stock options using the Black-Scholes option-pricing model were as follows for the three and nine months ended September 30, 2015 and 2014:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Expected volatility	46.1%	47.8%	46.1%	46.9%
Expected term (in years)	6.0	6.1	6.0	6.1
Risk-free interest rate	1.8%	1.9%	1.7%	1.8%
Expected dividend yield	%	%	%	%

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Beginning in the first quarter of 2015, the Company revised certain of its equity incentive programs to include RSUs, in addition to stock options, each representing the right to receive one share of the Company's Class A common stock and granted pursuant to the terms of the Company's Amended and Restated 2010 Employee, Director and Consultant Equity Incentive Plan. The RSUs generally vest 25% per year on the approximate anniversary of the date of grant until fully vested, provided the employee remains continuously employed with the Company through each vesting date. Shares of the Company's Class A common stock are delivered to the employee upon vesting, subject to payment of applicable withholding taxes. The fair value of all RSUs is based on the market value of the Company's Class A common stock on the date of grant. Compensation expense, including the effect of estimated forfeitures, is recognized over the applicable service period.

A summary of RSU activity for the nine months ended September 30, 2015 is as follows:

	Number of Shares (in thousands)	Weighted- Average Fair Value
Unvested as of December 31, 2014		
Granted	557	\$ 15.12
Vested		
Forfeited	(25)	15.62
Unvested as of September 30, 2015	532	\$ 15.09

**11. Related Party Transactions**

The Company has and currently obtains legal services from a law firm that is an investor in the Company. The Company paid an insignificant amount in legal fees to this investor during the three and nine months ended September 30, 2015 and 2014. At September 30, 2015 and December 31, 2014, the Company had an insignificant amount of accounts payable due to this related party.

In September 2009, Allergan became a related party when the Company sold to Allergan 2,083,333 shares of the Company's convertible preferred stock. In November 2009, Almirall became a related party when the Company sold to Almirall 681,819 shares of the Company's convertible preferred stock (Note 3). These shares of preferred stock converted to the Company's Class B common stock on a 1:1 basis upon the completion of the Company's initial public offering in February 2010. Amounts due to and due from Allergan and Almirall are reflected as related party accounts payable and related party accounts receivable, respectively. These balances are reported net of any balances due to or from the related party. At September 30, 2015, the Company had an insignificant amount in related party accounts receivable associated with Almirall and approximately \$34.4 million in related party accounts receivable, net of related party accounts payable, associated with Allergan. At December 31, 2014, the Company did not have any related party accounts receivable associated with Almirall and approximately \$25.8 million in related party accounts receivable, net of related party accounts payable, associated with Allergan.

**12. Subsequent Events**

In October 2015, Almirall transferred its exclusive license to develop and commercialize linaclotide in Europe to Allergan. Concurrently, Almirall and Allergan terminated the sublicense arrangement with respect to Mexico, returning the exclusive rights to commercialize linaclotide in Mexico to Allergan. Additionally, in October 2015, the Company and Allergan separately entered into an amendment to the license agreement

relating to the development and commercialization of linaclotide in Europe to modify the remaining sales-based milestones and royalties payable to the Company and to provide for Allergan's assumption of responsibility for, and cost of, the manufacturing of linaclotide API for Europe from the Company (Notes 3 and 6).

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Forward-Looking Information**

The following discussion of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and notes thereto appearing elsewhere in this Quarterly Report on Form 10-Q and the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K. This discussion contains forward-looking statements that involve significant risks and uncertainties. As a result of many factors, such as those set forth under Risk Factors in Item 1A of this Quarterly Report on Form 10-Q, our actual results may differ materially from those anticipated in these forward-looking statements.

**Overview**

We are an entrepreneurial pharmaceutical company focused on creating medicines that make a difference for patients, building value to earn the continued support of our fellow shareholders, and empowering our team to passionately pursue excellence. Our core strategy is to establish a leading gastrointestinal, or GI, therapeutics company, leveraging our development and commercial capabilities in addressing GI disorders as well as our pharmacologic expertise in guanylate cyclase, or GC, pathways.

We have one marketed product, linaclotide, which is available in the United States, or U.S., and Mexico under the trademarked name LINZESS® and is available in certain European countries and Canada under the trademarked name CONSTELLA®. Linaclotide is also being developed and commercialized in other parts of the world by certain of our partners.

In August 2012, the U.S. Food and Drug Administration, or FDA, approved LINZESS as a once-daily treatment for adult men and women suffering from irritable bowel syndrome with constipation, or IBS-C, or chronic idiopathic constipation, or CIC. We and Allergan plc (together with its affiliates), or Allergan (formerly Actavis plc), began commercializing LINZESS in the U.S. in December 2012.

In November 2012, the European Commission granted marketing authorization to CONSTELLA for the symptomatic treatment of moderate to severe IBS-C in adults. CONSTELLA is the first, and to date, only drug approved in the European Union, or E.U., for IBS-C. Our former European partner, Almirall, S.A., or Almirall, began commercializing CONSTELLA in Europe in the second quarter of 2013. In October 2015, Almirall transferred its exclusive license to develop and commercialize linaclotide in Europe to Allergan. Currently, CONSTELLA is commercially available in certain European countries, including the United Kingdom, Italy and Spain. In May 2014, Almirall suspended commercialization of CONSTELLA in Germany following an inability to reach agreement with the German National Association of Statutory Health Insurance Funds on a reimbursement price that reflects the innovation and value of CONSTELLA. Allergan is assessing all possibilities to facilitate continued access to CONSTELLA for appropriate patients in Germany.

In December 2013 and February 2014, linaclotide was approved in Canada and Mexico, respectively, as a treatment for adult women and men suffering from IBS-C or CIC. Allergan has exclusive rights to commercialize linaclotide in Canada as CONSTELLA and, through a sublicense from Allergan, Almirall had exclusive rights to commercialize linaclotide in Mexico as LINZESS. In May 2014, Allergan began

commercializing CONSTELLA in Canada and in June 2014, Almirall began commercializing LINZESS in Mexico. In October 2015, Almirall and Allergan terminated the sublicense arrangement with respect to Mexico, returning the exclusive rights to commercialize linaclotide in Mexico to Allergan.

Astellas Pharma Inc., or Astellas, our partner in Japan, is developing linaclotide for the treatment of patients with IBS-C and chronic constipation in its territory. In October 2014, Astellas initiated a double-blind, placebo-controlled Phase III clinical trial of linaclotide in adult patients with IBS-C. In October 2012, we entered into a collaboration agreement with AstraZeneca AB, or AstraZeneca, to co-develop and co-commercialize linaclotide in China, Hong Kong and Macau, with AstraZeneca having primary responsibility for the local operational execution. In July 2015, we and AstraZeneca reported positive top-line data from a double-blind, placebo-controlled Phase III clinical trial of linaclotide in adult patients with IBS-C. We continue to assess alternatives to bring linaclotide to IBS-C and CIC sufferers in the parts of the world outside of our partnered territories.

We and Allergan are also exploring development opportunities to enhance the clinical profile of LINZESS by seeking to expand its utility in its indicated populations, as well as studying linaclotide in additional indications and populations and in new formulations to assess its potential to treat various GI conditions. In October 2015, as part of this strategy, we and Allergan reported positive top-line results from a Phase III clinical trial in the U.S. evaluating a 72 mcg dose of linaclotide in adult patients with CIC in the U.S. If approved, the 72 mcg dose and the currently approved 145 mcg dose would provide a broader range of treatment options to physicians and adult CIC patients in the U.S. In addition to linaclotide-based opportunities, we are advancing multiple GI development programs as well as further leveraging our pharmacological expertise in GC pathways that we established through the development of linaclotide, a guanylate cyclase type-C, or GC-C, agonist, to advance a second GC program targeting soluble guanylate cyclase, or sGC. sGC is a validated mechanism with the potential for broad therapeutic utility and multiple opportunities for product development in cardiovascular disease and other indications.

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In August 2015, we and Allergan entered into an agreement for the co-promotion of VIBERZI (eluxadoline) in the U.S., Allergan's treatment for adults suffering from irritable bowel syndrome with diarrhea, or IBS-D. Under the terms of the agreement, our clinical sales specialists will detail VIBERZI to the approximately 25,000 health care practitioners to whom they detail LINZESS. Allergan will be responsible for all costs and activities relating to the commercialization of VIBERZI outside of the co-promotion. The agreement provides that the non-exclusive co-promotion will begin when VIBERZI becomes commercially available, and will continue until December 31, 2017, unless earlier terminated by either party pursuant to the provisions of the agreement. Our promotional efforts will be compensated based on the volume of calls delivered by our sales force, as well as agreed upon performance metrics, including the potential to achieve milestone payments up to \$20.0 million based on the net sales of VIBERZI in 2017 and 2018. We will also be compensated via reimbursements for medical education initiatives.

In October 2015, we and Allergan entered into an amendment to the license agreement relating to the development and commercialization of linaclotide in Europe to modify the remaining sales-based milestones and royalties payable to us and to provide for Allergan's assumption of responsibility for, and cost of, the manufacturing of linaclotide API for Europe from us. This amendment, together with the transfer of the European license for linaclotide from Almirall to Allergan, is more fully described in Note 3, *Collaboration and License Agreements*, to our condensed consolidated financial statements appearing elsewhere in this quarterly report on Form 10-Q.

To date, we have dedicated substantially all of our activities to the research, development and commercialization of linaclotide, as well as to the research and development of our other product candidates. We have incurred significant operating losses since our inception in 1998. As of September 30, 2015, we had an accumulated deficit of approximately \$1.1 billion and we expect to continue to incur net losses for the foreseeable future.

In June 2015, we issued approximately \$335.7 million in aggregate principal amount of 2.25% Convertible Senior Notes due 2022, or the 2022 Notes. We received net proceeds of approximately \$324.0 million from the sale of the 2022 Notes, after deducting fees and expenses of approximately \$11.7 million. Further, in February 2014, we sold 15,784,325 shares of our Class A common stock through a firm commitment, underwritten public offering at a price to the public of \$12.75 per share. As a result of this offering, we received aggregate net proceeds, after underwriting discounts and commissions and other offering expenses, of approximately \$190.4 million. The net proceeds from these offerings are being used to support the commercialization of LINZESS in the U.S. and to fund linaclotide and other development opportunities to advance our strategy to grow a leading GI company, in addition to other general corporate purposes.

On January 8, 2014, we announced a headcount reduction of approximately 10% to align our workforce with our strategy to grow a leading GI therapeutics company. As maximizing LINZESS is core to our strategy, our field-based sales force and medical science liaison teams were excluded from this reduction in workforce. During the three months ended March 31, 2014, we substantially completed the implementation of this reduction in workforce and recorded approximately \$4.3 million of costs in research and development and selling, general and administrative expenses, including employee severance, benefits and related costs. We did not record any additional charges associated with this workforce reduction during the year ended December 31, 2014. All payments related to this reduction in workforce were made by the end of 2014.

**Financial Overview**

*Revenue.* Revenue to date has been generated primarily through our collaboration agreements with Allergan for North America and AstraZeneca for China, Hong Kong and Macau, and our license agreements for the development and commercialization of linaclotide in Japan with Astellas and the development and commercialization of linaclotide in Europe with Allergan (formerly with Almirall). The terms of these agreements contain multiple deliverables which may include (i) licenses, (ii) research and development activities, and (iii) the manufacture of finished drug product, active pharmaceutical ingredient, or API, or development materials for the collaborative partners. Payments to us may include one or more of the following: nonrefundable license fees, payments for research and development activities, payments for the manufacture of finished drug product, API or development materials, payments based upon the achievement of certain milestones and royalties on product sales. Additionally, we receive our share of the net profits or bear our share of the net losses from the sale of linaclotide in the U.S. and China. LINZESS launched in the U.S. in December 2012 and CONSTELLA became commercially available in certain European countries beginning in the second quarter of 2013. Linaclotide is also approved in a number of other countries.

We record our share of the net profits and losses from the sales of LINZESS in the U.S. on a net basis and present the settlement payments as collaborative arrangements revenue or collaboration expense, as applicable. Net profits or losses consist of net sales to third-party customers in the U.S. less the cost of goods sold as well as selling, general and administrative expenses. Although we expect net sales to increase over time, the settlement payments between Allergan and us, resulting in collaborative arrangements revenue or collaboration expense, are subject to fluctuation based on the ratio of selling, general and administrative expenses incurred by each party. In addition, our collaborative arrangements revenue may fluctuate as a result of timing and amount of license fees and clinical and commercial milestones received and recognized under our current and future strategic partnerships as well as timing and amount of royalties from the sales of linaclotide in the European, Canadian or Mexican markets. One instance of this potential



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fluctuation relates to the challenging environment in the European pharmaceutical sector, including challenges in obtaining adequate pricing and reimbursement for pharmaceutical products in Europe. Based on the challenges, it became clear to us and our former European partner, Almirall, that revising certain aspects of our current partnership would benefit the potential for linaclotide. Accordingly, in June 2013 and February 2014, we amended the European license agreement to make the amount and timing of certain of the commercial launch milestones contingent on the reimbursement amount in such countries in exchange for additional new sales-based incentives and a more favorable royalty structure at certain sales thresholds. In October 2015, Almirall transferred its exclusive license to develop and commercialize linaclotide in Europe to Allergan. Concurrently, Almirall and Allergan terminated the sublicense arrangement with respect to Mexico, returning the exclusive rights to commercialize linaclotide in Mexico to Allergan. Additionally, in October 2015, we and Allergan separately entered into an amendment to the license agreement relating to the development and commercialization of linaclotide in Europe to modify the remaining sales-based milestones and royalties payable to us and to provide for Allergan's assumption of responsibility for, and cost of, the manufacturing of linaclotide API for Europe from us.

In March 2015, we entered into an agreement to co-promote Exact Sciences' Cologuard®, the first and only FDA-approved noninvasive stool DNA screening test for colorectal cancer. Under the terms of the arrangement, our sales team is promoting and educating health care practitioners regarding Cologuard, with LINZESS remaining our first-position product. We will be compensated from the net sales of Cologuard generated from the physicians on whom we call. Under the terms of the arrangement, we will be compensated via reimbursements for sales detailing, promotional support services and medical education initiatives. During the initial one-year term of the agreement, we could receive up to a maximum reimbursement of approximately \$4.8 million. Royalties are earned on the net sales of Cologuard generated from the healthcare practitioners on whom we call during the term, and for one year following the termination of the arrangement, less the sales promotion reimbursement to us.

*Cost of Revenue.* Cost of revenue is recognized upon shipment of linaclotide API to certain of our licensing partners outside of the U.S. Our cost of revenue consists of the internal and external costs of producing such API.

*Write-down of inventory to net realizable value and loss on non-cancelable purchase commitments.* During the three months ended June 30, 2015, Almirall reduced its near term demand forecast for the European territory. In addition, the CFDA made recent regulatory changes to the approval process in China which resulted in an extended timeline to commercialization for linaclotide. As a result, during the three months ended June 30, 2015, we wrote-down our on hand inventory balance of approximately \$5.0 million to zero, and also accrued approximately \$3.2 million for excess non-cancelable inventory purchase commitments.

Our loss on non-cancelable API purchase commitments for the three months ended September 30, 2015 was approximately \$9.4 million, which primarily relates to the amendment to the license agreement with Allergan pertaining to the development and commercialization of linaclotide for Europe executed in October 2015. Pursuant to the terms of the amendment, Allergan assumed responsibility for the manufacturing of linaclotide API for Europe, as well as the associated costs, which resulted in accruing for the loss on the non-cancelable inventory purchase commitments under one of our API supply agreements covering the commercial supply of linaclotide API for the European market. We have evaluated all remaining minimum purchase commitments under our API supply agreements for territories outside of North America and concluded that the approximately \$22.3 million of purchase commitments from the second API supply agreement covering the Japan, China, Hong Kong and Macau markets are realizable.

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These charges are more fully described in Note 6, *Inventory*, to our condensed consolidated financial statements appearing elsewhere in this quarterly report on Form 10-Q.

*Research and Development Expense.* Research and development expense consists of expenses incurred in connection with the discovery and development of our product candidates. These expenses consist primarily of compensation, benefits and other employee-related expenses, research and development related facility costs, third-party contract costs relating to nonclinical study and clinical trial activities, development of manufacturing processes, regulatory registration of third-party manufacturing facilities and costs associated with linaclotide API prior to meeting our inventory capitalization policy, as well as licensing fees for our product candidates. We charge all research and development expenses to operations as incurred. Under our collaboration agreements with Allergan for the U.S. and AstraZeneca for China, Hong Kong and Macau, we are reimbursed for certain research and development expenses, and we net these reimbursements against our research and development expenses as incurred. Payments to Allergan or AstraZeneca for such territories are recorded as incremental research and development expense.

The core of our research and development strategy is to leverage our development capabilities in addressing GI disorders as well as our pharmacologic expertise in GC pathways to develop new and innovative products.

Linaclotide. Our lead product is linaclotide, and it represents the largest portion of our research and development expense for our product candidates. Linaclotide is the first and, to date, only FDA-approved GC-C agonist. Linaclotide is approved in the U.S. and in a number of E.U. and other countries. In addition, Astellas initiated a Phase III clinical trial of linaclotide in adult patients with IBS-C for Japan and we and AstraZeneca reported positive top-line data from a Phase III clinical trial of linaclotide in adult patients with IBS-C for China.

We and Allergan are exploring development opportunities in the U.S. to enhance the clinical profile of LINZESS by seeking to expand its utility in its indicated populations, as well as studying linaclotide in additional indications and populations and in new formulations to assess its potential to treat various GI conditions. In October 2015, as part of this strategy, we and Allergan reported positive top-line results from a Phase III clinical trial in the U.S. evaluating a 72 mcg dose of linaclotide in adult patients with CIC. If approved, the 72 mcg dose and the currently approved 145 mcg dose would provide a broader range of treatment options to physicians

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and adult CIC patients in the U.S. Our development opportunities also include linaclotide colonic release, a targeted oral delivery formulation of linaclotide designed to potentially enhance lower abdominal pain relief in adult IBS-C patients, as well as providing the opportunity to investigate linaclotide as a potential treatment for multiple GI disorders with lower abdominal pain as a predominant symptom. Additionally, we and Allergan are studying linaclotide as a potential treatment of the GI dysfunction associated with opioid-induced constipation in adult patients and have established a plan with the FDA for clinical pediatric studies with linaclotide, as described below.

Development Candidates. In addition to linaclotide-based opportunities, we are advancing multiple GI development programs. This includes IW-9179, a GC-C agonist designed to target upper GI conditions, which is being explored for the treatment of diabetic gastroparesis and functional dyspepsia. Additionally, IW-3718 is a gastric retentive formulation of a bile acid sequestrant that is being evaluated for the potential treatment of GERD symptoms in patients who have not responded adequately to treatment with a proton pump inhibitor. We are also leveraging our pharmacological expertise in GC pathways that we established through the development of linaclotide, a GC-C agonist, to advance a second GC program targeting sGC, which we are exploring for utility in disorders associated with vascular dysfunction and fibrosis. We have additional assets in early development that we continue to advance, and we are exploring strategic options for further development of these assets.

Discovery Research. Our discovery efforts are primarily focused on identifying novel clinical candidates that draw on our proprietary and expanding expertise in GI disorders and GC.

The following table sets forth our research and development expenses related to our product pipeline for the three and nine months ended September 30, 2015 and 2014. These expenses relate primarily to external costs associated with nonclinical studies and clinical trial costs, costs incurred to develop manufacturing processes and register manufacturing facilities with the FDA and licensing fees for our product candidates. We allocate costs related to facilities, depreciation, share-based compensation, research and development support services, laboratory supplies and certain other costs directly to programs.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(in thousands)		(in thousands)	
Linaclotide	\$ 10,882	\$ 11,627	\$ 38,336	\$ 35,025
Development candidates:				
GI disorders (three compounds)(1)	5,613	4,185	12,862	11,443
sGC development candidates (two compounds)(1)	4,491	3,470	15,249	7,568
Central nervous system disorders (one compound)(1)	481	224	933	1,903
Total development candidates	10,585	7,879	29,044	20,914
Discovery research	4,363	5,616	13,739	18,469
	\$ 25,830	\$ 25,122	\$ 81,119	\$ 74,408

(1) Number of compounds is for the three months ended September 30, 2015.

Since 2004, the date we began tracking costs by program, we have incurred approximately \$345.0 million of research and development expenses related to linaclotide. The expenses for linaclotide include both our portion of the research and development costs incurred by Allergan for the U.S. and AstraZeneca for China, Hong Kong and Macau for linaclotide and invoiced to us under the cost-sharing provisions of our collaboration agreements, as well as the unreimbursed portion of research and development costs incurred by us under such cost-sharing provisions.

The lengthy process of securing regulatory approvals for new drugs requires the expenditure of substantial resources. Any failure by us to obtain, or any delay in obtaining, regulatory approvals would materially adversely affect our product development efforts and our business overall. In August 2012, the FDA approved our New Drug Applications for LINZESS as a once-daily treatment for adult men and women suffering from IBS-C or CIC. In connection with the FDA approval, we are required to conduct certain nonclinical and clinical studies, including those aimed at understanding: (a) whether orally administered linaclotide can be detected in breast milk, (b) the potential for antibodies to be developed to linaclotide, and if so, (c) whether antibodies specific for linaclotide could have any therapeutic or safety implications. In addition, we and Allergan established a nonclinical and clinical post-marketing plan with the FDA to understand the efficacy and safety of LINZESS in pediatric patients. The first step in this plan was to undertake certain additional nonclinical studies. We and Allergan have completed these nonclinical studies and have initiated two Phase II clinical pediatric studies in IBS-C patients age seven to 17 and functional constipation patients age six to 17. In October 2012, we entered into a collaboration agreement with AstraZeneca to co-develop and co-commercialize linaclotide in China, Hong Kong and Macau, with AstraZeneca having primary responsibility for the local operational execution. We and Allergan are also exploring development opportunities to enhance the clinical profile of LINZESS by seeking to expand its utility in its indicated populations, as well as studying linaclotide in additional indications and populations and in new formulations to assess its potential to treat various GI

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conditions. Therefore, we cannot currently estimate with any degree of certainty the amount of time or money that we will be required to expend in the future on linaclotide in pediatrics, for other geographic markets, within its indicated population, in additional indications and populations or in new formulations. In addition to linaclotide-based opportunities, we are advancing multiple GI development programs as well as further leveraging our pharmacological expertise in GC pathways that we established through the development of linaclotide, a GC-C agonist, to advance a second GC program targeting sGC. sGC is a validated mechanism with the potential for broad therapeutic utility and multiple opportunities for product development in cardiovascular disease and other indications. Given the inherent uncertainties that come with the development of pharmaceutical products, we cannot estimate with any degree of certainty how these programs will evolve, and therefore the amount of time or money that would be required to obtain regulatory approval to market them. As a result of these uncertainties surrounding the timing and outcome of any approvals, we are currently unable to estimate precisely when, if ever, linaclotide's utility will be expanded in its indicated population; if or when linaclotide will be developed in pediatrics or otherwise outside of its current markets, indications, populations or formulations; or when, if ever, any of our other product candidates will generate revenues and cash flows.

We invest carefully in our pipeline, and the commitment of funding for each subsequent stage of our development programs is dependent upon the receipt of clear, supportive data. In addition, we are actively engaged in evaluating externally-discovered drug candidates at all stages of development that fit within our core strategy. In evaluating potential assets, we apply the same criteria as those used for investments in internally-discovered assets.

The successful development of our product candidates is highly uncertain and subject to a number of risks including, but not limited to:

- The duration of clinical trials may vary substantially according to the type, complexity and novelty of the product candidate.
- The FDA and comparable agencies in foreign countries impose substantial requirements on the introduction of therapeutic pharmaceutical products, typically requiring lengthy and detailed laboratory and clinical testing procedures, sampling activities and other costly and time-consuming procedures.
- Data obtained from nonclinical and clinical activities at any step in the testing process may be adverse and lead to discontinuation or redirection of development activity. Data obtained from these activities also are susceptible to varying interpretations, which could delay, limit or prevent regulatory approval.
- The duration and cost of discovery, nonclinical studies and clinical trials may vary significantly over the life of a product candidate and are difficult to predict.
- The costs, timing and outcome of regulatory review of a product candidate may not be favorable.

- The emergence of competing technologies and products and other adverse market developments may negatively impact us.

As a result of the uncertainties discussed above, we are unable to determine the duration and costs to complete current or future nonclinical and clinical stages of our product candidates or when, or to what extent, we will generate revenues from the commercialization and sale of our product candidates. Development timelines, probability of success and development costs vary widely. We anticipate that we will make determinations as to which additional programs to pursue and how much funding to direct to each program on an ongoing basis in response to the data of each product candidate, the competitive landscape and ongoing assessments of such product candidate's commercial potential. As a result of the regulatory approvals beginning in 2012, linaclotide has been generating sales in connection with commercial launches in the U.S. and a number of E.U. and other countries.

We expect our research and development costs will be substantial for the foreseeable future. We will continue to invest in linaclotide including the areas of its supply chain, the investigation of ways to enhance the clinical profile within its indicated population and the exploration of its utility in other indications and populations and in new formulations. We will also invest in our other product candidates as we advance them through nonclinical studies and clinical trials, in addition to funding full-time equivalents for research and development activities under our external collaboration and license agreements.

*Selling, General and Administrative Expense.* Selling, general and administrative expense consists primarily of compensation, benefits and other employee-related expenses for personnel in our administrative, finance, legal, information technology, business development, commercial, sales, marketing, communications and human resource functions. Other costs include the legal costs of pursuing patent protection of our intellectual property, general and administrative related facility costs and professional fees for accounting and legal services. As we continue to invest in the commercialization of LINZESS, we expect our selling, general and administrative expenses will be substantial for the foreseeable future. We charge all selling, general and administrative expenses to operations as incurred.

Under our AstraZeneca collaboration agreement, we are reimbursed for certain selling, general and administrative expenses and we net these reimbursements against our selling, general and administrative expenses as incurred. We include Allergan's selling,

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general and administrative cost-sharing payments in the calculation of the net profits and net losses from the sale of LINZESS in the U.S. and present the net payment to or from Allergan as collaboration expense or collaborative arrangements revenue, respectively.

*Other (Expense) Income.* Interest expense consists primarily of cash and non-cash interest costs related to our outstanding 11% PhARMA Notes due 2024, or the PhARMA Notes, and the 2022 Notes issued in June 2015. Non-cash interest expense consists of amortization of the debt discount and associated debt issuance costs associated with the PhARMA Notes and 2022 Notes. We amortize these costs using the effective interest rate method over the life of the respective note agreements as interest expense in our statements of operations.

Interest income consists of interest earned on our cash, cash equivalents and marketable securities.

Loss on derivatives consists of the change in fair value of the Convertible Note Hedges and Note Hedge Warrants, which are recorded as derivative assets and liabilities because they do not qualify for equity classification or hedge accounting. The Convertible Note Hedges and the Note Hedge Warrants are recorded at fair value at each reporting period and changes in fair value are recorded immediately in our Condensed Consolidated Statements of Operations.

**Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations is based upon our condensed consolidated financial statements prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires us to make certain estimates and assumptions that may affect the reported amounts of assets, liabilities, revenues and expenses during the reported periods and related disclosures. These estimates and assumptions, including those related to revenue recognition, available-for-sale securities, inventory valuation and related reserves, impairment of long-lived assets, fair value of derivatives, balance sheet classification of notes payable and convertible notes, income taxes including the valuation allowance for deferred tax assets, research and development expenses, contingencies and share-based compensation, are monitored and analyzed by us for changes in facts and circumstances, and material changes in these estimates could occur in the future. We base our estimates on our historical experience, trends in the industry, and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from our estimates under different assumptions or conditions.

In June 2015, in connection with the issuance of the 2022 Notes and in order to reduce the potential dilution to our Class A common stock and/or offset cash payments due upon conversion of the 2022 Notes, we entered into the Convertible Note Hedges and Note Hedge Warrants transactions. These instruments were determined to be derivative financial instruments, as the instruments meet the criteria for classification as derivatives under Accounting Standards Codification ( ASC ) Topic 815, *Derivatives and Hedging* ( ASC 815 ). The derivatives are recorded as assets or liabilities at fair value using the Black-Scholes option pricing model, and the changes in fair value are immediately included in our Condensed Consolidated Statements of Operations as the derivatives had not been formally designated as hedges for accounting purposes in accordance with ASC 815. Changes in the fair value of the derivatives could vary significantly from period to period. Refer to Note 1, *Nature of Business*, in the accompanying notes to our condensed consolidated financial statements for additional information.

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Otherwise, during the nine months ended September 30, 2015, there were no material changes to our critical accounting policies as reported in our Annual Report on Form 10-K for the year ended December 31, 2014, which was filed with the Securities and Exchange Commission, or SEC, on February 18, 2015, or the 2014 Annual Report on Form 10-K.

### Results of Operations

The following discussion summarizes the key factors our management believes are necessary for an understanding of our condensed consolidated financial statements.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(in thousands)		(in thousands)	
Collaborative arrangements revenue:	\$ 39,572	\$ 16,918	\$ 96,248	\$ 38,363
Cost and expenses:				
Cost of revenue			12	3,548
Write-down of inventory to net realizable value and loss on non-cancellable purchase commitments	9,488		17,638	8,894
Research and development	25,830	25,122	81,119	74,408
Selling, general and administrative	30,439	28,535	93,740	87,758
Total cost and expenses	65,757	53,657	192,509	174,608
Other (expense) income:				
Interest expense	(10,021)	(5,320)	(21,115)	(15,906)
Interest and investment income	156	71	292	180
Loss on derivatives	(11,340)		(11,548)	
Other expense, net	(21,205)	(5,249)	(32,371)	(15,726)
Net loss	\$ (47,390)	\$ (41,988)	\$ (128,632)	\$ (151,971)



Table of Contents*Three and Nine Months Ended September 30, 2015 Compared to Three and Nine Months Ended September 30, 2014**Revenue*

	Three Months Ended September 30,		Change		Nine Months Ended September 30,		Change	
	2015	2014	\$	%	2015	2014	\$	%
	(dollars in thousands)				(dollars in thousands)			
Collaborative arrangements revenue	\$ 39,572	\$ 16,918	\$ 22,654	134%	\$ 96,248	\$ 38,363	\$ 57,885	151%

*Collaborative Arrangements Revenue.* The increase in revenue from collaborative arrangements of approximately \$22.7 million for the three months ended September 30, 2015 compared to the three months ended September 30, 2014 was primarily related to an approximately \$21.3 million increase in our share of the net profits from the sale of LINZESS in the U.S., an approximately \$2.1 million increase related to our co-promotion arrangement with Exact Sciences entered into in March 2015, an approximately \$0.5 million increase in revenue recognized from our linaclotide licensing partners for the achievement of milestones, and an approximately \$0.3 million increase in linaclotide royalty revenue from partnered territories. This increase was partially offset by an approximately \$1.5 million decrease in license revenue related to our collaboration agreement with AstraZeneca.

The increase in revenue from collaborative arrangements of approximately \$57.9 million for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 was primarily related to an approximately \$60.4 million increase in our share of the net profits from the sale of LINZESS in the U.S.; an approximately \$3.0 million increase related to our co-promotion arrangement with Exact Sciences entered into in March 2015, and an approximately \$0.5 million increase in royalty revenue from partnered territories. The increases were partially offset by an approximately \$5.3 million decrease in revenue from the shipments of linaclotide API to our licensing partners, primarily Almirall, an approximately \$0.4 million decrease in license revenue related to our collaboration agreement with AstraZeneca, and an approximately \$0.3 million net decrease in revenue recognized from our linaclotide licensing partners for the achievement of milestones.

*Cost and Expenses*

	Three Months Ended September 30,		Change		Nine Months Ended September 30,		Change	
	2015	2014	\$	%	2015	2014	\$	%
	(dollars in thousands)				(dollars in thousands)			
Cost and expenses:								
Cost of revenue	\$	\$	\$	%	12	\$ 3,548	\$ (3,536)	(100)%
Write-down of inventory to net realizable value and loss on non-cancellable purchase commitments	9,488	25,122	9,488	100%	17,638	8,894	8,744	98%
	25,830	25,122	708	3%	81,119	74,408	6,711	9%

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Research and development									
Selling, general and administrative	30,439	28,535	1,904	7%	93,740	87,758	5,982	7%	
Total cost and expenses	\$ 65,757	\$ 53,657	\$ 12,100	23%	\$ 192,509	\$ 174,608	\$ 17,901	10%	

*Cost of Revenue.* There was no change in cost of revenue for the three months ended September 30, 2015 compared to the three months ended September 30, 2014.

The decrease in cost of revenue of approximately \$3.5 million for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 was attributable to lower sales of linaclotide API to our licensing partners.

*Write-down of inventory to net realizable value and loss on non-cancelable purchase commitments.* The increase in write-down of inventory and loss on non-cancelable purchase commitments of approximately \$9.4 million for the three months ended September 30, 2015 compared to the three months ended September 30, 2014, and of approximately \$8.7 million for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 is primarily related to an accrual for a loss on non-cancelable inventory purchase commitments partially offset by an approximately \$3.9 million decrease in the amount of inventory written down to estimated net realizable value in the nine months ended September 30, 2015.

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Inventory represents linaclotide API that is available for commercial sale. We evaluate inventory levels quarterly and any inventory that has a cost basis in excess of its expected net realizable value, inventory that becomes obsolete, inventory in excess of expected sales requirements, inventory that fails to meet commercial sale specifications or is otherwise impaired is written down with a corresponding charge to the statement of operations in the period that the impairment is first identified.

We have entered into multiple commercial supply agreements for the purchase of linaclotide API, as we are responsible for supplying API to our collaboration partners outside of North America and Europe. Two of our API supply agreements contain minimum purchase commitments. In addition, we and Allergan are jointly obligated to make minimum purchases of linaclotide API for the territories covered by our collaboration with Allergan in North America. Currently, Allergan fulfills all such minimum purchase commitments. As part of our net realizable value assessment of our inventory, we assess whether we have any excess non-cancelable purchase commitments resulting from our two minimum supply agreements with our suppliers of linaclotide API outside of North America. In July 2015 and August 2015, we entered into amendments to our agreements with both of these suppliers of linaclotide API. The minimum purchase requirements from these amended supply agreements are included in our determination of our excess non-cancelable purchase commitments each period.

The determination of the net realizable value of inventory and non-cancelable purchase commitments is based on demand forecasts from our partners that are received quarterly, to project the next 24 months of demand and our internal forecast for projected demand in subsequent years. During the three months ended June 30, 2015, Almirall reduced its forecasted purchases of linaclotide API for Europe for the subsequent 18 months. In addition, the CFDA recently made regulatory changes to the marketing approval process in China which resulted in a lengthened approval timeline for linaclotide. The reduced demand from Almirall, and the extended timeline for commercialization of linaclotide in China resulted in lower projected sales of linaclotide API to our partners in Europe and China during the years included in the assessment. As a result, during the three months ended June 30, 2015, we wrote-down the balance of our inventory of approximately \$5.0 million to zero and accrued approximately \$3.2 million for excess non-cancelable inventory purchase commitments.

Our loss on non-cancelable API purchase commitments for the three months ended September 30, 2015 was approximately \$9.4 million, which primarily relates to the amendment to the license agreement with Allergan pertaining to the development and commercialization of linaclotide for Europe executed in October 2015. Pursuant to the terms of the amendment, Allergan assumed responsibility for the manufacturing of linaclotide API for Europe from us, as well as the associated costs, which resulted in the Company accruing for the loss on the non-cancelable inventory purchase commitments under one of our API supply agreements covering commercial supply of linaclotide for the European market. We have evaluated all remaining minimum purchase commitments under our API supply agreements for territories outside of North America and concluded that the approximately \$22.3 million of purchase commitments from the second API supply agreement covering the Japan, China, Hong Kong and Macau markets are realizable. These charges are more fully described in Note 6, *Inventory*, to our condensed consolidated financial statements appearing elsewhere in this quarterly report on Form 10-Q.

The write-down of inventory to net realizable value and the loss on non-cancelable purchase commitments is recorded as a separate line item in our Condensed Consolidated Statement of Operations. As of September 30, 2015, the accrual for excess purchase commitments is recorded as approximately \$2.5 million in accrued expenses and other current liabilities and approximately \$10.1 million in other liabilities in our Condensed Consolidated Balance Sheet.

During the three months ended June 30, 2014, Almirall reduced its inventory demand forecast, mainly due to the suspension of the commercialization of CONSTELLA in Germany, which led us to write down approximately \$8.9 million of inventory to net realizable value.

*Research and Development Expense.* The increase in research and development expense of approximately \$0.7 million for the three months ended September 30, 2015 compared to the three months ended September 30, 2014 was primarily related to an increase of approximately \$2.3 million in external costs related to the development of linaclotide, including increased costs associated with clinical trial activity; an increase of approximately \$2.0 million in compensation, share-based compensation, benefits and other employee-related expenses; and an increase of approximately \$1.0 million in research costs related to our early stage pipeline candidates. These increases were partially offset by a decrease of approximately \$2.1 million in operating costs, including information technology infrastructure costs and facility costs such as rent and amortization of leasehold improvements allocated to research and development; an approximately \$1.7 million decrease in net costs related to the collaboration with Allergan; an approximately \$0.5 million decrease in costs associated with the collaboration with AstraZeneca; and an approximately \$0.3 million decrease related to the development of manufacturing processes and costs associated with linaclotide API prior to meeting our inventory capitalization policy.

The increase in research and development expense of approximately \$6.7 million for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 was related to an increase of approximately \$20.0 million in external costs related to the development of linaclotide, including increased costs associated with clinical trial activity; an increase of approximately \$3.1 million in compensation, share-based compensation, benefits and other employee-related expenses; and an increase of approximately \$2.2 million in research costs related to our early stage pipeline candidates. These increases were partially

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offset by a decrease in costs of approximately \$11.5 million as a result of an increase in expense reimbursements related to the collaboration with Allergan; a decrease of approximately \$3.1 million related to our January 2014 workforce reduction; a decrease of approximately \$2.3 million in operating costs, including information technology infrastructure costs and facility costs such as rent and amortization of leasehold improvements allocated to research and development; a decrease of approximately \$1.1 million in costs related to the collaboration with AstraZeneca; and a decrease of approximately \$0.6 million related to the development of manufacturing processes and costs associated with linaclotide API prior to meeting our inventory capitalization policy.

*Selling, General and Administrative Expense.* Selling, general and administrative expenses increased approximately \$1.9 million for the three months ended September 30, 2015 compared to the three months ended September 30, 2014, primarily as a result of an approximately \$1.9 million increase in compensation, share-based compensation, benefits and other employee-related expenses, and an approximately \$0.5 million increase in costs associated with selling expenses and marketing programs. These increases were partially offset by an approximately \$0.4 million decrease in selling, general and administrative expenses related to facilities and information technology infrastructure costs associated with operating our Cambridge, Massachusetts facility, including rent and amortization of leasehold improvements.

Selling, general and administrative expenses increased approximately \$6.0 million for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 as a result of an approximately \$3.8 million increase in compensation, share-based compensation, benefits and other employee-related expenses, an approximately \$1.6 million increase in external consulting and other service costs primarily associated with commercial activities to support linaclotide, an approximately \$1.5 million increase in costs associated with selling expenses and marketing programs, and an approximately \$0.3 million increase in selling, general and administrative expenses related to facilities and information technology infrastructure costs associated with operating our Cambridge, Massachusetts facility, including rent and amortization of leasehold improvements. These increases were partially offset by a decrease in costs of approximately \$1.2 million related to our January 2014 workforce reduction.

*Other (Expense) Income, Net*

	Three Months Ended September 30,		Change		Nine Months Ended September 30,		Change	
	2015	2014	\$	%	2015	2014	\$	%
	(dollars in thousands)				(dollars in thousands)			
Other (expense) income:								
Interest expense	\$ (10,021)	\$ (5,320)	\$ (4,701)	88%	\$ (21,115)	\$ (15,906)	\$ (5,209)	33%
Interest and investment income	156	71	85	120%	292	180	112	62%
Loss on derivatives	(11,340)		(11,340)	(100)%	(11,548)		(11,548)	(100)%
Total other expense, net	\$ (21,205)	\$ (5,249)	\$ (15,956)	304%	\$ (32,371)	\$ (15,726)	\$ (16,645)	106%

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Interest expense increased approximately \$4.7 million and approximately \$5.2 million for the three and nine months ended September 30, 2015, respectively, compared to the three and nine months ended September 30, 2014 mainly due to an increase in interest expense of approximately \$5.0 million and \$5.8 million associated with our 2022 Notes. This increase was partially offset by a decrease of approximately \$0.3 million and approximately \$0.6 million in interest expense associated with the PhARMA Notes for the three and nine months ended September 30, 2015, respectively.

The approximately \$11.3 million increase in the net loss on derivatives for the three months ended September 30, 2015, compared to the three months ended September 30, 2014 is due to an approximately \$17.8 million decrease in the fair value of the Convertible Note Hedges, partially offset by an approximately \$6.5 million decrease in the fair value of the Note Hedge Warrants. The approximately \$11.5 million increase in the net loss on derivatives for the nine months ended September 30, 2015, compared to the nine months ended September 30, 2014 is due to an approximately \$19.4 million decrease in the fair value of the Convertible Note Hedges, partially offset by an approximately \$7.9 million decrease in the fair value of the Note Hedge Warrants.

### **Liquidity and Capital Resources**

At September 30, 2015, we had approximately \$462.3 million of unrestricted cash, cash equivalents and available-for-sale securities. Our cash equivalents include amounts held in money market funds. Our available-for-sale securities include amounts held in U.S. Treasury securities and U.S. government-sponsored securities. We invest cash in excess of immediate requirements in accordance with our investment policy, which limits the amounts we may invest in any one type of investment and requires all investments held by us to be at least A+ rated, with a remaining maturity when purchased of less than twelve months, so as to primarily achieve liquidity and capital preservation.

During the nine months ended September 30, 2015, our balances of cash, cash equivalents and available-for-sale securities increased approximately \$214.0 million. This increase is primarily due to approximately \$335.7 million in gross proceeds from the

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issuance of our 2022 Notes in June 2015, approximately \$70.8 million in gross proceeds from the issuance of Note Hedge Warrants issued in connection with the 2022 Notes, and approximately \$11.9 million in proceeds from the exercise of stock options and the issuance of shares pursuant to our employee stock purchase plan. These cash inflows were partially offset by the purchase of Convertible Note Hedges for approximately \$91.9 million in connection with our 2022 Notes, the payment of approximately \$11.7 million of debt issuance costs in connection with our 2022 Notes, as well as the cash used to operate our business, including payments related to, among other things, research and development and selling, general and administrative expenses as we continued to invest in our research pipeline and support the continued commercialization of LINZESS in the U.S. We also made principal payments of approximately \$8.4 million on our outstanding PharMA Notes, invested approximately \$3.3 million in capital expenditures, and made payments of approximately \$1.0 million on capital lease obligations.

We may from time to time seek to retire, redeem or repurchase all or part of our outstanding debt through cash purchases and/or exchanges, in open market purchases, privately negotiated transactions, by tender offer or otherwise. Such repurchases, redemptions or exchanges, if any, will depend on prevailing market conditions, liquidity requirements, contractual restrictions and other factors. The amounts involved may be material.

*Sources of Liquidity*

We have incurred losses since our inception in 1998 and, as of September 30, 2015, we had an accumulated deficit of approximately \$1.1 billion. We have financed our operations to date primarily through both the private sale of our preferred stock and the public sale of our common stock, including approximately \$203.2 million of net proceeds from our initial public offering, or IPO, in February 2010, and approximately \$413.4 million of net proceeds from our follow-on public offerings; payments received under our strategic collaborative arrangements, including upfront and milestone payments as well as reimbursement of certain expenses; debt financings, including approximately \$167.3 million of net proceeds from the private placement of our PharMA Notes in January 2013 and approximately \$324.0 million of net proceeds from the private placement of our 2022 Notes in June 2015; and the strategic sale of assets or businesses.

*Funding Requirements*

In August 2012, we received regulatory approval for LINZESS in the U.S. for the treatment of IBS-C or CIC in adults and, in December 2012, commenced our commercial launch with our collaboration partner, Allergan. While we began commercializing LINZESS in the fourth quarter of 2012, our company has not achieved profitability. In November 2012, our European partner, Almirall, received approval for CONSTELLA for the treatment of IBS-C in adults, which is currently being commercialized in certain European countries by Almirall. In December 2013 and February 2014, linaclotide was approved in Canada and Mexico, respectively, as a treatment for adult women and men suffering from IBS-C or CIC. Allergan has exclusive rights to commercialize linaclotide in Canada as CONSTELLA and, through a sublicense from Allergan, Almirall has exclusive rights to commercialize linaclotide in Mexico as LINZESS. In October 2015, Almirall and Allergan terminated the sublicense arrangement with respect to Mexico, returning the exclusive rights to commercialize linaclotide in Mexico to Allergan. In May 2014, Allergan began commercializing CONSTELLA in Canada and in June 2014, Almirall began commercializing LINZESS in Mexico. Our partnership with Allergan for North America requires total net sales of LINZESS in the U.S. to be reduced by commercial costs incurred by each party, and such resulting net profit or net loss attributable to LINZESS is shared equally between us and Allergan. Additionally, we receive royalties based on sales of linaclotide in the European territory, Canada, and Mexico from our partners. We cannot anticipate when, if ever, proceeds generated from sales of LINZESS and CONSTELLA will enable us to become cash flow positive. We anticipate that we will continue to incur substantial expenses for the next several years as we further develop and commercialize linaclotide in the U.S., China and other markets, and continue to invest in our pipeline and potentially

other external opportunities. In addition, we are generally required to make cash expenditures to manufacture linaclotide API in advance of selling it to our collaboration partners and collecting payments for such inventory sales, which may result in significant periodic uses of cash. We believe that our cash on hand as of September 30, 2015 will be sufficient to meet our projected operating needs at least through the next twelve months.

Our forecast of the period of time through which our financial resources will be adequate to support our operations, including the underlying estimates regarding the costs to obtain regulatory approval and the costs to commercialize linaclotide in the U.S., China and other markets, is a forward-looking statement that involves risks and uncertainties, and actual results could vary materially and negatively as a result of a number of factors, including the factors discussed in the Risk Factors section of this Quarterly Report on Form 10-Q. We have based our estimates on assumptions that may prove to be wrong, and we could utilize our available capital resources sooner than we currently expect.

Due to the numerous risks and uncertainties associated with the development and commercialization of our product candidates, we are unable to estimate precisely the amounts of capital outlays and operating expenditures necessary to complete the development of, and to obtain regulatory approval for, linaclotide (other than in the countries where it is already approved) and our other product candidates, or to commercialize linaclotide and our other product candidates, in each case, for all of the markets,



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indications, populations and formulations for which we believe each product candidate is suited. Our funding requirements will depend on many factors, including, but not limited to, the following:

- the rate of progress and cost of our commercialization activities;
- the expenses we incur in marketing and selling LINZESS and any other products;
- the revenue generated by sales of LINZESS, CONSTELLA and any other products;
- the success of our third-party manufacturing activities;
- the time and costs involved in developing, and obtaining regulatory approvals for, our product candidates;
- the success of our research and development efforts;
- the emergence of competing or complementary developments;
- the costs of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights;
- the terms and timing of any additional collaborative, licensing or other arrangements that we may establish;  
and
- the acquisition of businesses, products and technologies.

*Financing Strategy*

We may, from time to time, consider additional funding through a combination of new collaborative arrangements, strategic alliances, and additional equity and debt financings or from other sources. We will continue to manage our capital structure and to consider all financing opportunities, whenever they may occur, that could strengthen our long-term liquidity profile. Any such capital transactions may or may not be similar to transactions in which we have engaged in the past. There can be no assurance that any such financing opportunities will also be available on acceptable terms, if at all.

### Contractual Commitments and Obligations

In June 2015, we issued approximately \$335.7 million of 2.25% Convertible Senior Notes due June 15, 2022. The 2022 Notes are governed by an indenture between us and U.S. Bank National Association, as the trustee, or the Indenture. The 2022 Notes are senior unsecured obligations and bear interest at a rate of 2.25% per year, payable on June 15 and December 15 of each year, beginning on December 15, 2015. The 2022 Notes will mature on June 15, 2022, unless earlier converted or repurchased. The initial conversion rate for the 2022 Notes is 60.3209 shares of Class A common stock (subject to adjustment as provided for in the Indenture) per \$1,000 principal amount of the 2022 Notes, which is equal to an initial conversion price of approximately \$16.58 per share. In addition, to minimize the impact of potential dilution to our common stock upon conversion of the 2022 Notes, we entered into convertible note hedges covering 20,249,665 shares of our Class A common stock in connection with the 2022 Notes, or the Convertible Note Hedges. Concurrently with entering into the Convertible Note Hedges, we entered into warrant transactions whereby, subject to adjustment, we sold note hedge warrants to acquire 20,249,665 shares of our Class A common stock at an initial strike price of approximately \$21.50 per share, or the Note Hedge Warrants. Refer to Note 9, Notes Payable, in the accompanying notes to our condensed consolidated financial statements for additional information.

In July 2015 and August 2015, we amended two of our commercial supply agreements with contract manufacturing organizations for the purchase of linaclotide finished drug product and API. The agreements include minimum purchase requirements by calendar year. The table below reflects our amended minimum purchase requirements under these commercial supply agreements, as well as any outstanding non-cancelable purchase orders, by calendar year, related to the supply contracts associated with the territories not covered by our collaboration with Allergan for North America.

	Total	Payments Due by Period			
		Less Than 1 Year	1 3 Years (in thousands)	3 5 Years	More Than 5 Years
Commercial supply obligations	\$ 34,950	\$ 2,510	\$ 7,048	\$ 10,478	\$ 14,914

Otherwise, the disclosure of our contractual obligations and commitments was reported in our 2014 Annual Report on Form 10-K. There have been no other material changes from the contractual commitments and obligations previously disclosed in our 2014 Annual Report on Form 10-K in this Quarterly Report on Form 10-Q.

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**Off-Balance Sheet Arrangements**

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, that would have been established for the purpose of facilitating off-balance sheet arrangements (as that term is defined in Item 303(a)(4)(ii) of Regulation S-K) or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in those types of relationships. We enter into guarantees in the ordinary course of business related to the guarantee of our own performance and the performance of our subsidiaries.

**New Accounting Pronouncements**

For a discussion of recent accounting pronouncements please refer to Note 2, Summary of Significant Accounting Policies, in our 2014 Annual Report on Form 10-K and Note 1, Nature of Business, in this Quarterly Report on Form 10-Q.

During the three months ended June 30, 2015, we early adopted Accounting Standards Update, or ASU, No. 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, or ASU 2015-03. ASU 2015-03 requires debt issuance costs to be presented in the Balance Sheets as a direct deduction from the associated debt liability. We elected early adoption in the three months ended June 30, 2015, which resulted in a balance sheet reclassification of issuance costs in connection with the Pharma Notes of approximately \$1.4 million recorded in prepaid expenses and other current assets and approximately \$2.8 million in other assets to a reduction in Pharma notes payable as of December 31, 2014. Refer to Note 1, Nature of Business, and Note 9, Notes Payable, in the accompanying notes to our condensed consolidated financial statements for additional information.

Otherwise, we did not adopt any new accounting pronouncements during the nine months ended September 30, 2015 that had a material effect on our condensed consolidated financial statements included in this report.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

**Interest Rate Risk**

We are exposed to market risk related to changes in interest rates. We invest our cash in a variety of financial instruments, principally securities issued by the U.S. government and its agencies and money market instruments. The goals of our investment policy are preservation of capital, fulfillment of liquidity needs and fiduciary control of cash and investments. We also seek to maximize income from our investments without assuming significant risk.

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Our primary exposure to market risk is interest income sensitivity, which is affected by changes in the general level of interest rates, particularly because our investments are in short-term marketable securities. Due to the short-term duration of our investment portfolio and the low risk profile of our investments, an immediate 1% change in interest rates would not have a material effect on the fair market value of our portfolio. Accordingly, we would not expect our operating results or cash flows to be affected to any significant degree by the effect of a sudden change in market interest rates on our investment portfolio.

We do not believe our cash, cash equivalents and available-for-sale securities have significant risk of default or illiquidity. While we believe our cash, cash equivalents and available-for-sale securities do not contain excessive risk, we cannot provide absolute assurance that in the future our investments will not be subject to adverse changes in market value. In addition, we maintain significant amounts of cash, cash equivalents and available-for-sale securities at one or more financial institutions that are in excess of federally insured limits. Given the potential instability of financial institutions, we cannot provide assurance that we will not experience losses on these deposits.

Our capital lease obligations, PhaRMA Notes and 2022 Notes bear interest at a fixed rate and therefore have minimal exposure to changes in interest rates; however, because these interest rates are fixed, we may be paying a higher interest rate, relative to market, in the future if our credit rating improves or other circumstances change.

### **Equity Price Risk**

#### *2022 Notes*

Our 2022 Notes include conversion and settlement provisions that are based on the price of our Class A common stock at conversion or at maturity of the 2022 Notes. The amount of cash we may be required to pay is determined by the price of our Class A common stock. The fair value of our 2022 Notes is dependent on the price and volatility of our Class A common stock and will generally increase or decrease as the market price of our Class A common stock changes.

The 2022 Notes are convertible into Class A common stock at an initial conversion rate of 60.3209 shares of Class A common stock (subject to adjustment as provided for in the Indenture) per \$1,000 principal amount of the 2022 Notes, which is equal to an initial conversion price of approximately \$16.58 per share. The 2022 Notes will mature on June 15, 2022 unless earlier converted

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or repurchased. The 2022 Notes bear cash interest at an annual rate of 2.25%, payable on June 15 and December 15 of each year, beginning on December 15, 2015. As of September 30, 2015, the fair value of the 2022 Notes was estimated by us to be \$302.7 million. Refer to Note 9, Notes Payable, and Note 4, Fair Value of Financial Instruments, in the accompanying notes to our condensed consolidated financial statements for additional information.

*Convertible Note Hedge and Warrant Transactions with Respect to 2022 Notes*

To minimize the impact of potential dilution to our common stock upon conversion of the 2022 Notes, we entered into Convertible Note Hedges. Concurrently with entering into the Convertible Note Hedges, we entered into warrant transactions whereby we sold Note Hedge Warrants to acquire, subject to customary adjustments, 20,249,665 shares of our Class A common stock at an initial strike price of approximately \$21.50 per share, subject to adjustment. Refer to Note 9, Notes Payable, in the accompanying notes to our condensed consolidated financial statements for additional information.

**Foreign Currency Risk**

We have no significant operations outside the U.S. and we do not expect to be impacted significantly by foreign currency fluctuations.

**Effects of Inflation**

We do not believe that inflation and changing prices over the three and nine months ended September 30, 2015 and 2014 had a significant impact on our results of operations.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

As required by Rule 13a-15(b) of the Securities Exchange Act of 1934, or the Exchange Act, our management, including our principal executive officer and our principal financial officer, conducted an evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective at the reasonable assurance level in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports we file under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to

allow timely decisions regarding required disclosure.

**Changes in Internal Control**

As required by Rule 13a-15(d) of the Exchange Act, our management, including our principal executive officer and our principal financial officer, conducted an evaluation of the internal control over financial reporting to determine whether any changes occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, our principal executive officer and principal financial officer concluded no such changes during the period covered by this Quarterly Report on Form 10-Q materially affected, or were reasonably likely to materially affect, our internal control over financial reporting.

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**PART II OTHER INFORMATION**

**Item 1A. Risk Factors**

*In addition to the other information in this Quarterly Report on Form 10-Q, any of the factors described below could significantly and negatively affect our business, financial condition, results of operations or prospects. The trading price of our Class A common stock may decline due to these risks.*

**Risks Related to Our Business and Industry**

*We are highly dependent on the commercial success of LINZESS in the U.S. for the foreseeable future; we may be unable to attain profitability and positive cash flow from operations.*

In August 2012, the FDA approved LINZESS as a once-daily treatment for adult men and women suffering from IBS-C or CIC. We and our partner, Allergan plc (together with its affiliates), or Allergan (formerly Actavis plc), began selling LINZESS in the U.S. during December 2012. The commercial success of LINZESS depends on a number of factors, including:

- the effectiveness of LINZESS as a treatment for adult patients with IBS-C or CIC;
- the size of the treatable patient population;
- the effectiveness of the sales, managed markets and marketing efforts by us and Allergan;
- the adoption of LINZESS by physicians, which depends on whether physicians view it as a safe and effective treatment for adult patients with IBS-C and CIC;
- our success in educating and activating adult IBS-C and CIC patients to enable them to more effectively communicate their symptoms and treatment history to their physicians;

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- our ability to both secure and maintain adequate reimbursement for, and optimize patient access to, LINZESS by providing third party payers with a strong value proposition based on the existing burden of illness associated with IBS-C and CIC and the benefits of LINZESS;
- the effectiveness of our partners' distribution networks;
- the occurrence of any side effects, adverse reactions or misuse, or any unfavorable publicity in these areas, associated with LINZESS; and
- the development or commercialization of competing products or therapies for the treatment of IBS-C or CIC, or their associated symptoms.

Our revenues from the commercialization of LINZESS are subject to these factors, and therefore may be unpredictable from quarter-to-quarter. Ultimately, we may never generate sufficient revenues from LINZESS to reach or maintain profitability for our company or to sustain our anticipated levels of operations.

### *Linacotide may cause undesirable side effects or have other properties that could limit its commercial potential.*

The most commonly reported adverse reaction in the Phase III placebo-controlled trials for linaclotide in IBS-C and CIC was diarrhea. Severe diarrhea was reported in 2% or less of the linaclotide-treated patients, and its incidence was similar between the IBS-C and CIC populations in these trials. If we or others identify previously unknown side effects, if known side effects are more frequent or severe than in the past, if we or others detect unexpected safety signals for linaclotide or any products perceived to be similar to linaclotide, or if any of the foregoing are perceived to have occurred, then in any of these circumstances:

- sales of linaclotide may be impaired;
- regulatory approvals for linaclotide may be denied, restricted or withdrawn;
- we may decide to, or be required to, send product warning letters or field alerts to physicians, pharmacists and hospitals;
- reformulation of the product, additional nonclinical or clinical studies, changes in labeling or changes to or reapprovals of manufacturing facilities may be required;



- we may be precluded from pursuing additional development opportunities to enhance the clinical profile of LINZESS within its indicated populations, as well as be precluded from studying linaclotide in additional indications and populations and in new formulations;

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- our reputation in the marketplace may suffer; and
- government investigations or lawsuits, including class action suits, may be brought against us.

Any of the above occurrences would harm or prevent sales of linaclotide, increase our expenses and impair our ability to successfully commercialize linaclotide.

Furthermore, with LINZESS and CONSTELLA commercially available in certain countries and used in wider populations and in less rigorously controlled environments than in clinical studies, and as we and Allergan explore development opportunities to enhance the clinical profile of LINZESS through additional clinical trials, the number of patients treated with linaclotide within and outside of its current indications or patient populations may expand, which could result in the identification of previously unknown side effects, increased frequency or severity of known side effects, or detection of unexpected safety signals. As a result, regulatory authorities, healthcare practitioners, third party payers or patients may perceive or conclude that the use of linaclotide is associated with serious adverse effects, undermining our commercialization efforts.

In addition, the FDA-approved label for LINZESS contains a boxed warning about its use in pediatric patients. LINZESS is contraindicated in pediatric patients up to 6 years of age based on nonclinical data from studies in neonatal mice approximately equivalent to human pediatric patients less than 2 years of age. There is also a warning advising physicians to avoid the use of LINZESS in pediatric patients 6 through 17 years of age. This warning is based on data in young juvenile mice and the lack of clinical safety and efficacy data in pediatric patients of any age group. We and Allergan have established a nonclinical and clinical post-marketing plan with the FDA to understand the safety and efficacy of LINZESS in pediatric patients, which is discussed below.

***We rely entirely on contract manufacturers and our collaboration partners to manufacture and distribute linaclotide. If they are unable to comply with applicable regulatory requirements, unable to source sufficient raw materials, experience manufacturing or distribution difficulties, or are otherwise unable to manufacture and distribute sufficient quantities to meet demand, our commercialization efforts may be materially harmed.***

We have no internal manufacturing or distribution capabilities. Instead, we rely on a combination of contract manufacturers and our partners to manufacture linaclotide API and final linaclotide drug product, and to distribute that drug product to third party purchasers. We have commercial supply agreements with independent third parties to manufacture the linaclotide API used to support all of our partnered and unpartnered territories. Each of Allergan and Astellas is responsible for drug product and finished goods manufacturing (including bottling and packaging) for its respective territories, and distributing the finished goods to wholesalers. Among our drug product manufacturers, only Allergan has manufactured linaclotide on a commercial scale. We have an agreement with an independent third party to serve as an additional source of drug product manufacturing of linaclotide for our partnered territories and we have worked with our partners to achieve sufficient redundancy in this component of the linaclotide supply chain. Under our collaboration with AstraZeneca, we are accountable for drug product and finished goods manufacturing for China, Hong Kong and Macau.

Each of our linaclotide API and drug product manufacturers must comply with current good manufacturing practices, or GMP, and other stringent regulatory requirements enforced by the FDA and foreign regulatory authorities in other jurisdictions. These requirements include, among other things, quality control, quality assurance and the maintenance of records and documentation, which occur in addition to our quality

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assurance release of linaclotide API. Manufacturers of linaclotide may be unable to comply with these GMP requirements and with other regulatory requirements. We have little control over our manufacturers or collaboration partners compliance with these regulations and standards.

Our manufacturers may experience problems with their respective manufacturing and distribution operations and processes, including for example, quality issues, including product specification and stability failures, procedural deviations, improper equipment installation or operation, utility failures, contamination and natural disasters. In addition, our API manufacturers acquire the raw materials necessary to make linaclotide API from a limited number of sources. Any delay or disruption in the availability of these raw materials or a change in raw material suppliers could result in production disruptions, delays or higher costs with consequent adverse effects on us.

The manufacture of pharmaceutical products requires significant expertise and capital investment, including the development of advanced manufacturing techniques and process controls. Manufacturers of pharmaceutical products often encounter difficulties in commercial production. These problems include difficulties with production costs and yields, quality control, including stability of the product and quality assurance testing, and shortages of qualified personnel, as well as compliance with federal, state and foreign regulations and the challenges associated with complex supply chain management. Even if our manufacturers do not experience problems and commercial manufacturing is achieved, their maximum or available manufacturing capacities may be insufficient to meet commercial demand. Finding alternative manufacturers or adding additional manufacturers requires a significant amount of time

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and involves significant expense. New manufacturers would need to develop and implement the necessary production techniques and processes, which along with their facilities, would need to be inspected and approved by the regulatory authorities in each applicable territory.

If our API or drug product manufacturers fail to adhere to applicable GMP or other regulatory requirements, experience delays or disruptions in the availability of raw materials or experience manufacturing or distribution problems, we will suffer significant consequences, including product seizures or recalls, loss of product approval, fines and sanctions, reputational damage, shipment delays, inventory shortages, inventory write-offs and other product-related charges and increased manufacturing costs. If we experience any of these results, or if our manufacturers maximum or available capacities are insufficient to meet demand, we may not be able to successfully commercialize linaclotide.

***If any of our partners undergoes a change in control or in management, this may adversely affect our collaborative relationship or the success of the commercialization of LINZESS in the U.S. or the continued launches and commercialization of CONSTELLA in the E.U., or the ability to achieve regulatory approval, launch and commercialize linaclotide in our other partnered territories.***

We work jointly and collaboratively with each of our partners on many aspects of the development, manufacturing and commercialization of linaclotide. In doing so, we have established relationships with several key members of the management teams of our linaclotide partners in functional areas such as development, quality, regulatory, drug safety and pharmacovigilance, operations, marketing, sales, field operations and medical science. Further, the success of our collaborations is highly dependent on the resources, efforts and skills of our partners and their key employees. As we and our partners commercialize LINZESS in the U.S., continue to launch and commercialize CONSTELLA in the E.U. and develop, launch and commercialize linaclotide in other parts of the world, the drug's success becomes more dependent on us maintaining highly collaborative and well aligned partnerships. If any of our linaclotide partners undergo a change of control or in management in the future, we would need to reestablish many relationships and confirm continued alignment on our development and commercialization strategy for linaclotide. Further, in connection with any change of control or in management, there is inherent uncertainty and disruption in operations, which could result in distraction, inefficiencies, and misalignment of priorities. As a result, in the event of a change of control or in management at one of our partners, we cannot be sure that we will be able to successfully execute on our development and commercialization strategy for linaclotide in an effective and efficient manner and without disruption or reduced performance. Finally, any change of control or in management may result in a reprioritization of linaclotide within a partner's portfolio, or such partner may fail to maintain the financial or other resources necessary to continue supporting its portion of the development, manufacturing or commercialization of linaclotide.

If any of our partners undergoes a change of control and the acquirer either is unable to perform such partner's obligations under its collaboration or license agreement with us or has a product that competes with linaclotide that such acquirer does not divest, we have the right to terminate the collaboration or license agreement and reacquire that partner's rights with respect to linaclotide. If we elect to exercise these rights in such circumstances, we will need to either establish the capability to develop, manufacture and commercialize linaclotide in that partnered territory on our own or we will need to establish a relationship with a new partner. We have assembled a team of specialists in manufacturing, quality, sales, marketing, payer, pricing and field operations, and specialized medical scientists, who represent the functional areas necessary for a successful commercial launch of a high potential, GI therapy and who support the commercialization of LINZESS in the U.S. If Allergan was subject to a change of control that allowed us to further commercialize LINZESS in the U.S. on our own, and we chose to do so, we would need to enhance each of these functional aspects to replace the capabilities that Allergan was previously providing to the collaboration. Any such transition might result in a period of reduced efficiency or performance by our operations and commercialization teams, which could adversely affect our ability to commercialize LINZESS.

Although many members of our global operations, commercial and medical affairs teams have strategic oversight of, and a certain level of involvement in, their functional areas globally, we do not have corresponding operational capabilities in these areas outside of the U.S. If Allergan, Astellas or AstraZeneca was subject to a change of control that allowed us to continue linaclotide's development or commercialization anywhere outside of the U.S. on our own, and we chose to do so rather than establishing a relationship with a new partner, we would need to

build operational capabilities in the relevant territory. In any of these situations, the timeline and likelihood of achieving regulatory approval and, ultimately, the commercialization of linaclotide could be negatively impacted.

***We must work effectively and collaboratively with Allergan to market and sell LINZESS in the U.S. in order for it to achieve its maximum commercial potential.***

We are working closely with Allergan to implement our joint commercialization plan for LINZESS. The commercialization plan includes an agreed upon marketing campaign that targets the physicians who see patients who could benefit from LINZESS treatment. Our marketing campaign also targets the adult men and women who suffer from IBS-C or CIC. Our commercialization

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plan also includes an integrated call plan for our sales forces to optimize the education of specific gastroenterologists and primary care physicians on whom our and Allergan's sales representatives call, and the frequency with which the representatives meet with them.

In order to optimize the commercial potential of LINZESS, we and Allergan must execute upon this commercialization plan effectively and efficiently. In addition, we and Allergan must continually assess and modify our commercialization plan in a coordinated and integrated fashion in order to adapt to the promotional response. Further, we and Allergan must continue to focus and refine our marketing campaign to ensure a clear and understandable physician-patient dialogue around IBS-C, CIC and the potential for LINZESS as an appropriate therapy. In addition, we and Allergan must provide our sales forces with the highest quality support, guidance and oversight in order for them to continue to effectively promote LINZESS to gastroenterologists and primary care physicians. If we and Allergan fail to perform these commercial functions in the highest quality manner and in accordance with our joint commercialization plan and related agreements, LINZESS will not achieve its maximum commercial potential and we may suffer financial harm. Our efforts to further target and engage adult patients with IBS-C or CIC may not effectively increase appropriate patient awareness or patient/physician dialogue, and may not increase the revenues that we generate from LINZESS.

***We are subject to uncertainty relating to pricing and reimbursement policies which, if not favorable for linaclotide, could hinder or prevent linaclotide's commercial success.***

Our and Allergan's ability to commercialize LINZESS in the U.S. successfully depends in part on the coverage and reimbursement levels set by governmental authorities, private health insurers and other third-party payers. In determining whether to approve reimbursement for LINZESS and at what level, we expect that third-party payers will consider factors that include the efficacy, cost effectiveness and safety of LINZESS, as well as the availability of other treatments including generic prescription drugs and over-the-counter alternatives. Further, in order to maintain acceptable reimbursement levels and access for patients at copay levels that are reasonable and customary, we may face increasing pressure to offer discounts or rebates from list prices or discounts to a greater number of third-party payers or other unfavorable pricing modifications. Obtaining and maintaining favorable reimbursement can be a time consuming and expensive process, and there is no guarantee that we or Allergan will be able to negotiate pricing terms with all third-party payers at levels that are profitable to us, or at all. Certain third-party payers also require prior authorization for, or even refuse to provide, reimbursement for LINZESS, and others may do so in the future. Our business would be materially adversely affected if we and Allergan are not able to receive approval for reimbursement of LINZESS from third-party payers on a broad, timely or satisfactory basis; if reimbursement is subject to overly restrictive prior authorization requirements; or if reimbursement is not maintained at a satisfactory level or becomes subject to prior authorization. In addition, our business could be adversely affected if private insurers, including managed care organizations, the Medicare or Medicaid programs or other reimbursing bodies or payers limit or reduce the indications for or conditions under which LINZESS may be reimbursed.

We expect to experience pricing pressures in connection with the sale of linaclotide and our future products due to the healthcare reforms discussed below, as well as the trend toward programs aimed at reducing healthcare costs, the increasing influence of health maintenance organizations, the ongoing debates on reducing government spending and additional legislative proposals. These healthcare reform efforts or any future legislation or regulatory actions aimed at controlling and reducing healthcare costs, including through measures designed to limit reimbursement, restrict access or impose unfavorable pricing modifications on pharmaceutical products, could impact our and our partners ability to obtain or maintain reimbursement for linaclotide at a satisfactory level, or at all, which could materially harm our business and financial results.

In some foreign countries, particularly Canada and the countries of Europe, the pricing and payment of prescription pharmaceuticals is subject to governmental control. In these countries, pricing negotiations with governmental authorities can take six to 12 months or longer after the receipt of regulatory approval and product launch. To obtain favorable reimbursement for the indications sought or pricing approval in some countries, we and our partners may be required to conduct a clinical trial that compares the cost-effectiveness of our products, including linaclotide, to

other available therapies. In addition, in countries in which linaclotide is the only approved therapy for a particular indication, such as CONSTELLA as the only product approved for the symptomatic treatment of moderate to severe IBS-C in adults in Europe, there may be disagreement as to what the most comparable product is, or if there even is one. Further, several European countries have implemented government measures to either freeze or reduce pricing of pharmaceutical products. Many third-party payers and governmental authorities also consider the price for which the same product is being sold in other countries to determine their own pricing and reimbursement strategy, so if linaclotide is priced low or gets limited reimbursement in a particular country, this could result in similarly low pricing and reimbursement in other countries. If reimbursement for our products is unavailable in any country in which reimbursement is sought, limited in scope or amount, or if pricing is set at or reduced to unsatisfactory levels, our ability to successfully commercialize linaclotide in such country would be impacted negatively. Furthermore, if these measures prevent us or any of our partners from selling linaclotide on a profitable basis in a particular country, they could prevent the commercial launch or continued sale of linaclotide in that country.

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***If the pricing and reimbursement of CONSTELLA in the E.U. is low, our royalty revenues based on sales of linaclotide will be adversely affected.***

In November 2012, the European Commission granted marketing authorization to CONSTELLA for the symptomatic treatment of moderate to severe IBS-C in adults. This approval followed the positive recommendation received from the European Committee for Medicinal Products for Human Use in September 2012. In October 2015, Almirall transferred its exclusive license to develop and commercialize linaclotide in Europe to Allergan. Currently, CONSTELLA is commercially available in certain European countries, including the United Kingdom, Italy and Spain. In May 2014, our former European partner Almirall suspended commercialization of CONSTELLA in Germany following an inability to reach agreement with the German National Association of Statutory Health Insurance Funds on a reimbursement price that reflects the innovation and value of CONSTELLA. Allergan is assessing all possibilities to facilitate continued access to CONSTELLA for appropriate patients in Germany.

The pricing and reimbursement strategy is a key component of Allergan's commercialization plan for CONSTELLA in Europe. Reimbursement sources are different in each country, and each country may include a combination of distinct potential payers, including private insurance and governmental payers. Countries in Europe may restrict the range of medicinal products for which their national health insurance systems provide reimbursement and control the prices of medicinal products for human use. Our revenues may suffer if Allergan is unable to successfully and timely conclude reimbursement, price approval or funding processes and market CONSTELLA in key member states of the E.U., or if coverage and reimbursement for CONSTELLA is limited or reduced. If Allergan is not able to obtain coverage, pricing or reimbursement on acceptable terms or at all, or if such terms change in any countries in its territory, Allergan may not be able to, or may decide not to, sell CONSTELLA in such countries. Further, Allergan could sell CONSTELLA at a low price. Since we receive royalties on net sales of CONSTELLA in the E.U., which is correlated directly to the price at which Allergan sells CONSTELLA in the E.U., our royalty revenues globally could be limited should Allergan sell CONSTELLA at a low price or elect not to launch in a certain country within the E.U.

***Because we work with partners to develop, manufacture and commercialize linaclotide, we are dependent upon third parties, and our relationships with those third parties, in our efforts to commercialize LINZESS and to obtain regulatory approval for, and to commercialize, linaclotide in our other partnered territories.***

Allergan played a significant role in the conduct of the clinical trials for linaclotide and in the subsequent collection and analysis of data, and Allergan holds the NDA for LINZESS. In addition, we are commercializing LINZESS in the U.S. with Allergan. Allergan is also responsible for the development, regulatory approval and commercialization of linaclotide in Canada and Mexico, which, for Mexico, it had sublicensed its commercialization rights to Almirall. In October 2015, in connection with the transfer of the exclusive license to develop and commercialize linaclotide in Europe to Allergan, Almirall and Allergan terminated the sublicense arrangement with respect to Mexico, returning the exclusive rights to commercialize linaclotide in Mexico to Allergan. As a result, Allergan is also commercializing LINZESS in Mexico and CONSTELLA in Canada, as well as commercializing CONSTELLA in certain countries in Europe, with responsibility for obtaining regulatory approval of linaclotide in the other countries in its territory. Astellas, our partner in Japan, is responsible for completing the clinical programs and obtaining regulatory approval of linaclotide in its territory. Further, we are jointly overseeing the development, and will jointly oversee the commercialization, of linaclotide in China, Hong Kong and Macau through our collaboration with AstraZeneca, with AstraZeneca having primary responsibility for the local operational execution. Upon any approval, each of Astellas and AstraZeneca, as well as Allergan for the European region, is responsible for commercializing linaclotide in its respective territory, and each has agreed to use commercially reasonable efforts to do so. Each of our partners is responsible for reporting adverse event information from its territory to us. Finally, each of our partners, other than AstraZeneca, is responsible for drug product manufacturing of linaclotide and making it into finished goods (including bottling and packaging) for its respective territory. The integration of our efforts with our partners' efforts is subject to the uncertainty of the markets for pharmaceutical products in each partner's respective territories, and accordingly, these relationships must evolve to meet any new challenges that arise in those regions.



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These integrated functions may not be carried out effectively and efficiently if we fail to communicate and coordinate with our partners, and vice versa. Our partnering strategy imposes obligations, risks and operational requirements on us as the central node in our global network of partners. If we do not effectively communicate with each partner and ensure that the entire network is making integrated and cohesive decisions focused on the global brand for linaclotide, linaclotide will not achieve its maximum commercial potential. As the holder of the global safety database for linaclotide, we are responsible for coordinating the safety surveillance and adverse event reporting efforts worldwide. If we are unsuccessful in doing so due to poor process, execution, oversight, communication, adjudication or otherwise, then our and our partner's ability to obtain and maintain regulatory approval of linaclotide will be at risk.

We have limited ability to control the amount or timing of resources that our partners devote to linaclotide. If any of our partners fails to devote sufficient time and resources to linaclotide, or if its performance is substandard, it will delay the potential submission or approval of regulatory applications for linaclotide, as well as the manufacturing and commercialization of linaclotide in the particular territory. A material breach by any of our partners of our collaboration or license agreement with such partner, or a significant disagreement between us and a partner, could also delay the regulatory approval and commercialization of linaclotide, potentially lead to costly litigation, and could have a material adverse impact on our financial condition. Moreover, although we have non-compete restrictions in place with each of our partners, they may have relationships with other commercial entities, some of which may compete with us. If any of our partners assists our competitors, it could harm our competitive position.

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*Even though LINZESS is approved by the FDA for the treatment of adults with IBS-C or CIC, it faces future post-approval development and regulatory requirements, which will present additional challenges.*

In August 2012, the FDA approved LINZESS as a once-daily treatment for adult men and women suffering from IBS-C or CIC. LINZESS is subject to ongoing FDA requirements governing the labeling, packaging, storage, advertising, promotion, recordkeeping and submission of safety and other post-market information.

LINZESS is contraindicated in pediatric patients up to 6 years of age based on nonclinical data from studies in neonatal mice approximately equivalent to human pediatric patients less than 2 years of age. There is also a warning advising physicians to avoid the use of LINZESS in pediatric patients 6 through 17 years of age. This warning is based on data in young juvenile mice and the lack of clinical safety and efficacy data in pediatric patients of any age group. We and Allergan have established a nonclinical and clinical post-marketing plan with the FDA to understand the safety and efficacy of LINZESS in pediatric patients. The first step in this plan was to undertake additional nonclinical studies to further understand the results of the earlier neonatal mouse study and to understand the tolerability of LINZESS in older juvenile mice. We and Allergan have completed these nonclinical studies and have initiated two Phase II clinical pediatric studies in IBS-C patients age seven to 17 and functional constipation patients age six to 17. Our ability to conduct clinical studies in younger pediatric patients will depend, in part, on the safety and efficacy data from our clinical studies in older pediatric patients. Our ability to ever expand the indication for LINZESS to pediatrics will depend on, among other things, our successful completion of pediatric clinical studies.

We and Allergan have also committed to certain nonclinical and clinical studies aimed at understanding: (a) whether orally administered linaclotide can be detected in breast milk, (b) the potential for antibodies to be developed to linaclotide, and if so, (c) whether antibodies specific for linaclotide could have any therapeutic or safety implications. We expect to complete these studies over the next three to five years.

These post-approval requirements impose burdens and costs on us. Failure to complete the required studies and meet our other post-approval commitments would lead to negative regulatory action at the FDA, which could include withdrawal of regulatory approval of LINZESS for the treatment of adults with IBS-C or CIC.

Manufacturers of drug products and their facilities are subject to continual review and periodic inspections by the FDA and other regulatory authorities for compliance with GMP regulations. If we or a regulatory agency discovers previously unknown problems with a product, such as adverse events of unanticipated severity or frequency, or problems with a facility where the product is manufactured, a regulatory agency may impose restrictions on that product or the manufacturer, including requiring implementation of a risk evaluation and mitigation strategy program, withdrawal of the product from the market or suspension of manufacturing. If we, our partners or the manufacturing facilities for linaclotide fail to comply with applicable regulatory requirements, a regulatory agency may:

- issue warning letters or untitled letters;
- impose civil or criminal penalties;

- suspend or withdraw regulatory approval;
- suspend any ongoing clinical trials;
- refuse to approve pending applications or supplements to applications submitted by us;
- impose restrictions on operations, including costly new manufacturing requirements; or
- seize or detain products or require us to initiate a product recall.

*Even though linaclotide is approved for marketing in the U.S. as LINZESS and in the E.U. as CONSTELLA, and is approved for marketing in a number of other countries, we or our collaborators may never receive approval to commercialize linaclotide in additional parts of the world.*

In order to market any products outside of the U.S., we or our partners must comply with numerous and varying regulatory requirements of other jurisdictions regarding safety and efficacy. Approval procedures vary among jurisdictions and can involve product testing and administrative review periods different from, and greater than, those in the U.S., the E.U. and the other countries where linaclotide is approved. Potential risks include that the regulatory authorities:

- may not deem linaclotide safe and effective;
- may not find the data from nonclinical studies and clinical trials sufficient to support approval;
- may not approve of manufacturing processes and facilities;
- may not approve linaclotide for any or all indications or patient populations for which approval is sought;
- may require significant warnings or restrictions on use to the product label for linaclotide; or



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- may change their approval policies or adopt new regulations.

If any of the foregoing were to occur, our receipt of regulatory approval in the applicable jurisdiction could be delayed or we may never receive approval at all. Further, regulatory approval in one jurisdiction does not ensure regulatory approval in another, but a failure or delay in obtaining regulatory approval in one jurisdiction may have a negative effect on the regulatory processes in others. If linaclotide is not approved for all indications or patient populations or with the label requested, this would limit the uses of linaclotide and have an adverse effect on its commercial potential or require costly post-marketing studies.

*We face potential product liability exposure, and, if claims brought against us are successful, we could incur substantial liabilities.*

The use of our product candidates in clinical trials and the sale of marketed products expose us to product liability claims. If we do not successfully defend ourselves against product liability claims, we could incur substantial liabilities. In addition, regardless of merit or eventual outcome, product liability claims may result in:

- decreased demand for approved products;
- impairment of our business reputation;
- withdrawal of clinical trial participants;
- initiation of investigations by regulators;
- litigation costs;
- distraction of management's attention from our primary business;
- substantial monetary awards to patients or other claimants;

- loss of revenues; and
  
- the inability to commercialize our product candidates.

We currently have product liability insurance coverage for the commercial sale of linaclotide and for the clinical trials of our product candidates which is subject to industry-standard terms, conditions and exclusions. Our insurance coverage may not be sufficient to reimburse us for expenses or losses associated with claims. Moreover, insurance coverage is becoming increasingly expensive, and, in the future, we may not be able to maintain insurance coverage at a reasonable cost or in sufficient amounts to protect us against losses. On occasion, large judgments have been awarded in lawsuits based on drugs that had unanticipated side effects. A successful product liability claim or series of claims could cause our stock price to decline and, if judgments exceed our insurance coverage, could decrease our cash and adversely affect our business.

***We may face competition in the IBS-C and CIC marketplace, and new products may emerge that provide different or better alternatives for treatment of GI conditions.***

Linaclotide competes globally with certain prescription therapies and over the counter products for the treatment of IBS-C and CIC, or their associated symptoms. The availability of prescription competitors and over the counter products for GI conditions could limit the demand, and the price we are able to charge, for linaclotide unless we are able to differentiate linaclotide on the basis of its actual or perceived benefits. New developments, including the development of other drug technologies and methods of preventing the incidence of disease, occur in the pharmaceutical and medical technology industries at a rapid pace. These developments may render linaclotide obsolete or noncompetitive.

We believe other companies are developing products which could compete with linaclotide, should they be approved by the FDA or foreign regulatory authorities. Currently, there are compounds in late stage development and other potential competitors are in earlier stages of development for the treatment of patients with either IBS-C or CIC. If our potential competitors are successful in completing drug development for their drug candidates and obtain approval from the FDA or foreign regulatory authorities, they could limit the demand for linaclotide.

In addition, certain of our competitors have substantially greater financial, technical and human resources than us. Mergers and acquisitions in the pharmaceutical industry may result in even more resources being concentrated in our competitors. Competition may increase further as a result of advances made in the commercial applicability of technologies and greater availability of capital for investment in these fields.

***We will incur significant liability if it is determined that we are promoting any off-label use of LINZESS or any other product.***

Physicians are permitted to prescribe drug products and medical devices for uses that are not described in the product's labeling and that differ from those approved by the FDA or other applicable regulatory agencies. Such off-label uses are common across medical specialties. Although the FDA and other regulatory agencies do not regulate a physician's choice of treatments, the FDA and other regulatory agencies do restrict communications on the subject of off-label use. Companies are not permitted to promote drugs or medical devices for off-label uses. Accordingly, we may not promote LINZESS in the U.S. for use in any indications other than IBS-C or CIC or in any patient populations other than adult men and women. Similarly, we may not promote



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any other approved product we develop, license, co-promote or otherwise partner for any indication, population or use not described in such product's label. The FDA and other regulatory and enforcement authorities actively enforce laws and regulations prohibiting promotion of off-label uses and the promotion of products for which marketing approval has not been obtained. A company that is found to have improperly promoted off-label uses will be subject to significant liability, including civil and administrative remedies as well as criminal sanctions.

Notwithstanding the regulatory restrictions on off-label promotion, the FDA and other regulatory authorities allow companies to engage in truthful, non-misleading, and non-promotional scientific exchange concerning their products. We intend to engage in medical education activities and communicate with healthcare providers in compliance with all applicable laws, regulatory guidance and industry best practices. Although we believe we have put in place a robust compliance program, which is designed to ensure that all such activities are performed in a legal and compliant manner, we cannot be certain that our program will address all areas of potential exposure and the risks in this area cannot be entirely eliminated.

***If we fail to comply with healthcare regulations, we could face substantial penalties and our business, operations and financial condition could be adversely affected.***

Even though we do not (and do not expect in the future to) control referrals of healthcare services or bill directly to Medicare, Medicaid or other third-party payers, certain federal and state healthcare laws and regulations pertaining to fraud and abuse and patients' rights are and will be applicable to our business. We are subject to healthcare fraud and abuse and patient privacy regulation by both the federal government and the states in which we conduct our business. The regulations include:

- federal healthcare program anti-kickback laws, which prohibit, among other things, persons from soliciting, receiving or providing remuneration, directly or indirectly, to induce either the referral of an individual, for an item or service or the purchasing or ordering of a good or service, for which payment may be made under federal healthcare programs such as Medicare and Medicaid;
- federal false claims laws which prohibit, among other things, individuals or entities from knowingly presenting, or causing to be presented, claims for payment from Medicare, Medicaid, or other third-party payers that are false or fraudulent, and which may apply to entities like us which provide coding and billing advice to customers;
- the federal Health Insurance Portability and Accountability Act of 1996, which prohibits executing a scheme to defraud any healthcare benefit program or making false statements relating to healthcare matters and which also imposes certain requirements relating to the privacy, security and transmission of individually identifiable health information;
- the Federal Food, Drug, and Cosmetic Act, which among other things, strictly regulates drug product and medical device marketing, prohibits manufacturers from marketing such products for off-label use and regulates the



distribution of samples;

- state law equivalents of each of the above federal laws, such as anti-kickback and false claims laws which may apply to items or services reimbursed by any third-party payer, including commercial insurers, and state laws governing the privacy and security of health information in certain circumstances, many of which differ from each other in significant ways and often are not preempted by federal laws, thus complicating compliance efforts;
- the federal Foreign Corrupt Practices Act which prohibits corporations and individuals from paying, offering to pay, or authorizing the payment of anything of value to any foreign government official, government staff member, political party, or political candidate in an attempt to obtain or retain business or to otherwise influence a person working in an official capacity; and
- the federal Physician Payments Sunshine Act, which was passed as part of the Patient Protection and Affordable Care Act of 2010, and similar state laws in certain states, that require pharmaceutical and medical device companies to monitor and report payments, gifts, the provision of samples and other remuneration made to physicians and other healthcare professional and healthcare organizations.

If our operations are found to be in violation of any of the laws described above or any other laws, rules or regulations that apply to us, we will be subject to penalties, including civil and criminal penalties, damages, fines and the curtailment or restructuring of our operations. Any penalties, damages, fines, curtailment or restructuring of our operations could adversely affect our ability to operate our business and our financial results. Although compliance programs can mitigate the risk of investigation and prosecution for violations of these laws, rules or regulations, we cannot be certain that our program will address all areas of potential exposure and the risks in this area cannot be entirely eliminated, particularly because the requirements in this space are constantly evolving. Any action against us for violation of these laws, rules or regulations, even if we successfully defend against it, could cause us to incur significant legal expenses and divert our management's attention from the operation of our business, as well as damage our business or reputation. Moreover, achieving and sustaining compliance with applicable federal and state privacy, security, fraud and reporting laws may prove costly.

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***Healthcare reform and other governmental and private payer initiatives may have an adverse effect upon, and could prevent, our products or product candidates' commercial success.***

The U.S. government and individual states are aggressively pursuing healthcare reform, as evidenced by the passing of the Patient Protection and Affordable Care Act, as modified by the Health Care and Education Reconciliation Act of 2010. These healthcare reform laws contain several cost containment measures that could adversely affect our future revenue, including, for example, increased drug rebates under Medicaid for brand name prescription drugs, extension of Medicaid rebates to Medicaid managed care plans, and extension of so-called 340B discounted pricing on pharmaceuticals sold to certain healthcare providers. Additional provisions of the healthcare reform laws that may negatively affect our future revenue and prospects for profitability include the assessment of an annual fee based on our proportionate share of sales of brand name prescription drugs to certain government programs, including Medicare and Medicaid, as well as mandatory discounts on pharmaceuticals sold to certain Medicare Part D beneficiaries. Other aspects of healthcare reform, such as expanded government enforcement authority and heightened standards that could increase compliance-related costs, could also affect our business.

In addition to governmental efforts in the U.S., foreign jurisdictions as well as private health insurers and managed care plans are likely to continue challenging manufacturers' ability to obtain reimbursement, as well as the level of reimbursement, for pharmaceuticals and other healthcare-related products and services. These cost-control initiatives could significantly decrease the available coverage and the price we might establish for linaclotide and our other potential products, which would have an adverse effect on our financial results.

The Food and Drug Administration Amendments Act of 2007 also provides the FDA enhanced post-marketing authority, including the authority to require post-marketing studies and clinical trials, labeling changes based on new safety information, and compliance with risk evaluations and mitigation strategies approved by the FDA. We and Allergan have established a nonclinical and clinical post-marketing plan with the FDA to understand the safety and efficacy of LINZESS in pediatrics, which is discussed above. The FDA's exercise of this authority has resulted (and is expected to continue to result) in increased development-related costs following the commercial launch of LINZESS for the treatment of adult men and women suffering from IBS-C or CIC, and could result in potential restrictions on the sale and/or distribution of LINZESS, even in its approved indications and patient populations.

***In pursuing our growth strategy, we will incur a variety of costs and may devote resources to potential opportunities that are never completed or for which we never receive the benefit. Our failure to successfully discover, acquire, develop and market additional product candidates or approved products would impair our ability to grow and adversely affect our business.***

As part of our growth strategy, we intend to explore further linaclotide development opportunities. We and Allergan are exploring development opportunities to enhance the clinical profile of LINZESS by seeking to expand its utility in its indicated populations, as well as studying linaclotide in additional indications and populations and in new formulations to assess its potential to treat various GI conditions. These development efforts may fail or may not increase the revenues that we generate from LINZESS. Furthermore, they may result in adverse events, or perceived adverse events, in certain patient populations that are then attributed to the currently approved patient population, which may result in adverse regulatory action at the FDA or in other countries or harm linaclotide's reputation in the marketplace, each of which could materially harm our revenues from linaclotide.

We are also pursuing various other programs in our pipeline. We may spend several years and make significant investments in developing any current or future internal product candidate, and failure may occur at any point. Our product candidates are in various stages of development and must satisfy rigorous standards of safety and efficacy before they can be approved for sale by the FDA. To satisfy these standards, we must allocate resources among our various development programs and we must engage in costly and lengthy discovery and development efforts,

which are subject to unanticipated delays and other significant uncertainties. Despite our efforts, our product candidates may not offer therapeutic or other improvement over existing competitive drugs, be proven safe and effective in clinical trials, or meet applicable regulatory standards. It is possible that none of the product candidates we are developing will be approved for commercial sale, which would impair our ability to grow.

We have ongoing or planned nonclinical and clinical trials for linaclotide and a number of our internal product candidates, and the strength of our company's pipeline will depend in large part on the outcomes of these studies. Many companies in the pharmaceutical industry have suffered significant setbacks in clinical trials even after achieving promising results in earlier nonclinical or clinical trials. The findings from our completed nonclinical studies may not be replicated in later clinical trials, and our clinical trials may not be predictive of the results we may obtain in later-stage clinical trials or of the likelihood of regulatory approval. Results from our clinical trials and findings from our nonclinical studies could lead to abrupt changes in our development activities, including the possible limitation or cessation of development activities associated with a particular product candidate or program. Furthermore, our analysis of data obtained from nonclinical and clinical activities is subject to confirmation and interpretation by the FDA and other applicable regulatory authorities, which could delay, limit or prevent regulatory approval. Satisfaction of FDA or other applicable regulatory requirements is costly, time-consuming, uncertain and subject to unanticipated delays.

In addition, because our internal research capabilities are limited, we may be dependent upon pharmaceutical and biotechnology companies, academic scientists and other researchers to sell or license products or technology to us. The success of this strategy depends partly upon our ability to identify, select, discover and acquire promising pharmaceutical product candidates and products. The process of proposing, negotiating and implementing a license or acquisition of a product candidate or approved product is lengthy and complex. Other companies, including some with substantially greater financial, marketing and sales resources, may compete with us for the license or acquisition of product candidates and approved products. We have limited resources to identify and

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execute the acquisition or in-licensing of third-party products, businesses and technologies and integrate them into our current infrastructure. Moreover, we may devote resources to potential acquisitions or in-licensing opportunities that are never completed, or we may fail to realize the anticipated benefits of such efforts. We may not be able to acquire the rights to additional products or product candidates on terms that we find acceptable, or at all.

In addition, future acquisitions may entail numerous operational and financial risks, including:

- exposure to unknown liabilities;
- disruption of our business and diversion of our management's time and attention to develop acquired products, product candidates or technologies;
- incurrence of substantial debt, dilutive issuances of securities or depletion of cash to pay for acquisitions;
- higher than expected acquisition and integration costs;
- difficulty in combining the operations and personnel of any acquired businesses with our operations and personnel;
- increased amortization expenses;
- impairment of relationships with key suppliers or customers of any acquired businesses due to changes in management and ownership; and
- inability to motivate key employees of any acquired businesses.

Further, any product candidate that we acquire may require additional development efforts prior to commercial sale, including extensive clinical testing and approval by the FDA and applicable foreign regulatory authorities. All product candidates are prone to risks of failure typical of pharmaceutical product development, including the possibility that a product candidate will not be shown to be sufficiently safe and effective for approval by regulatory authorities.

*Delays in the completion of clinical testing of any of our product candidates could result in increased costs and delay or limit our ability to generate revenues.*

Delays in the completion of clinical testing could significantly affect our product development costs. We do not know whether planned clinical trials will be completed on schedule, if at all. The commencement and completion of clinical trials can be delayed for a number of reasons, including delays related to:

- obtaining regulatory approval to commence a clinical trial;
- reaching agreement on acceptable terms with prospective clinical research organizations, or CROs, and trial sites, the terms of which can be subject to extensive negotiation and may vary significantly among different CROs and trial sites;
- manufacturing sufficient quantities of a product candidate for use in clinical trials;
- obtaining institutional review board approval to conduct a clinical trial at a prospective site;
- recruiting and enrolling patients to participate in clinical trials for a variety of reasons, including competition from other clinical trial programs for the treatment of similar conditions; and
- maintaining patients who have initiated a clinical trial but may be prone to withdraw due to side effects from the therapy, lack of efficacy or personal issues, or who are lost to further follow-up.

Clinical trials may also be delayed as a result of ambiguous or negative interim results. In addition, a clinical trial may be suspended or terminated by us, an institutional review board overseeing the clinical trial at a clinical trial site (with respect to that site), the FDA, or other regulatory authorities due to a number of factors, including:

- failure to conduct the clinical trial in accordance with regulatory requirements or the study protocols;
- inspection of the clinical trial operations or trial sites by the FDA or other regulatory authorities resulting in the imposition of a clinical hold;

- unforeseen safety issues; or
- lack of adequate enrollment or funding to continue the clinical trial.

Additionally, changes in regulatory requirements and guidance may occur, and we may need to amend clinical trial protocols to reflect these changes. Each protocol amendment would require institutional review board review and approval, which may adversely impact the costs, timing or successful completion of the associated clinical trials. If we experience delays in completion, or if we terminate any of our clinical trials, the commercial prospects for our product candidate may be harmed, and our ability to generate product revenues will be delayed. In addition, many of the factors that cause, or lead to, a delay in the commencement or completion of clinical trials may also ultimately lead to the denial of regulatory approval.

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***We may not be able to manage our business effectively if we lose any of our current management team or if we are unable to attract and motivate key personnel.***

We may not be able to attract or motivate qualified management and scientific, clinical, operations and commercial personnel in the future due to the intense competition for qualified personnel among biotechnology, pharmaceutical and other businesses, particularly in the greater-Boston area. If we are not able to attract and motivate necessary personnel to accomplish our business objectives, we will experience constraints that will significantly impede the achievement of our objectives.

We are highly dependent on the drug discovery, development, regulatory, commercial, financial and other expertise of our management, particularly Peter M. Hecht, Ph.D., our chief executive officer; Mark G. Currie, Ph.D., our senior vice president, chief scientific officer and president of research and development; Tom Graney, our chief financial officer and senior vice president, finance and corporate strategy; Thomas A. McCourt, our senior vice president, marketing and sales and chief commercial officer; and Halley E. Gilbert, our senior vice president, chief legal officer, and secretary. Transitions in our senior management team may result in operational disruptions, and our business may be harmed as a result. In addition to the competition for personnel, the Boston area in particular is characterized by a high cost of living. As such, we could have difficulty attracting experienced personnel to our company and may be required to expend significant financial resources in our employee recruitment efforts.

We also have scientific and clinical advisors who assist us in formulating our product development, clinical strategies and our global supply chain plans, as well as sales and marketing advisors who have assisted us in our commercialization strategy and brand plan for linaclotide. These advisors are not our employees and may have commitments to, or consulting or advisory contracts with, other entities that may limit their availability to us, or may have arrangements with other companies to assist in the development and commercialization of products that may compete with ours.

***Security breaches and other disruptions could compromise our information and expose us to liability, which would cause our business and reputation to suffer.***

In the ordinary course of our business, we collect and store sensitive data, including intellectual property, our proprietary business information and that of our suppliers and business partners, as well as personally identifiable information of linaclotide patients, clinical trial participants and employees. We also have outsourced elements of our information technology structure, and as a result, we are managing independent vendor relationships with third parties who may or could have access to our confidential information. Similarly, our business partners and other third party providers possess certain of our sensitive data. The secure maintenance of this information is critical to our operations and business strategy. Despite our security measures, our information technology and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. We, our partners, vendors and other third party providers could be susceptible to third party attacks on our, and their, information security systems, which attacks are of ever increasing levels of sophistication and are made by groups and individuals with a wide range of motives and expertise, including criminal groups. Any such breach could compromise our, and their, networks and the information stored there could be accessed, publicly disclosed, lost or stolen. Any such access, disclosure or other loss of information could result in legal claims or proceedings, liability under laws that protect the privacy of personal information, disrupt our operations, and damage our reputation, any of which could adversely affect our business.

***Our business involves the use of hazardous materials, and we must comply with environmental laws and regulations, which can be expensive and restrict how we do business.***

Our activities involve the controlled storage, use and disposal of hazardous materials. We are subject to federal, state, city and local laws and regulations governing the use, manufacture, storage, handling and disposal of these hazardous materials. Although we believe that the safety procedures we use for handling and disposing of these materials comply with the standards prescribed by these laws and regulations, we cannot eliminate the risk of accidental contamination or injury from these materials. In the event of an accident, local, city, state or federal authorities may curtail the use of these materials and interrupt our business operations. We do not currently maintain hazardous materials insurance coverage.

### **Risks Related to Intellectual Property**

*Limitations on our patent rights relating to our product candidates may limit our ability to prevent third parties from competing against us.*

Our success depends on our ability to obtain and maintain patent protection for our product candidates, preserve our trade secrets, prevent third parties from infringing upon our proprietary rights and operate without infringing upon the proprietary rights of others.

The strength of patents in the pharmaceutical industry involves complex legal and scientific questions and can be uncertain. Patent applications in the U.S. and most other countries are confidential for a period of time until they are published, and publication of discoveries in scientific or patent literature typically lags actual discoveries by several months or more. As a result, we cannot be certain that we were the first to conceive inventions covered by our patents and pending patent applications or that we were the first to file patent applications for such inventions. In addition, we cannot be certain that our patent applications will be granted, that any



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issued patents will adequately protect our intellectual property, or that such patents will not be challenged, narrowed, invalidated or circumvented.

We have several issued patents and pending applications in the U.S. related to LINZESS, including a LINZESS composition of matter and methods of use patent (U.S. Patent 7,304,036) and two patents relating to our commercial, room temperature stable formulation of linaclotide and methods of using this formulation. We also have additional U.S. patents and applications covering processes for making LINZESS, formulations and dosing regimens thereof, and molecules related to LINZESS. Although none of these issued patents currently is subject to a patent reexamination or review, we cannot guarantee that they will not be subject to reexamination or review by the U.S. Patent and Trademark Office, or the USPTO, in the future. If any or all of our LINZESS-related patents were invalidated, we would still have at least five years of marketing exclusivity under the Hatch-Waxman Act from FDA approval of LINZESS. We believe that each of the patents in our linaclotide patent portfolio was rightfully issued and the portfolio gives us sufficient freedom to operate; however, if any of our present or future patents is invalidated, this could have an adverse effect on our business and financial results, particularly for the period beyond five years following marketing approval.

In March 2013, an opposition to one of our granted patents covering linaclotide was filed in Europe. In April 2015, the patent was upheld in its entirety by the European Patent Office, affirming the strength of our intellectual property and our belief that the opposition was without merit. We believe that this patent was appropriately granted but we cannot be certain of this until the opposition proceedings, including the associated appeals process, are complete. While the opposition is ongoing, we will incur additional expense and be required to focus additional efforts on the proceedings. However, even if this patent were ultimately found to be invalid, we have other composition of matter- and use-related linaclotide patents that are granted and in force, and we believe these patents provide strong and sufficient patent protection in Europe.

Furthermore, the America Invents Act, which was signed into law in 2011, has made several major changes in the U.S. patent statutes. These changes will permit third parties to challenge our patents more easily and will create uncertainty with respect to the interpretation and practice of U.S. patent law for the foreseeable future.

We also rely upon unpatented trade secrets, unpatented know-how and continuing technological innovation to develop and maintain our competitive position, which we seek to protect, in part, by confidentiality agreements with our employees and our collaborators and consultants. We also have agreements with our employees and selected consultants that obligate them to assign their inventions to us. It is possible, however, that technology relevant to our business will be independently developed by a person that is not a party to such an agreement. Furthermore, if the employees and consultants that are parties to these agreements breach or violate the terms of these agreements, we may not have adequate remedies, and we could lose our trade secrets through such breaches or violations. Further, our trade secrets could otherwise become known or be independently discovered by our competitors.

In addition, the laws of certain foreign countries do not protect proprietary rights to the same extent or in the same manner as the U.S., and, therefore, we may encounter problems in protecting and defending our intellectual property in certain foreign jurisdictions.

***If we are sued for infringing intellectual property rights of third parties, it will be costly and time consuming, and an unfavorable outcome in such litigation could have a material adverse effect on our business.***

## Edgar Filing: IRONWOOD PHARMACEUTICALS INC - Form 10-Q

Our commercial success depends on our ability, and the ability of our collaborators, to develop, manufacture, market and sell our products and use our proprietary technologies without infringing the proprietary rights of third parties. Numerous U.S. and foreign issued patents and pending patent applications, which are owned by third parties, exist in the fields in which we and our collaborators are developing products. As the biotechnology and pharmaceutical industry expands and more patents are issued, the risk increases that our potential products may give rise to claims of infringement of the patent rights of others. There may be issued patents of third parties of which we are currently unaware that may be infringed by linaclotide or our product candidates. Because patent applications can take many years to issue, there may be currently pending applications which may later result in issued patents that linaclotide or our product candidates may infringe.

We may be exposed to, or threatened with, litigation by third parties alleging that linaclotide or our product candidates infringe their intellectual property rights. If linaclotide or one of our product candidates is found to infringe the intellectual property rights of a third party, we or our collaborators could be enjoined by a court and required to pay damages and could be unable to commercialize linaclotide or the applicable product candidate unless we obtain a license to the intellectual property rights. A license may not be available to us on acceptable terms, if at all. In addition, during litigation, the counter-party could obtain a preliminary injunction or other equitable relief which could prohibit us from making, using or selling our products, pending a trial on the merits, which may not occur for several years.

There is a substantial amount of litigation involving patent and other intellectual property rights in the biotechnology and pharmaceutical industries generally. If a third party claims that we or our collaborators infringe its intellectual property rights, we may face a number of issues, including, but not limited to:

- infringement and other intellectual property claims which, regardless of merit, may be expensive and time-consuming to litigate and may divert our management's attention from our core business;

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- substantial damages for infringement, which we may have to pay if a court decides that the product at issue infringes on or violates the third party's rights, and, if the court finds that the infringement was willful, we could be ordered to pay treble damages and the patent owner's attorneys' fees;
- a court prohibiting us from selling our product unless the third party licenses its rights to us, which it is not required to do;
- if a license is available from a third party, we may have to pay substantial royalties, fees or grant cross-licenses to our intellectual property rights; and
- redesigning our products so they do not infringe, which may not be possible or may require substantial monetary expenditures and time.

*We may become involved in lawsuits to protect or enforce our patents, which could be expensive and time consuming, and unfavorable outcomes in such litigation could have a material adverse effect on our business.*

Competitors may infringe our patents or may assert our patents are invalid. To counter ongoing or potential infringement or unauthorized use, we may be required to file infringement claims, which can be expensive and time-consuming. Litigation with generic manufacturers has become increasingly common in the biotechnology and pharmaceutical industries. In addition, in an infringement or invalidity proceeding, a court or patent administrative body may determine that a patent of ours is not valid or is unenforceable, or may refuse to stop the other party from using the technology at issue on the grounds that our patents do not cover the technology in question. An adverse result in any litigation or defense proceedings could put one or more of our patents at risk of being invalidated or interpreted narrowly and could put our patent applications at risk of not issuing.

Interference or derivation proceedings brought by the USPTO may be necessary to determine the priority of inventions with respect to our patents and patent applications or those of our collaborators. An unfavorable outcome could require us to cease using the technology or to attempt to license rights to it from the prevailing party. Our business could be harmed if a prevailing party does not offer us a license on terms that are acceptable to us. Litigation or interference proceedings may fail and, even if successful, may result in substantial costs and distraction of our management and other employees. In addition, we may not be able to prevent, alone or with our collaborators, misappropriation of our proprietary rights, particularly in countries where the laws may not protect those rights as fully as in the U.S.

Furthermore, because of the substantial amount of discovery required in connection with intellectual property litigation, as well as the potential for public announcements of the results of hearings, motions or other interim proceeding or developments, there is a risk that some of our confidential information could be compromised by disclosure during this type of litigation.

**Risks Related to Our Finances and Capital Requirements**

*We have incurred significant operating losses since our inception and anticipate that we will incur continued losses for the foreseeable future.*

In recent years, we have focused primarily on developing, manufacturing and commercializing linaclotide. We and Allergan launched LINZESS in the U.S. in December 2012, and we believe that it will take us some time to attain profitability and positive cash flow from operations for Ironwood. We have financed our operations to date primarily through the issuance of equity, our collaboration and license arrangements, our January 2013 issuance of our PhaRMA Notes related to the sales of LINZESS in the U.S. and our June 2015 issuance of our 2022 Notes, and we have incurred losses in each year since our inception in 1998. We incurred net losses of approximately \$128.6 million and \$152.0 million in the nine months ended September 30, 2015 and 2014, respectively. As of September 30, 2015, we had an accumulated deficit of approximately \$1.1 billion. Our prior losses and expected future losses, have had and we expect will continue to have, an adverse effect on our stockholders equity and working capital. We expect to continue to incur substantial expenses in connection with our efforts to commercialize linaclotide and our research and development of our product candidates. As a result, we expect to continue to incur significant operating losses for the foreseeable future. Because of the numerous risks and uncertainties associated with developing pharmaceutical products, we are unable to predict the extent of any future losses or when, or if, our company will become profitable.

*We may need additional funding and may be unable to raise capital when needed, which could cause us to delay, reduce or eliminate our product development programs or commercialization efforts.*

In June 2015, we issued approximately \$335.7 million aggregate principal amount of our 2022 Notes and we have previously raised additional funds through other capital raising activities, including the sale of shares of our Class A common stock in public offerings and the issuance of our PhaRMA Notes in January 2013. However, marketing and selling a primary care drug, purchasing commercial quantities of pharmaceutical products, and developing product candidates and conducting clinical trials are expensive and uncertain. Circumstances, our strategic imperatives, or opportunities to create or acquire new programs, as well as maturities, redemptions or repurchases of our outstanding debt securities, could require us to, or we may choose to, seek to raise additional funds. The amount and timing of our future funding requirements will depend on many factors, including, but not limited to:

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- the level of underlying demand for linaclotide by prescribers and patients in the U.S., the E.U. and the other countries where it is approved;
- the costs associated with commercializing LINZESS in the U.S.;
- the costs of maintaining and expanding sales, marketing and distribution capabilities for linaclotide;
- the regulatory approval of linaclotide outside of the U.S., the E.U. and the other countries where it is approved, and the timing of commercial launches in those countries, as well as the associated development and commercial milestones and royalties;
- the rate of progress, the cost of our clinical trials and the other costs associated with our product development programs, including our post-approval nonclinical and clinical studies of linaclotide in pediatrics and our investment to enhance the clinical profile of LINZESS within its indicated populations, as well as to study linaclotide in additional indications and populations and in new formulations to assess its potential to treat various GI conditions;
- the costs and timing of in-licensing additional products or product candidates or acquiring other complementary companies;
- the status, terms and timing of any collaboration, licensing, co-commercialization or other arrangements;
- the timing of any regulatory approvals of our product candidates;
- whether the holders of our 2022 Notes hold the notes to maturity without conversion into our Class A common stock and whether we are required to repurchase our 2022 Notes prior to maturity upon a fundamental change, as defined in the indenture governing the 2022 Notes; and
- whether we seek to redeem or repurchase all or part of our outstanding debt through cash purchases and/or exchanges, in open market purchases, privately negotiated transactions, by tender offer or otherwise.

Additional funding may not be available on acceptable terms or at all. If adequate funds are not available, we may be required to delay or reduce the scope of our commercialization efforts, delay, reduce or eliminate one or more of our development programs or delay or abandon potential strategic opportunities.

***Our ability to pay principal of and interest on our outstanding debt securities will depend in part on the receipt of payments from Allergan under our collaboration agreement for North America.***

In January 2013, we issued \$175.0 million aggregate principal amount of our PhaRMA Notes bearing an annual interest rate of 11% and in June 2015, we issued approximately \$335.7 million aggregate principal amount of our 2022 Notes bearing an annual interest rate of 2.25%. Quarterly interest payments on our PhaRMA Notes commenced on June 15, 2013 and semi-annual payments on our 2022 Notes will commence on December 15, 2015. In March 2014, we began making quarterly payments on the PhaRMA Notes equal to the greater of (i) 7.5% of net sales of LINZESS in the U.S. for the preceding quarter and (ii) the quarterly interest amount. Principal on the PhaRMA Notes is repaid in an amount equal to the difference between (i) and (ii) above, when this is a positive number, until the principal has been paid in full. We expect that for the next few years, at a minimum, the net quarterly payments from Allergan will be our primary source of cash flow from operations. If the cash flows derived from the net quarterly payments that we receive from Allergan under the collaboration agreement for North America are insufficient on any particular payment date to fund the interest payment on our outstanding indebtedness, at a minimum, we will be obligated to pay the amounts of such shortfall out of our general funds. The determination of whether Allergan will be obligated to make a net quarterly payment to us in respect of a particular quarterly period is a function of the revenue generated by LINZESS in the U.S. as well as the development, manufacturing and commercialization expenses incurred by each of us and Allergan under the collaboration agreement for North America. Accordingly, since we believe that it will take our company some time to attain profitability and positive cash flow from operations, we cannot guarantee that (i) we will have the available funds to fund the interest payment on our outstanding indebtedness, at a minimum, in the event that there is a deficiency in the net quarterly payment received from Allergan, (ii) there will be a net quarterly payment from Allergan at all or (iii) we will not also be required to make a true-up payment to Allergan under the collaboration agreement for North America, in each case, in respect of a particular quarterly period.

***Our indebtedness could adversely affect our financial condition or restrict our future operations.***

As of September 30, 2015, we had total indebtedness of approximately \$501.1 million and available cash, cash equivalents and available for sale securities of \$462.3 million. We chose to issue our PhaRMA Notes and 2022 Notes based on the additional strategic optionality that they create for us, and the limited restrictions that these debt securities place on our ability to run our business compared to other potential available financing transactions. However, our indebtedness, combined with our other financial obligations and contractual commitments, could have other important consequences on our business, including:

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- limiting our ability to obtain additional financing to fund future working capital, capital expenditures or other general corporate purposes, including product development, commercialization efforts, research and development activities, strategic arrangements, acquisitions and refinancing of our outstanding debt;
- requiring a substantial portion of our cash flow to be dedicated to debt service payments instead of other purposes, thereby reducing the amount of cash flow available for working capital, capital expenditures, corporate transactions and other general corporate purposes;
- increasing our vulnerability to adverse changes in general economic, industry and competitive conditions;
- limiting our flexibility in planning for and reacting to changes in the industry in which we compete;
- placing us at a disadvantage compared to other, less leveraged competitors or competitors with comparable debt at more favorable interest rates; and
- increasing our cost of borrowing.

If we do not generate sufficient cash flow from operations or if future borrowings are not available to us in an amount sufficient to pay our indebtedness, including payments of principal when due on our outstanding indebtedness or, in the case of our 2022 Notes, in connection with a transaction involving us that constitutes a fundamental change under the indenture governing the 2022 Notes, or to fund our liquidity needs, we may be forced to refinance all or a portion of our indebtedness on or before the maturity dates thereof, sell assets, reduce or delay currently planned activities or curtail operations, seek to raise additional capital or take other actions. We may not be able to execute any of these actions on commercially reasonable terms or at all. This, together with any of the factors described above, could materially and adversely affect our business, financial condition and results of operations.

In addition, while our 2022 Notes do not include covenants restricting the operation of our business except in certain limited circumstances, in the event of a default under the 2022 Notes, the noteholders or the trustee under the indenture governing the 2022 Notes may accelerate our payment obligations under the 2022 Notes, which could have a material adverse effect on our business, financial condition and results of operations. We are also required to offer to repurchase the 2022 Notes upon the occurrence of a fundamental change, which could include, among other things, any acquisition of our company (other than an acquisition in which at least 90% of the consideration is common stock listed on The NASDAQ Global or Global Select Market or The New York Stock Exchange), subject to the terms of the 2022 Notes indenture. The repurchase price must be paid in cash, and this obligation may have the effect of discouraging, delaying or preventing an acquisition of our company that would otherwise be beneficial to our security holders.

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Further, although we are not as restricted under our PhaRMA Notes as we might have been under a more traditional secured credit facility provided by a bank, the indenture governing our PhaRMA Notes contains a number of restrictive covenants that impose restrictions on us and may limit our ability to engage in certain acts, including restrictions on our ability to:

- amend our collaboration agreement with Allergan for North America in a way that would have a material adverse effect on the noteholders' rights, or terminate this collaboration agreement with respect to the U.S.;
- transfer our rights to commercialize the product under our collaboration agreement with Allergan for North America; and
- incur certain liens.

Upon a breach of the covenants under our PhaRMA Notes indenture, or if certain other defaults thereunder occur, the holders of our PhaRMA Notes could elect to declare all amounts outstanding under our PhaRMA Notes to be immediately due and payable and we cannot be certain that we will have sufficient assets to repay them. If we are unable to repay those amounts, the holders of our PhaRMA Notes could proceed against the collateral granted to them to secure the debt securities and we could be forced into bankruptcy or liquidation. If we breach our covenants under our PhaRMA Notes indenture and seek a waiver, we may not be able to obtain a waiver from the required noteholders. If this occurs, we would be in default under our PhaRMA Notes indenture and the holders of our PhaRMA Notes could exercise their rights, as described above.

Each of our 2022 Notes and the PhaRMA Notes also include cross-default features providing that a default under the indenture governing either the 2022 Notes or the PhaRMA Notes would likely result in a default under the indenture governing the other indebtedness. In the event of such default, the trustee or noteholders could elect to declare all amounts outstanding to be immediately due and payable under the applicable indenture, which could have a material adverse effect on our business, financial condition and results of operations.



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*Convertible note hedge and warrant transactions entered into in connection with our 2022 Notes may affect the value of our Class A common stock.*

In connection with our 2022 Notes, we entered into Convertible Note Hedges and separate Note Hedge Warrant transactions with certain financial institutions. These transactions are expected generally to reduce the potential dilution upon any conversion of our 2022 Notes or offset any cash payments we are required to make in excess of the principal amount of converted 2022 Notes, as the case may be.

In connection with these transactions, the financial institutions purchased our Class A common stock in secondary market transactions and entered into various over-the-counter derivative transactions with respect to our Class A common stock. These entities or their affiliates are likely to modify their hedge positions from time to time prior to conversion or maturity of the 2022 Notes by purchasing and selling shares of our Class A common stock or other instruments they may wish to use in connection with such hedging. Any of these activities could adversely affect the value of our Class A common stock and, as a result, the number of shares and the value of the Class A common stock noteholders will receive upon conversion of the 2022 Notes. In addition, under certain circumstances the counterparties have the right to terminate the Convertible Note Hedges and settle the Note Hedge Warrants at fair value (as defined in the applicable confirmations), which may result in us not receiving all or any portion of the anticipated benefit of the Convertible Note Hedges. If the price of our Class A common stock increases such that the hedge transactions settle in our favor, we could also be exposed to credit risk related to the counterparties to the Convertible Note Hedges, which would limit or eliminate the benefit of such transactions to us.

*Our quarterly and annual operating results may fluctuate significantly.*

We expect our operating results to be subject to frequent fluctuations. Our net loss and other operating results will be affected by numerous factors, including:

- the level of underlying demand for linaclotide in the U.S., the E.U. and the other countries where it is approved, and wholesalers' buying patterns;
- the costs associated with commercializing LINZESS in the U.S.;
- the achievement and timing of milestone payments under our existing collaboration and license agreements;
- our execution of any collaboration, partnership, licensing or other strategic arrangements, and the timing of payments we may make or receive under these arrangements;

- any excess or obsolete inventory or asset impairments and associated write-downs;
- variations in the level of expenses related to our development programs;
- addition or termination of clinical trials;
- regulatory developments affecting linaclotide or our product candidates; and
- any material lawsuit in which we may become involved.

If our operating results fall below the expectations of investors or securities analysts, the price of our Class A common stock could decline substantially. Furthermore, any quarterly or annual fluctuations in our operating results may, in turn, cause the price of our stock to fluctuate substantially.

***Our ability to use net operating loss and tax credit carryforwards and certain built-in losses to reduce future tax payments is limited by provisions of the Internal Revenue Code, and it is possible that certain transactions or a combination of certain transactions may result in material additional limitations on our ability to use our net operating loss and tax credit carryforwards.***

Sections 382 and 383 of the Internal Revenue Code of 1986, as amended, contain rules that limit the ability of a company that undergoes an ownership change, which is generally any change in ownership of more than 50% of its stock over a three-year period, to utilize its net operating loss and tax credit carryforwards and certain built-in losses recognized in years after the ownership change. These rules generally operate by focusing on ownership changes involving stockholders owning directly or indirectly 5% or more of the stock of a company and any change in ownership arising from a new issuance of stock by the company. Generally, if an ownership change occurs, the yearly taxable income limitation on the use of net operating loss and tax credit carryforwards and certain built-in losses is equal to the product of the applicable long term tax exempt rate and the value of the company's stock immediately before the ownership change. We may be unable to offset our taxable income with losses, or our tax liability with credits, before such losses and credits expire and therefore would incur larger federal or state income tax liability. We have completed several financings since our inception which may have resulted in a change in control as defined by Section 382, or could result in a change in control in the future.

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**Risks Relating to Securities Markets and Investment in Our Stock**

*Anti-takeover provisions under our charter documents and Delaware law could delay or prevent a change of control which could negatively impact the market price of our Class A common stock.*

Provisions in our certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control. These provisions include the following:

- Our certificate of incorporation provides for a dual class common stock structure. As a result of this structure, holders of our Class B common stock have significant influence over certain matters requiring stockholder approval, including a merger involving Ironwood, a sale of substantially all Ironwood assets and a dissolution or liquidation of Ironwood. This concentrated control could discourage others from initiating a change of control transaction that other stockholders may view as beneficial.
- Our board of directors is divided into three classes serving staggered three-year terms, such that not all members of the board are elected at one time. This staggered board structure prevents stockholders from replacing the entire board at a single stockholders meeting.
- Our board of directors has the right to elect directors to fill a vacancy created by the expansion of the board of directors or the resignation, death or removal of a director, which prevents stockholders from being able to fill vacancies on our board of directors.
- Our board of directors may issue, without stockholder approval, shares of preferred stock. The ability to authorize preferred stock makes it possible for our board of directors to issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us.
- Stockholders must provide advance notice to nominate individuals for election to the board of directors or to propose matters that can be acted upon at a stockholders meeting. Furthermore, stockholders may only remove a member of our board of directors for cause. These provisions may discourage or deter a potential acquirer from conducting a solicitation of proxies to elect such acquirer's own slate of directors or otherwise attempting to obtain control of our company.

- Our stockholders may not act by written consent. As a result, a holder, or holders, controlling a majority of our capital stock are not able to take certain actions outside of a stockholders meeting.
- Special meetings of stockholders may be called only by the chairman of our board of directors, our chief executive officer or a majority of our board of directors. As a result, a holder, or holders, controlling a majority of our capital stock are not able to call a special meeting.
- A majority of the outstanding shares of Class B common stock are required to amend our certificate of incorporation and a super-majority (80%) of the outstanding shares of common stock are required to amend our bylaws, which make it more difficult to change the provisions described above.

In addition, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which may prohibit certain business combinations with stockholders owning 15% or more of our outstanding voting stock. These and other provisions in our certificate of incorporation and our bylaws and in the Delaware General Corporation Law could make it more difficult for stockholders or potential acquirers to obtain control of our board of directors or initiate actions that are opposed by the then-current board of directors.

***The concentration of voting control on certain corporate matters with our pre-IPO stockholders will limit the ability of the holders of our Class A common stock to influence such matters.***

Because of our dual class common stock structure, the holders of our Class B common stock, who consist of our pre-IPO investors (and their affiliates), founders, directors, executives and certain of our employees, are able to control certain corporate matters listed below if any such matter is submitted to our stockholders for approval even though such stockholders own less than 50% of the outstanding shares of our common stock. As of September 30, 2015, there were 126,820,615 and 15,841,444 shares of our Class A common stock and Class B common stock issued and outstanding, respectively, and an aggregate of 15,946,129 and 4,990,312 outstanding stock options (vested and unvested) and 531,901 and zero unvested restricted stock units for shares of our Class A common stock and Class B common stock, respectively. As of September 30, 2015, the holders of our Class A common stock own approximately 89% and the holders of our Class B common stock own approximately 11% of the outstanding shares of Class A common stock and Class B common stock, combined. However, because of our dual class common stock structure these holders of our Class A common stock have approximately 44% and holders of our Class B common stock have approximately 56% of the total votes on each of the matters identified in the list below. This concentrated control of our Class B common stockholders limits the ability of the Class A common stockholders to influence those corporate matters and, as a result, we may take actions that many of our stockholders do not view as beneficial, which could adversely affect the market price of our Class A common stock.

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Each share of Class A common stock and each share of Class B common stock has one vote per share on all matters except for the following matters, for which each share of our Class B common stock has ten votes per share and each share of our Class A common stock has one vote per share:

- adoption of a merger or consolidation agreement involving Ironwood;
- a sale of all or substantially all of Ironwood's assets;
- a dissolution or liquidation of Ironwood; and
- every matter, if and when any individual, entity or group (as that term is used in Regulation 13D of the Exchange Act) has, or has publicly disclosed (through a press release or a filing with the SEC) an intent to have, beneficial ownership of 30% or more of the number of outstanding shares of Class A common stock and Class B common stock, combined.

*If we identify a material weakness in our internal control over financial reporting, it could have an adverse effect on our business and financial results and our ability to meet our reporting obligations could be negatively affected, each of which could negatively affect the trading price of our Class A common stock.*

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis. Accordingly, a material weakness increases the risk that the financial information we report contains material errors.

We regularly review and update our internal controls, disclosure controls and procedures, and corporate governance policies. In addition, we are required under the Sarbanes-Oxley Act of 2002 to report annually on our internal control over financial reporting. Our system of internal controls, however well designed and operated, is based in part on certain assumptions and includes elements that rely on information from third parties, including our collaboration partners. Our system can provide only reasonable, not absolute, assurances that the objectives of the system are met. If we, or our independent registered public accounting firm, determine that our internal controls over financial reporting are not effective, or we discover areas that need improvement in the future, these shortcomings could have an adverse effect on our business and financial results, and the price of our Class A common stock could be negatively affected.

Further, we are dependent on our collaboration partners for information related to our results of operations. Our net profit or net loss generated from the sales of LINZESS in the U.S. is partially determined based on amounts provided by Allergan and involves the use of estimates and judgments, which could be modified in the future. We are also highly dependent on our partners for timely and accurate information regarding any revenues realized from sales of linaclotide in their respective territories, and in the case of Allergan for the U.S. and AstraZeneca for China,

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Hong Kong and Macau, the costs incurred in developing and commercializing it in order to accurately report our results of operations. Our results of operations are also dependent on the timeliness and accuracy of information from any other licensing, collaboration or other partners we may have, as well as our and our partners' use of estimates and judgments. If we do not receive timely and accurate information or if estimated activity levels associated with the relevant collaboration at a given point in time are incorrect, whether the result of a material weakness or not, we could be required to record adjustments in future periods. Such adjustments, if significant, could have an adverse effect on our financial results, which could lead to a decline in our Class A common stock price.

If we cannot conclude that we have effective internal control over our financial reporting, or if our independent registered public accounting firm is unable to provide an unqualified opinion regarding the effectiveness of our internal control over financial reporting, investors could lose confidence in the reliability of our financial statements, which could lead to a decline in our stock price. Failure to comply with reporting requirements could also subject us to sanctions and/or investigations by the SEC, The NASDAQ Stock Market or other regulatory authorities.

*We expect that the price of our Class A common stock will fluctuate substantially.*

The market price of our Class A common stock may be highly volatile due to many factors, including:

- the commercial performance of linaclotide in the U.S., the E.U. and the other countries where it is approved;
- any third-party coverage and reimbursement policies for linaclotide;
- market conditions in the pharmaceutical and biotechnology sectors;
- developments, litigation or public concern about the safety of linaclotide or our potential products;
- announcements of the introduction of new products by us or our competitors;
- announcements concerning product development results, including clinical trial results, or intellectual property rights of us or others;

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- actual and anticipated fluctuations in our quarterly and annual operating results;
- deviations in our operating results from any guidance we may provide or the estimates of securities analysts;
- sales of additional shares of our common stock or sales of securities convertible into common stock or the perception that these sales might occur;
- additions or departures of key personnel;
- developments concerning current or future collaboration, partnership, licensing or other strategic arrangements; and
- discussion of us or our stock price in the financial or scientific press or in online investor communities.

The realization of any of the risks described in these Risk Factors could have a dramatic and material adverse impact on the market price of our Class A common stock. In addition, class action litigation has often been instituted against companies whose securities have experienced periods of volatility. Any such litigation brought against us could result in substantial costs and a diversion of management attention, which could hurt our business, operating results and financial condition.

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**Item 6. Exhibits**

See the Exhibit Index following the signature page to this Quarterly Report on Form 10-Q.



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**SIGNATURES**

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

**Ironwood Pharmaceuticals, Inc.**

Date: November 5, 2015

By: /s/ PETER M. HECHT  
Peter M. Hecht, Ph.D.  
Chief Executive Officer and Director  
*(Principal Executive Officer)*

Date: November 5, 2015

By: /s/ GINA CONSYLMAN  
Gina Consylman  
Vice President, Finance and Chief Accounting Officer  
*(Principal Accounting Officer)*

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**EXHIBIT INDEX**

<b>Exhibit No:</b>	<b>Description</b>
3.1	Eleventh Amended and Restated Certificate of Incorporation. Incorporated by reference to Exhibit 3.1 of Ironwood Pharmaceuticals, Inc. s Annual Report on Form 10-K for the year ended December 31, 2009, filed with the SEC on March 30, 2010.
3.2	Fifth Amended and Restated Bylaws. Incorporated by reference to Exhibit 3.2 of Ironwood Pharmaceuticals, Inc. s Annual Report on Form 10-K for the year ended December 31, 2009, filed with the SEC on March 30, 2010.
31.1*	Certification of Chief Executive Officer pursuant to Rules 13a-14 or 15d-14 of the Exchange Act.
31.2*	Certification of Chief Financial Officer pursuant to Rules 13a-14 or 15d-14 of the Exchange Act.
32.1	Certification of Chief Executive Officer pursuant to Rules 13a-14(b) or 15d-14(b) of the Exchange Act and 18 U.S.C. Section 1350.
32.2	Certification of Chief Financial Officer pursuant to Rules 13a-14(b) or 15d-14(b) of the Exchange Act and 18 U.S.C. Section 1350.
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document.
101.LAB*	XBRL Taxonomy Extension Label Linkbase Database.
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document.
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document.

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\* Filed herewith.

Furnished herewith.