

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

/ X / ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED JUNE 30, 1997.

/ / 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: 0-16159

LECTEC CORPORATION

(Exact name of registrant as specified in its charter)

MINNESOTA

41-1301878

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

10701 RED CIRCLE DRIVE, MINNETONKA, MINNESOTA  
(Address of principal executive offices)

55343  
(Zip Code)

Registrant's telephone number, including area code: (612) 933-2291

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:  
Common Stock, par value \$0.01 per share.

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 [ X ] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein; and will not be contained, to the best of the Registrant's knowledge, in the definitive proxy statement incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

The aggregate market value of the Common Stock held by non-affiliates of the Registrant as of September 19, 1997 was \$17,558,896 based upon the last reported sale price of the Common Stock at that date by the Nasdaq Stock Market.

The number of shares outstanding of the Registrant's Common Stock as of September 19, 1997 was 3,842,818 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of this Annual Report on Form 10-K incorporates by reference information from the Registrant's Proxy Statement for its Annual Meeting of Shareholders to be held November 20, 1997 (1997 Proxy Statement).

PART I

ITEM 1. BUSINESS

GENERAL

LecTec Corporation (the "Company") designs, manufactures and markets resting diagnostic (ECG or "electrocardiograph") electrodes, conductive and non-conductive adhesive hydrogels, medical tapes and patches for the topical application of drugs or other therapeutic compounds. The Company markets its products to medical products distributors, physician clinics, hospital purchasing groups, hospitals, consumers through retail distribution channels, original equipment manufacturers (OEMs) and direct selling groups. All of the products manufactured by the Company are designed to be highly compatible with skin, the largest organ of the human body.

The Company developed one of the first solid gel disposable ECG electrodes, which did not require the use of aqueous conductive gels in order to maintain contact with the skin. The Company has since continued to develop, manufacture and market electrodes as well as hydrogels, medical tapes, topical drug delivery systems, patches and therapeutic products. A hydrogel is a polymer network having an affinity for water and similar materials which is ideal for electrical conductivity and skin compatibility. The Company holds domestic and foreign patents on several products.

The Company, through its research and development efforts, is investigating new systems and products for topical drug delivery, new conductive adhesive hydrogel polymers, medical tapes and wound care treatments, as well as a smoking cessation pill. In addition, existing technologies are being refined for product line extensions and for new markets.

The Company was organized in 1977 as a Minnesota corporation. Its principal executive office is located at 10701 Red Circle Drive, Minnetonka, Minnesota 55343, and its telephone number is (612) 933-2291.

#### PRODUCTS

The Company applies its patented conductive, skin compatible, adhesive hydrogels technology to cardiac diagnostic electrodes. The Company's patented natural and synthetic-based polymers are self-adherent and are capable of being made electrically conductive. Using natural-based polymers, the Company developed one of the first solid gel disposable resting diagnostic ECG electrodes. All of the Company's electrodes are electrically and chemically stable.

All of the Company's skin interface technologies are chemically compatible with human skin, thereby reducing or eliminating skin irritation, reducing damage to the skin as well as the risk of infection. The electrical and adhesive properties and the dimensions of the Company's products are highly consistent and reproducible from product to product because the conductive polymer is in a solid form, different from some of the conductive gels used in competitive products. An integral part of the Company's proprietary technology is the use of environmentally responsible substances and processes in the manufacturing of its products.

#### CONDUCTIVE PRODUCTS

The Company's conductive products include diagnostic electrodes and electrically conductive and non-conductive adhesive hydrogels.

The solid gel design of the Company's electrodes provides more consistent electrical performance and eliminates clean-up time. Currently the Company has three different types of diagnostic electrodes: T-1000 Plus, a disposable electrode made of natural polymer solid gel with gentle adhesion; MP-3000, a synthetic solid gel electrode with aggressive adhesion which meets all AAMI (American Association For Medical Instrumentation) standards including defibrillation recovery; and AG4000, a synthetic solid gel, silver substrate electrode which also meets all AAMI standards including defibrillation recovery.

The Company manufactures synthetic and natural-based hydrogels. The Company pioneered hydrogel technology and developed alternatives to competitors' hydrogels that are resistant to dehydration, evaporation problems and changes in their electrical and physical properties. The Company

also manufactures high quality adhesives used for attaching devices to the body. The hydrogels can be modified to deliver specific medications to the skin for topical use or through the skin for localized and systemic application. The hydrogels also can be manufactured to have various levels of conductivity, with or without self-adhesive properties, for diagnostic electrodes, electrosurgical grounding pads, external pacing and defibrillation electrodes, TENS (Transcutaneous Electronic Nerve Stimulation) products and iontophoretic return electrodes. Sales of conductive products accounted for approximately 63%, 61% and 52% of the Company's total sales for the fiscal years 1997, 1996 and 1995.

#### MEDICAL TAPE PRODUCTS

The Company manufactures and markets hypo-allergenic medical tape products in various individual slit roll widths and in large jumbo rolls for the world market. The Company's medical tape business includes the U.S. healthcare market (hospitals and alternate care segments), the U.S. consumer market and the international healthcare market. Medical tape products manufactured and marketed by the Company are configured in both finished rolls and semi-finished master rolls. The Company's medical tape product line is comprised of the standard paper, plastic and cloth products widely used in the healthcare industry.

The Company offers branded, private label and converter alliance (selling of semi-finished goods to a manufacturer who then converts the goods into a finished product) programs. The Company recently finalized a new LecTec brand strategy which it believes will allow access to several new markets that are not currently being served by the Company through private label distribution channels.

Sales of medical tapes accounted for approximately 25%, 24% and 26% of the Company's total sales for the fiscal years 1997, 1996 and 1995.

#### THERAPEUTIC PRODUCTS

The Company manufactures and markets topical drug delivery patches. The hydrogel-based patch products use a monolithic (single structure adhesive) system that delivers drugs and other therapeutic compounds onto and into the skin. Products currently manufactured using the adhesive-based patch technology are analgesic patches for localized pain relief, wart removers, and a corn and

callus remover. These products are marketed as OTC (over-the-counter) products. Analgesic patches are marketed under the LecTec brand TheraPatch(TM) and through several other marketing partners. Sales of therapeutic products accounted for approximately 12%, 15% and 22% of the Company's total sales for the fiscal years 1997, 1996 and 1995 (see further discussion of therapeutic product sales under Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of this Form 10-K).

#### CUSTOMERS

Burdick Corporation accounted for 19%, 17% and 15% of the Company's total sales for the fiscal years 1997, 1996 and 1995. The Company sold its products to approximately 140 active customers in 1997 and 150 active customers during 1996 and 1995. The Company's backlog orders (purchase orders received from customers for future shipment) as of August 12, 1997 totaled \$1,663,000 (all of which the Company expects to fill in fiscal 1998), compared with approximately \$1,319,000 on August 12, 1996.

#### GOVERNMENTAL AND ENVIRONMENTAL REGULATION

Design development planning, clinical testing, manufacturing, packaging, labeling and distribution of the Company's products are subject to federal (FDA - Food and Drug Administration), state, local and foreign regulation. The Company's electrodes under current FDA policy are marketed pursuant to Section 510(k) notification, which is a means of obtaining FDA clearance to market a medical device. The Company's topical drug products are marketed under the OTC monographs (submission requirements). Any new drug and transdermal new drug development is marketed after approval of a New Drug Application (NDA) containing full reports of detailed laboratory and clinical investigations on laboratory animals and human patients.

The Company does not use solvents in the manufacturing of its products and thus maintains environmental responsibility. The Company does not anticipate any major expenditures for environmental controls during the next fiscal year.

#### COMPETITION

The markets for electrodes, hydrogels, medical tapes, topical drug delivery patches and therapeutic products are highly competitive. Firms in the medical supply industry compete on the basis of product performance, pricing, distribution and service. Many of the Company's major competitors have significantly greater financial, marketing and technological resources than the Company. However, the Company believes that it competes on the basis of proprietary technology and its ability to manufacture and market its products to multiple healthcare market segments.

Over the past several years there has been a number of mergers within the electrode and hydrogel industries, resulting in fewer but larger competitors. The Company has also noted a consolidation of customers and reduction in the number of manufacturers of medical tapes.

The Company's OTC analgesic patch competes with ointments, lotions and creams manufactured by various competitors. Schering Plough (Dr. Scholl's), the major competitor of two of the Company's therapeutic products, an OTC corn and callous remover and an OTC wart remover, holds in excess of 85% U.S. market share for both products.

The Company believes its proprietary technology, customer focus and flexible manufacturing capabilities position it competitively in the U.S. and international markets.

#### PATENTS AND TRADEMARKS

The Company has U.S. and foreign patents on adhesive membranes, electrodes, transdermal and topical delivery systems and tape structures. Twenty-two U.S. patents and fourteen international patents are currently assigned or licensed to the Company. Three U.S. patents were issued to the Company during fiscal 1997. The first two patents cover cotinine's use in aiding smoking cessation. The third patent covers a synthesis or method of producing cotinine. Thirteen U.S. and foreign applications are pending and the Company has an exclusive license to seven other pending applications. The patents most pertinent to the Company's major products have been issued and have a remaining duration in excess of seven years.

Two registrations of trademarks were received in fiscal 1997. Five other trademark registrations are pending, three of which were filed in fiscal 1997.

The Company expects that its products will be subject to continuous modifications due to improvements in materials and rapid technological advances in the market for medical products. Therefore, the Company's continued success does not depend solely upon ownership of patents, but upon technical expertise, creative skills and the ability to forge these talents into the timely release of new products into the marketplace.

The Company uses both patents and trade secrets to protect its proprietary property and information. In addition, the Company monitors

competitive products and patent publications to be aware of potential infringement of its rights.

#### RESEARCH AND DEVELOPMENT

The Company's research and development staff consists of professionals drawn from the business and academic communities with experience in the biological, chemical, pharmaceutical and engineering sciences. The research and development staff is responsible for the investigation, development and implementation of new and approved products and new technologies.

The Company may develop products jointly with corporations and/or with inventors from outside the Company via research and development contracts or other forms of working alliances. Resulting products may then be marketed by the Company, by sponsoring partners or through a marketing

arrangement with an appropriate distributor. Research and development contract opportunities are evaluated on an individual basis.

Research and development resources are being used to fund development of new analgesic patch products, conductive products, medical tapes, specialty wound management products and a cotinine based smoking cessation product.

In November 1996, the Company was informed that the FDA had accepted its IND (Investigational New Drug) submission for cotinine. The Company believes that cotinine is a promising non-nicotine drug for use in treating tobacco withdrawal symptoms. Because of the additional cost associated with the remaining clinical work on cotinine, the Company is actively seeking outside partners to help fund and move this non-nicotine program to completion.

In fiscal years 1997, 1996 and 1995, the Company spent approximately \$1,515,000, \$1,975,000 and \$1,877,000 on research and development.

#### MARKETING AND MARKETING STRATEGY

The Company markets and sells its products to medical products distributors, physician clinic, hospital purchasing organizations, hospitals, consumers through retail partners, original equipment manufacturers (OEMs) and direct selling groups.

The Company recently implemented a proactive marketing and sales strategy to expand its existing customer business relationships and to develop a base of new customers. The Company also recently formalized a balanced distribution strategy, consisting of traditional private label distribution and a new LecTec brand strategy. This balanced approach is designed to increase penetration of current markets, while allowing the Company to move into several highly promising new healthcare markets for its electrode, medical tape and analgesic patch products.

The Company has not experienced any significant seasonality in sales of its products.

The Company sells its products in the U.S., Canada, Europe, Asia, and portions of Latin America. Export sales accounted for 19% of total sales during each of the years ended June 30, 1997 and 1996, and 18% of total sales during the year ended June 30, 1995.

The Company's international sales are made by the Company's corporate sales force. The Company does not maintain a separate international marketing staff or operations. The following table sets forth export sales by geographic area:

	Years ended June 30		
	1997	1996	1995
Canada	\$ 117,966	\$ 80,746	\$ 113,597
Europe	1,456,141	1,652,941	1,171,910
Asia	229,506	466,777	1,122,179
Latin America	484,319	225,440	195,663
Total Export Sales	\$2,287,932	\$2,425,904	\$2,603,349

#### MANUFACTURING

The Company manufactures its conductive and therapeutic membranes at the Company's Minnetonka, Minnesota facility. The Minnetonka facility also manufactures and packages the Company's therapeutic products and conducts raw material processing operations. The Company's second manufacturing facility in Edina, Minnesota is the primary site for the manufacturing and packaging of medical tape and diagnostic electrodes. The Edina location also provides the majority of the Company's warehouse capacity.

The Company believes that the raw materials used in manufacturing its products are generally available from multiple suppliers.

## EMPLOYEES

As of June 30, 1997, the Company employed 72 full-time employees. None of the Company's employees are represented by any labor unions or other collective bargaining units. The Company believes relations with its employees are good.

## PHARMADYNE CORPORATION AND RESTRUCTURING CHARGE

During 1993, the Company invested \$175,000 in Pharmadyne Corporation, which represented a 19.5% ownership interest in Pharmadyne. The investment was recorded at cost. During 1994, the Company purchased additional shares of Pharmadyne common stock for \$183,000 and increased the Company's ownership to 51%. The acquisition was accounted for as a purchase and the acquired goodwill of approximately \$590,000 was fully amortized on a straight-line basis over three years.

During 1996 the Company made advances to Pharmadyne and received a warrant to purchase 227,959 additional shares of Pharmadyne at \$1 per share. On September 5, 1996 the Company exercised the warrant and increased its ownership interest in Pharmadyne to 61%.

During 1997, the Company adopted a plan for eliminating the Pharmadyne subsidiary and recorded a nonrecurring restructuring charge of \$2,180,000. The restructuring charge included approximately \$1,369,000 for the planned acquisition of the minority interests in Pharmadyne in exchange for newly issued shares of LecTec Corporation common stock, \$480,000 for the write-off of Pharmadyne's 15% interest in Natus, L.L.C., an Arizona-based direct marketing company, and \$331,000 for completion of restructuring activities, consisting primarily of fees for professional services. The Pharmadyne restructuring plan is expected to enable the Company to execute a broad-based, strategic marketing plan to increase pain patch sales by reaching end-users through multiple channels of distribution including retail outlets, clinics, nursing homes, hospitals and other healthcare providers. Going forward the Company should also benefit from a more efficient and lower-cost distribution system. The Company expects to complete the restructuring during fiscal 1998.

## EXECUTIVE OFFICERS OF THE REGISTRANT

Name	Age	Title
Rodney A. Young	42	Chairman, Chief Executive Officer and President
Deborah L. Moore	40	Chief Financial Officer and Secretary
Jane M. Nichols	51	Vice President, Marketing and New Business Development
Daniel M. McWhorter	57	Vice President, Research and Development
Robert A. Eno	42	Vice President, Operations

Rodney A. Young is Chairman, Chief Executive Officer and President. He joined the Company in August, 1996. Mr. Young has 19 years of medical industry experience in sales and marketing for Upjohn Company and 3M and was most recently Vice President and General Manager of the Specialized Distribution Division of Baxter International, Inc.

Deborah L. Moore is Chief Financial Officer and Secretary. She joined the Company in February, 1997. Ms. Moore's 20-year professional background includes public accounting with the big six firms of Ernst & Young LLP and Deloitte & Touche LLP and was most recently the Vice President of Corporate Development for Varitronic Systems, Inc.

Jane M. Nichols is Vice President, Marketing and New Business Development. She joined the Company in April, 1997. Ms. Nichol's 25-year career includes clinical, technical and management roles at Methodist Hospital and Park Nicollet Medical Centers, and senior marketing positions at 3M and Ecolab.

Daniel M. McWhorter is Vice President, Research and Development. He joined the Company in January, 1997. Mr. McWhorter has more than 25 years of experience in the medical products industry

including both technical and general management positions at The Kendall Company and Pharmacia Deltec and senior technical positions at Abbott Laboratories and Mentor Corporation.

Robert A. Eno is Vice President, Operations. He joined the Company in September, 1997. Mr. Eno has had 19 years of industrial and manufacturing engineering and operations management experience at St. Jude Medical Inc., ADC Telecommunications Inc., Paco Corporation and Eaton Corporation.

## ITEM 2. PROPERTIES

The Company owns a building located in Minnetonka, Minnesota, containing 18,000 square feet of office and laboratory space and 12,000 square feet of manufacturing and warehouse space. In addition, the Company leases a building in Edina, Minnesota containing 29,000 square feet.

## ITEM 3. LEGAL PROCEEDINGS

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

The Company's common stock trades on the Nasdaq National Market tier of The Nasdaq Stock Market ("Nasdaq") under the symbol LECT.

The following table sets forth the high and low daily trade price information for the Company's common stock for each quarter of fiscal 1997 and 1996. Such prices reflect interdealer prices, without retail mark-up, mark-down, or commission, and may not necessarily represent actual transactions.

YEARS ENDED JUNE 30,	1997		1996	
	HIGH	LOW	HIGH	LOW
First Quarter	\$13.500	\$8.500	\$12.250	\$8.500
Second Quarter	9.500	5.500	13.250	8.750
Third Quarter	8.500	5.000	12.000	9.750
Fourth Quarter	7.000	4.875	16.000	9.875

As of September 19, 1997 the Company had 3,842,818 shares of common stock outstanding, and 377 common shareholders of record which does not include beneficial owners whose shares were held of record by nominees or broker dealers.

The Company has not declared or paid cash dividends on its common stock since its inception, and intends to retain all earnings for use in its business for the foreseeable future.

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

<TABLE>  
<CAPTION>

STATEMENT OF OPERATIONS DATA

Years ended June 30,	1997	1996	1995	1994	1993
<S>	<C>	<C>	<C>	<C>	<C>
Net sales	\$12,256,327	\$13,100,754	\$14,138,290	\$10,715,490	\$ 9,224,005
Gross profit	4,324,180	4,969,659	5,697,562	4,041,853	3,434,128
Earnings (loss) from operations	(2,215,951) *	(724,074)	69,761	837,161	750,335
Earnings (loss) before equity in losses of unconsolidated subsidiary	(2,140,660) *	(632,193)	153,863	768,974	745,282
Equity in losses of unconsolidated subsidiary	126,067	--	--	133,639	163,442
Net earnings (loss)	(2,266,727) *	(632,193)	153,863	635,335	581,840
Net earnings (loss) per common and common equivalent share	(.59) *	(.17)	.04	.17	.15

BALANCE SHEET DATA

At June 30,	1997	1996	1995	1994	1993
Cash, cash equivalents and short-term investments	\$ 1,242,777	\$ 800,693	\$ 839,942	\$ 2,182,570	\$ 3,469,632
Current assets	6,873,696	5,624,682	5,764,363	6,124,640	6,082,934
Working capital	4,035,084	4,240,024	4,490,796	4,737,567	5,471,894
Property, plant and equipment, net	4,592,304	5,112,975	5,559,807	4,705,602	3,016,761
Long-term investments	8,013	574,806	568,156	585,855	1,195,922
Total assets	11,837,356	12,494,003	12,646,745	12,363,075	10,876,068
Long-term liabilities	211,000	174,000	167,000	139,000	64,000
Shareholders' equity	8,787,744	10,935,345	11,206,178	10,837,002	10,201,028

</TABLE>

\* Includes a nonrecurring restructuring charge of \$2,180,353 or \$.57 per share.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS  
NET SALES

Net sales were \$12,256,000 in 1997, a decrease of 6% from net sales of \$13,101,000 in 1996. Net sales were \$14,138,000 in 1995. The decrease in 1997 net sales was due primarily to the absence of direct marketing sales for the entire 1997 fiscal year. While there were no direct marketing sales in fiscal 1997, such sales totaled \$1,410,000 or 10.8% of total net sales in fiscal 1996. The Company's Pharmadyne Corporation subsidiary divested of its direct marketing related assets near the end of the third quarter of fiscal 1996. In 1997, the absence of direct marketing therapeutic product sales was partially offset by an increase in the volume of therapeutic products sold through indirect distribution channels. Net sales of conductive products and medical tape products each decreased by 3% in 1997 from the prior year.

The decrease in net sales for 1996 from 1995 was primarily attributable to decreased therapeutic product sales resulting from the divestiture of direct marketing related assets in the third quarter of fiscal 1996. Additionally, medical tape sales decreased by \$508,000 offset by an increase of \$606,000 in conductive product sales.

Net sales of conductive products (medical electrodes and conductive hydrogels) decreased by 3% in 1997 to \$7,714,000 from \$7,940,000 in 1996. Conductive product net sales were \$7,334,000 in 1995. These fluctuations in sales were primarily volume-related. The Company expects to maintain or increase fiscal 1997 levels of conductive sales in fiscal 1998.

Net sales of medical tapes decreased by 3% in 1997 to \$3,093,000 from \$3,180,000 in 1996. Medical tape net sales were \$3,688,000 in 1995. The decrease in 1997 was primarily attributable to the absence of an order from an international customer whose business fluctuates annually. Excluding sales to this international customer, medical tape sales to all other customers increased by 7% in 1997. This increase was primarily the result of increased sales volume. The decrease in 1996 from 1995 was primarily attributable to reduced sales volume to the international customer which more than offset the increased sales volume associated with new product offerings. The Company expects to maintain or increase fiscal 1997 levels of medical tape product sales in fiscal 1998.

Net sales of therapeutic products decreased 27% in 1997 to \$1,449,000 from \$1,981,000 in 1996. Therapeutic product net sales were \$3,116,000 in fiscal 1995. The decrease in 1997 was primarily due to the absence of Pharmadyne direct marketing sales for the entire 1997 fiscal year as compared to the inclusion of direct marketing sales for the first three quarters of fiscal 1996 which totaled \$1,410,000. The absence of direct marketing sales beginning in the fourth quarter of 1996 resulted from the divestiture of Pharmadyne's direct marketing related assets near the end of the third quarter of 1996. The decrease in 1996 net sales compared to 1995 net sales was primarily attributable to the decrease in the third quarter and the absence in the fourth quarter of the Pharmadyne direct marketing related sales. Management believes that sales of the Company's therapeutic pain patch product will represent an increased percentage of total net sales during fiscal 1998 due to the addition of professional sales management personnel and increased marketing activities.

International sales, consisting primarily of semi-finished conductive and medical tape products sold to overseas converters for final processing, packaging and marketing, were 19% of total net sales in 1997 and 1996, and 18% in 1995. The Company expects fiscal 1998 international sales to be comparable to fiscal 1997 sales levels.

GROSS PROFIT

The Company's gross profit was \$4,324,000 in 1997, down from \$4,970,000 in 1996. Gross profit was \$5,698,000 in 1995. As a percentage of net sales, gross profit was 35.3% in 1997, 37.9% in 1996 and 40.3% in 1995. In 1997, the decrease in the gross profit percent resulted primarily from the absence of higher margin direct marketing related sales and increased inventory obsolescence costs which were partially offset by decreased material and labor costs for conductive products. In 1996, the decrease in the gross profit percent was primarily attributable to decreased sales of higher margin therapeutic products and increased overhead costs.

While direct marketing sales carried higher gross margins than sales made through the Company's indirect distribution channels, the selling, general and administrative costs associated with the direct marketing operation were substantially greater than the costs required to support sales through indirect distribution. The higher operating expenses of the direct marketing organization more than offset the higher gross margins associated with those sales.

#### SELLING, GENERAL AND ADMINISTRATIVE (SG&A) EXPENSES

Selling, general and administrative expenses totaled \$2,845,000 or 23.2% of net sales in 1997, compared to \$3,718,000 or 28.4% of net sales in 1996, and \$3,751,000 or 26.5% of net sales in 1995. The 1997 decrease was primarily due to the absence of the direct marketing expenses of the Pharmadyne subsidiary during all of 1997 as compared to 1996 which included direct marketing expenses for the first three quarters. The 1997 decrease was partially offset by increased administrative expenses associated with hiring a new executive staff, and separation costs associated with former executives. The 1996 decrease was primarily due to the absence of costs in the fourth quarter from direct marketing related operations. The Company anticipates SG&A expenses in fiscal 1998 will be comparable to fiscal 1997.

#### RESEARCH AND DEVELOPMENT (R&D) EXPENSES

Research and development expenses totaled \$1,515,000 or 12.4% of net sales in 1997, compared to \$1,975,000 or 15.1% of net sales in 1996, and \$1,877,000 or 13.3% of net sales in 1995. The high levels of R&D expenditures over this three-year period reflect the utilization of internally-generated funds to develop additional therapeutic products and a new cotinine-based product. The decrease in 1997 R&D expense was primarily due to decreased labor costs and decreased cotinine related expenses. Substantially all of the dollar increase in R&D during fiscal 1996 was associated with clinical studies for a non-nicotine cotinine-based smoking cessation product. R&D resources are also being used to fund development of new analgesic patch products, conductive products and specialized medical tapes. Management believes that R&D expenditures, as a percentage of net sales, will be in the range of 10% to 12% for the immediate future.

#### RESTRUCTURING CHARGE

During 1997 the Company recorded a nonrecurring restructuring charge of \$2,180,000 related to its plan for eliminating the Pharmadyne Corporation subsidiary. The restructuring charge included approximately \$1,369,000 for the planned acquisition of the minority interests in Pharmadyne in exchange for newly issued shares of LecTec Corporation common stock, \$480,000 for the write-off of Pharmadyne's 15% interest in Natus, L.L.C., an Arizona-based direct marketing company, and \$331,000 for the completion of restructuring activities, consisting primarily of fees for professional services. The Company expects to complete the restructuring during fiscal 1998.

#### OTHER INCOME (EXPENSE)

Other income totaled \$75,000 in 1997, up from \$54,000 in 1996 and \$73,000 in 1995. The increase in 1997 resulted primarily from a gain on the sale of equipment. In 1996 the decline resulted primarily from a reduction of interest income due to the liquidation of short-term investments during 1995.

#### INCOME TAX

The Company recorded no income tax expense or benefit in 1997, compared to an income tax benefit of \$38,000 in 1996 and a benefit of \$11,000 in 1995. There was no income tax benefit recorded during 1997 due primarily to the effect of the non-deductible restructuring charge. The tax benefit in 1996 resulted from losses incurred in 1996 reduced by the effect of the subsidiary losses which could not be utilized by the Company at that time and the effect of goodwill amortization. The tax benefit in 1995 was primarily attributable to R&D tax credits and alternative minimum tax credits.

#### EQUITY IN LOSSES OF UNCONSOLIDATED SUBSIDIARY

On March 12, 1996, the Company contributed the direct marketing related assets of the Pharmadyne Corporation to Natus L.L.C. (an Arizona limited liability company) in exchange for a 15%

interest in Natus L.L.C. This investment was accounted for using the equity method. During 1997 the Company recorded \$126,000 of equity in the losses of Natus L.L.C. The remaining investment in Natus L.L.C. of \$480,100 was fully written off in 1997 as part of the \$2,180,000 restructuring charge.

#### EARNINGS SUMMARY

The restructuring charge of \$2,180,000 or \$.57 per share was the primary component of the total net loss in 1997 of \$2,267,000 or \$.59 per share. Excluding the impact of this one-time charge, the loss for 1997 was \$87,000 or \$.02 per share. The net loss in 1996 was \$632,000 or \$.17 per share compared to net earnings of \$154,000 or \$.04 per share in 1995. The largest components of the net loss for fiscal 1996 were the losses associated with the direct marketing related operations of the Pharmadyne Corporation subsidiary and increased R&D expense.

#### EFFECT OF INFLATION

Inflation has not had a significant impact on the Company as it has generally been able to adjust its selling prices as the costs of materials and other expenses have changed.

#### LIQUIDITY AND CAPITAL RESOURCES



Cash and cash equivalents decreased by \$136,000 to \$665,000 at June 30, 1997 from \$801,000 at June 30, 1996. Short and long-term investments increased by \$11,000 to \$586,000 at June 30, 1997 from \$575,000 at June 30, 1996. Capital spending for various equipment totaled \$187,000 in 1997. There were no material commitments for capital expenditures at June 30, 1997.

Working capital totaled \$4,035,000 at June 30, 1997, compared to \$4,240,000 at the end of fiscal 1996. The Company's current ratio was 2.4 at June 30, 1997 compared to 4.1 at June 30, 1996. Excluding the accrued restructuring charge, the Company's current ratio at June 30, 1997 was 5.2. Increased raw material inventory levels due to increased supplier purchase quantity requirements and investments reclassified as short-term were significant factors impacting the current ratio at June 30, 1997 as well.

Net property, plant and equipment decreased by \$521,000 to \$4,592,000 at June 30, 1997 from \$5,113,000 at June 30, 1996, reflecting the excess of depreciation expense over additions.

The Company has no short or long-term debt. During August 1997 the Company obtained an unsecured \$1,000,000 working capital line of credit which expires in September 1998. The previous working capital line of credit expired January 1, 1997. There were no borrowings outstanding under the previous line of credit as of June 30, 1996, nor during fiscal year 1997. Shareholders' equity decreased by \$2,147,000 to \$8,788,000 as of June 30, 1997 from \$10,935,000 as of June 30, 1996, primarily due to the impact of the \$2,180,000 restructuring charge.

Management believes that internally-generated cash-flow and the existing short-term line of credit will be sufficient to support anticipated operating and capital spending requirements during fiscal 1998.

#### FORWARD-LOOKING STATEMENTS

From time to time, in reports filed with the Securities and Exchange Commission, in press releases, and in other communications to shareholders or the investment community, the Company may provide forward-looking statements concerning possible or anticipated future results of operations or business developments which are typically preceded by the words "believes", "expects", "anticipates", "intends", "will", "may", "should" or similar expressions. Such forward-looking statements are subject to risks and uncertainties which could cause results or developments to differ materially from those indicated in the forward-looking statements. Such risks and uncertainties include, but are not limited to, the buying patterns of major customers; competitive forces including new products or pricing pressures; costs associated with and acceptance of the Company's new brand strategy; impact of interruptions to production; dependence on key personnel; need for regulatory approvals; changes in governmental regulatory requirements or accounting pronouncements; and ability to satisfy funding requirements for operating needs, expansion or capital expenditures.

#### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

LecTec Corporation and Subsidiaries Financial Statements Furnished Pursuant to the Requirements of Form 10-K.

#### REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Shareholders and  
Board of Directors  
LecTec Corporation

We have audited the accompanying consolidated balance sheets of LecTec Corporation and subsidiaries as of June 30, 1997 and 1996, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended June 30, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of LecTec Corporation and subsidiaries as of June 30, 1997 and 1996, and the consolidated results of their operations and their consolidated cash flows for each of the three years in the period ended June 30, 1997, in conformity with generally accepted accounting principles.

## GRANT THORNTON LLP

Minneapolis, Minnesota  
August 22, 1997

## LECTEC CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

June 30

ASSETS	1997	1996
<b>CURRENT ASSETS</b>		
Cash and cash equivalents (note A)	\$ 665,190	\$ 800,693
Short-term investments (note A)	577,587	--
Receivables		
Trade, net of allowances of \$67,126 in 1997 and \$74,208 in 1996	2,178,984	1,847,736
Refundable income taxes	401,263	375,580
Other	22,780	182,247
	2,603,027	2,405,563
Inventories (note A)	2,577,021	2,011,327
Prepaid expenses and other	84,871	123,099
Deferred income taxes (note D)	366,000	284,000
<b>Total current assets</b>	<b>6,873,696</b>	<b>5,624,682</b>
<b>PROPERTY, PLANT AND EQUIPMENT - AT COST</b> (note A)		
Building and improvements	1,635,157	1,629,630
Equipment	6,578,960	6,414,132
Furniture and fixtures	371,670	354,985
	8,585,787	8,398,747
Less accumulated depreciation	4,241,214	3,533,503
	4,344,573	4,865,244
Land	247,731	247,731
	4,592,304	5,112,975
<b>OTHER ASSETS</b>		
Patents and trademarks, less accumulated amortization of \$846,914 in 1997 and \$687,871 in 1996 (note A)	363,343	417,681
Goodwill, less accumulated amortization of \$590,000 in 1997 and \$442,503 in 1996 (notes A and G)	--	147,497
Long-term investments (note A)	8,013	574,806
Investment in limited liability company (note H)	--	606,167
Other	--	10,195
	371,356	1,756,346
	<b>\$11,837,356</b>	<b>\$12,494,003</b>

The accompanying notes are an integral part of these statements.

## LECTEC CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS - CONTINUED

June 30

LIABILITIES AND SHAREHOLDERS' EQUITY	1997	1996
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 779,699	\$ 894,846
Accrued expenses		
Payroll related	324,381	304,527
Restructuring charge (note G)	1,521,107	--
Other	213,425	185,285
<b>Total current liabilities</b>	<b>2,838,612</b>	<b>1,384,658</b>
<b>DEFERRED INCOME TAXES (note D)</b>	<b>211,000</b>	<b>174,000</b>

## COMMITMENTS AND CONTINGENCIES

## SHAREHOLDERS' EQUITY (note F)

Common stock, \$.01 par value; 15,000,000 shares authorized; issued and outstanding: 3,842,800 shares in 1997 and 3,835,800 shares in 1996	38,428	38,358
Additional paid-in capital	10,476,428	10,368,166
Unrealized losses on securities available-for-sale (note A)	(33,372)	(44,166)
Retained earnings (deficit)	(1,693,740)	572,987
	-----	-----
	8,787,744	10,935,345
	-----	-----
	\$11,837,356	\$12,494,003
	=====	=====

The accompanying notes are an integral part of these statements.

## LECTEC CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

&lt;TABLE&gt;

&lt;CAPTION&gt;

Years ended June 30

	1997	1996	1995
<S>	<C>	<C>	<C>
Net sales (notes A and I)	\$ 12,256,327	\$ 13,100,754	\$ 14,138,290
Cost of goods sold	7,932,147	8,131,095	8,440,728
	-----	-----	-----
Gross profit	4,324,180	4,969,659	5,697,562
Operating expenses			
Selling, general and administrative	2,844,618	3,718,496	3,751,194
Research and development	1,515,160	1,975,237	1,876,607
Restructuring charge (note G)	2,180,353	--	--
	-----	-----	-----
	6,540,131	5,693,733	5,627,801
	-----	-----	-----
Earnings (loss) from operations	(2,215,951)	(724,074)	69,761
Other income (expense)			
Interest income	22,150	26,554	35,846
Dividend income	37,610	38,029	38,487
Other	15,531	(10,702)	(1,231)
	-----	-----	-----
	75,291	53,881	73,102
	-----	-----	-----
Earnings (loss) before income taxes and equity in losses of unconsolidated subsidiary	(2,140,660)	(670,193)	142,863
Income tax benefit (note D)	--	(38,000)	(11,000)
	-----	-----	-----
Earnings (loss) before equity in losses of unconsolidated subsidiary	(2,140,660)	(632,193)	153,863
Equity in losses of unconsolidated subsidiary (note H)	126,067	--	--
	-----	-----	-----
Net earnings (loss)	\$ (2,266,727)	\$ (632,193)	\$ 153,863
	=====	=====	=====
Net earnings (loss) per common and common equivalent share (note A)	\$ (.59)	\$ (.17)	\$ .04
	=====	=====	=====
Weighted average number of common and common equivalent shares outstanding during the year	3,836,618	3,801,155	3,826,905
	=====	=====	=====

&lt;/TABLE&gt;

The accompanying notes are an integral part of these statements.

## LECTEC CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

YEARS ENDED JUNE 30, 1997, 1996 AND 1995

&lt;TABLE&gt;

<CAPTION>

	Common stock		Additional paid-in capital	Unrealized losses on securities available- for-sale	Retained earnings (deficit)	Total shareholders' equity
	Shares	Amount				
<S>	<C>	<C>	<C>	<C>	<C>	<C>
Balance, June 30, 1994	3,757,000	\$ 37,570	\$ 9,809,079	\$ (60,964)	\$ 1,051,317	\$ 10,837,002
Net earnings	--	--	--	--	153,863	153,863
Cost of shares retired	(2,102)	(21)	(17,330)	--	--	(17,351)
Common stock issued upon exercise of options (note F)	31,602	316	162,200	--	--	162,516
Unrealized gain on securities available-for-sale (note A)	--	--	--	10,148	--	10,148
Tax benefit from exercise of stock options	--	--	60,000	--	--	60,000
Balance, June 30, 1995	3,786,500	37,865	10,013,949	(50,816)	1,205,180	11,206,178
Net loss	--	--	--	--	(632,193)	(632,193)
Cost of shares retired	(16,281)	(163)	(184,319)	--	--	(184,482)
Common stock issued upon exercise of options (note F)	65,581	656	450,536	--	--	451,192
Unrealized gain on securities available-for-sale (note A)	--	--	--	6,650	--	6,650
Tax benefit from exercise of stock options	--	--	88,000	--	--	88,000
Balance, June 30, 1996	3,835,800	38,358	10,368,166	(44,166)	572,987	10,935,345
Net loss	--	--	--	--	(2,266,727)	(2,266,727)
Cost of shares retired	(8,278)	(83)	(54,023)	--	--	(54,106)
Common stock issued upon exercise of options (note F)	15,278	153	51,690	--	--	51,843
Unrealized gain on securities available-for-sale (note A)	--	--	--	10,794	--	10,794
Investment by Pharmadyne minority shareholders	--	--	83,595	--	--	83,595
Tax benefit from exercise of stock options	--	--	27,000	--	--	27,000
Balance, June 30, 1997	3,842,800	\$ 38,428	\$ 10,476,428	\$ (33,372)	\$ (1,693,740)	\$ 8,787,744

</TABLE>

The accompanying notes are an integral part of these statements.

LECTEC CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS

<TABLE>

<CAPTION>

Years ended June 30

	1997	1996	1995
<S>	<C>	<C>	<C>
Cash flows from operating activities:			
Net earnings (loss)	\$ (2,266,727)	\$ (632,193)	\$ 153,863
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:			
Restructuring charge	2,180,353	--	--
Depreciation and amortization	1,014,251	1,128,103	932,051
Deferred income taxes	(45,000)	65,000	(149,000)
Equity in losses of unconsolidated subsidiary	126,067	--	--
Changes in operating assets and liabilities:			
Trade and other receivables	(171,781)	161,057	(410,006)
Refundable income taxes	(25,683)	(256,040)	109,714
Inventories	(565,694)	(298,803)	(325,219)
Prepaid expenses and other	38,228	(29,011)	(128,059)
Accounts payable	(31,552)	123,375	(189,057)
Accrued expenses	(104,152)	(12,284)	83,770
Net cash provided by operating activities	148,310	249,204	78,057
Cash flows from investing activities:			
Purchase of property, plant and equipment	(187,040)	(430,956)	(1,471,427)
Investment in patents and trademarks	(104,705)	(164,796)	(141,665)
Purchase of investments	--	--	(249,603)
Sale of investments	--	--	1,674,250
Other	10,195	40,589	19,395

Net cash used in investing activities	(281,550)	(555,163)	(169,050)
Cash flows from financing activities:			
Issuance of common stock	51,843	451,192	162,516
Retirement of common stock	(54,106)	(184,482)	(17,351)
	-----	-----	-----
Net cash provided by (used in) financing activities	(2,263)	266,710	145,165
	-----	-----	-----
Net increase (decrease) in cash and cash equivalents	(135,503)	(39,249)	54,172
Cash and cash equivalents at beginning of year	800,693	839,942	785,770
	-----	-----	-----
Cash and cash equivalents at end of year	\$ 665,190	\$ 800,693	\$ 839,942
	=====	=====	=====
Supplemental disclosures:			
Cash paid during the year for interest	\$ 6,189	\$ --	\$ --
	=====	=====	=====
Cash paid during the year for income taxes	\$ 6,000	\$ 33,199	\$ 137,922
	=====	=====	=====

</TABLE>

The accompanying notes are an integral part of these statements.

LECTEC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED JUNE 30, 1997, 1996 AND 1995

NOTE A - SUMMARY OF ACCOUNTING POLICIES

LectTec Corporation (the Company) is primarily engaged in the research, design, manufacture and sale of diagnostic electrodes, conductive hydrogels, medical tapes and therapeutic products. The Company sells and extends credit without collateral to customers located throughout the United States as well as Canada, Europe, Asia and Latin America. A summary of the Company's significant accounting policies consistently applied in the preparation of the accompanying financial statements follows:

1. Basis of Financial Statement Presentation

The consolidated financial statements include the accounts of LectTec Corporation ("LectTec"), LectTec International Corporation, a wholly-owned subsidiary, and Pharmadyne Corporation, a 61% owned subsidiary (note G). All material intercompany accounts and transactions have been eliminated. The Company also has a 15% investment in an unconsolidated subsidiary (note H).

2. Cash and Cash Equivalents

The Company considers all highly liquid temporary investments with an original maturity of three months or less to be cash equivalents. Cash equivalents consist primarily of money market accounts.

3. Investments

The Company's investments are classified as available-for-sale, consist primarily of a preferred stock fund classified as short-term at June 30, 1997 and long-term at June 30, 1996 and are reported at fair value. The Company utilizes the specific identification method in computing realized gains and losses.

LECTEC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

YEARS ENDED JUNE 30, 1997, 1996 AND 1995

NOTE A - SUMMARY OF ACCOUNTING POLICIES - Continued

4. Inventories

Inventories are stated at the lower of cost (determined on a first-in, first-out basis) or market and consist of the following:

June 30	
-----	-----
1997	1996
-----	-----

Raw materials	\$1,655,924	\$1,144,078
Work in process	184,208	229,974
Finished goods	736,889	637,275
	-----	-----
	\$2,577,021	\$2,011,327
	=====	=====

#### 5. Depreciation and Amortization

Depreciation is provided in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives. The straight-line method of depreciation is followed for financial reporting purposes, and accelerated methods are used for tax purposes. Estimated useful lives used in the calculation of depreciation for financial statement purposes are:

Buildings and improvements	5 - 40 years
Equipment	4 - 15 years
Furniture and fixtures	5 - 7 years

The investment in patents and trademarks consists primarily of the cost of applying for patents and trademarks. Patents and trademarks are amortized on a straight-line basis over the estimated useful life of the asset, generally three to five years.

Goodwill represents the excess of cost over the fair value of net assets acquired and was amortized on a straight-line basis over three years.

#### 6. Revenue Recognition

Sales are recognized at the time of shipment of product against a confirmed sales order.

### LECTEC CORPORATION AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

YEARS ENDED JUNE 30, 1997, 1996 AND 1995

#### NOTE A - SUMMARY OF ACCOUNTING POLICIES - Continued

#### 7. Net Earnings (Loss) Per Common and Common Equivalent Share

Net earnings (loss) per common and common equivalent share have been computed by dividing net earnings (loss) by the weighted average number of common and common equivalent shares outstanding during the years. Common equivalent shares included in the computation represent shares issuable upon the assumed exercise of stock options, when dilutive.

#### 8. Use of Estimates

In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### 9. Reclassifications

Certain 1996 amounts have been reclassified to conform to the 1997 financial statement presentation.

#### 10. New Accounting Pronouncements

The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) 128, "Earnings Per Share," which is effective for financial statements issued after December 15, 1997. Early adoption of the new standard is not permitted. The new standard eliminates primary and fully diluted earnings per share and requires presentation of basic and diluted earnings per share together with disclosure of how the per share amounts were computed.

### LECTEC CORPORATION AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

YEARS ENDED JUNE 30, 1997, 1996 AND 1995

#### NOTE A - SUMMARY OF ACCOUNTING POLICIES - Continued

In June 1997, the FASB issued SFAS 130, "Reporting Comprehensive Income," and SFAS 131, "Disclosures about Segments of an Enterprise and Related Information," which are effective for fiscal year 1999. SFAS 130 will require the Company to display an amount representing total comprehensive income, as defined by the statement, as part of the Company's basic financial statements. Comprehensive income will include items such as unrealized gains or losses on certain

investment securities. SFAS 131 will require the Company to disclose financial and other information about its business segments, their products and services, geographic areas, major customers, sales, profits, assets and other information.

The adoption of these statements is not expected to have a material effect on the consolidated financial statements of the Company.

**NOTE B - LINE OF CREDIT**

The Company's unsecured \$1,000,000 working capital line of credit expired on January 1, 1997 and during August 1997 the Company entered into an unsecured \$1,000,000 working capital line of credit which expires September 1998. Interest is at the bank's reference rate (effective rate of 8.5% at June 30, 1997). There were no borrowings outstanding on the previous line of credit as of June 30, 1996, nor during fiscal 1997. The new credit agreement contains certain restrictive covenants which require the Company to maintain, among other things, specified levels of working capital and net worth and certain financial ratios.

**NOTE C - COMMITMENTS AND CONTINGENCIES**

The Company conducts portions of its operations in a leased facility. The lease provides for payment of a portion of taxes and other operating expenses by the Company.

**LECTEC CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**YEARS ENDED JUNE 30, 1997, 1996 AND 1995**

**NOTE C - COMMITMENTS AND CONTINGENCIES - Continued**

The minimum rental commitments under all operating leases are as follows for the years ending June 30:

1998	\$ 239,230
1999	222,576
2000	228,439
2001	233,140
2002	240,209
Thereafter	-
	-----
	\$1,163,594
	=====

Total rent expense for operating leases was \$224,849, \$219,095 and \$223,147 for the years ended June 30, 1997, 1996 and 1995.

The Company is subject to various legal proceedings in the normal course of business. Management believes these proceedings will not have a material adverse effect on the Company's financial position or results of operations.

**NOTE D - INCOME TAXES**

The provision for income tax expense (benefit) consists of the following:

	Years ended June 30		
	1997	1996	1995
	-----	-----	-----
Current			
Federal	\$ 43,000	\$ (17,000)	\$ 136,000
State	2,000	2,000	2,000
	-----	-----	-----
	45,000	(15,000)	138,000
Deferred			
Federal	(45,000)	(23,000)	(149,000)
State	-	-	-
	-----	-----	-----
	(45,000)	(23,000)	(149,000)
	-----	-----	-----
	\$ -	\$ (38,000)	\$ (11,000)
	=====	=====	=====

**LECTEC CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**YEARS ENDED JUNE 30, 1997, 1996 AND 1995**

**NOTE D - INCOME TAXES - Continued**

Deferred tax assets and liabilities represent the tax effects, based upon current tax law, of cumulative future deductible or taxable items that have been

recognized in the financial statements as follows:

	June 30	
	1997	1996
<i>Deferred current assets and liabilities:</i>		
Net operating loss carryforwards	\$ 848,800	\$ 481,200
Tax credit carryforwards	260,000	207,100
Inventory capitalization and reserve	124,800	79,200
Vacation pay accrual	37,800	36,100
Other	4,400	7,400
	1,275,800	811,000
Valuation allowance	(909,800)	(527,000)
	\$ 366,000	\$ 284,000
<i>Deferred long-term assets and liabilities:</i>		
Tax depreciation in excess of book depreciation	\$(293,100)	\$(278,300)
Charitable contribution carryforwards	64,400	57,100
Other	46,400	47,200
	(182,300)	(174,000)
Valuation allowance	(28,700)	-
	\$ (211,000)	\$ (174,000)

At June 30, 1997, Pharmadyne has available net operating loss carryforwards of approximately \$1,900,000 which can be used to reduce future taxable income. These carryforwards begin to expire in 2007 and cannot be utilized to offset taxable income of LectTec. The utilization of a portion of these net operating loss carryforwards by Pharmadyne is restricted under Section 382 of the Internal Revenue Code due to past ownership changes. A valuation allowance has been recorded for these net operating loss carryforwards as they may not be realizable.

#### LECTEC CORPORATION AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

YEARS ENDED JUNE 30, 1997, 1996 AND 1995

#### NOTE D - INCOME TAXES - Continued

At June 30, 1997, LectTec has available tax credit carryforwards of approximately \$260,000 which can be used to reduce future tax liabilities. These carryforwards begin to expire in 2008. LectTec also has available a net operating loss carryforward of approximately \$594,000, which can be used to reduce future taxable income of LectTec. This carryforward expires in 2011.

A valuation allowance has also been recorded for a portion of LectTec's deferred tax assets as they may not be fully realizable.

Differences between income tax expense (benefit) and the statutory federal income tax rate of 34% are as follows:

	1997	1996	1995
Federal statutory income tax rate	(34.0)%	(34.0)%	34.0 %
State income taxes, net of federal benefit	0.1	0.2	0.1
Nondeductible restructuring charge	34.6	-	-
Tax credits	-	-	(74.7)
Foreign sales corporation	(2.1)	(5.5)	(24.9)
Subsidiary loss producing no benefit	.6	25.7	29.9
Tax exempt investment income	(0.8)	(0.8)	(14.7)
Goodwill amortization	2.3	10.0	46.8
Prior years' overaccruals	-	-	(4.8)
Other	(.7)	(1.3)	.6
	- %	(5.7)%	(7.7)%

#### NOTE E - EMPLOYEE BENEFIT PLANS

The Company has a profit sharing benefit plan covering substantially all employees who have completed one year of service. The Company's contributions are discretionary as determined by the Board of Directors, subject to certain limitations under the Internal Revenue Code. Pension expense under this plan was \$55,585 for the year ended June 30, 1995. No contributions were made to the plan for the years ended June 30, 1997 and 1996.



## LECTEC CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

YEARS ENDED JUNE 30, 1997, 1996 AND 1995

## NOTE E - EMPLOYEE BENEFIT PLANS - Continued

The Company has a profit sharing bonus plan covering substantially all employees who have completed two calendar quarters of employment. The quarterly bonuses are paid from a pool equal to a maximum of 9% of pretax income net of certain reductions, including the profit sharing distribution, and a reserve based on the preceding quarter's net earnings. Profit sharing bonus expense under this plan was \$2,820 and \$18,534 for the years ended June 30, 1996 and 1995. There was no bonus expense for the year ended June 30, 1997.

The Company maintains a contributory 401(k) profit sharing benefit plan covering substantially all employees who have completed one year of service. The Company matches 50% of voluntary employee contributions to the plan not to exceed 50% of a maximum 5% of a participant's compensation. The Company's contributions under this plan were \$37,936, \$44,549 and \$37,230 for the years ended June 30, 1997, 1996 and 1995.

## NOTE F - STOCK OPTIONS

The Company has stock option plans for the benefit of selected officers, employees and directors of the Company. A total of 973,049 shares of common stock are reserved for issuance under the plans. Options under the Company's plans are granted at fair market value and expire ten years from the grant date. Options given to directors are exercisable at the date of grant. Options given to selected officers and employees are exercisable at such times as set forth in the individual option agreements, generally vesting 100% after four years.

A summary of the Company's stock option transactions for the years ended June 30, 1997, 1996 and 1995 is as follows:

	Number of shares	Weighted average exercise price
	-----	-----
Outstanding at June 30, 1994	425,714	\$ 7.38
Granted	117,000	9.45
Exercised	(31,602)	5.17
Canceled	(33,316)	7.85
	-----	
Outstanding at June 30, 1995	477,796	7.99
Granted	133,500	10.18
Exercised	(65,581)	6.87
Canceled	(21,020)	8.92
	-----	

## LECTEC CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

YEARS ENDED JUNE 30, 1997, 1996 AND 1995

## NOTE F - STOCK OPTIONS - Continued

	Number of shares	Weighted average exercise price
	-----	-----
Outstanding at June 30, 1996	524,695	\$8.65
Granted	343,350	8.26
Exercised	(15,278)	3.39
Canceled	(129,934)	9.30
	-----	-----
Outstanding at June 30, 1997	722,833	\$8.46
	=====	=====

A total of 371,946, 264,945 and 217,749 options were exercisable at June 30, 1997, 1996 and 1995, with a weighted average price of \$8.30, \$7.50 and \$6.57.

The following information applies to grants that are outstanding at June 30, 1997:

&lt;TABLE&gt;

&lt;CAPTION&gt;

Range of exercise prices	Options outstanding			Options exercisable	
	Number outstanding	Weighted average contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
-----	-----	-----	-----	-----	-----
<S>	<C>	<C>	<C>	<C>	<C>

\$3.34 - \$ 4.43	46,036	.75 years	\$3.54	46,036	\$3.54
6.00 - 8.62	292,773	4.25 years	7.32	99,923	8.04
9.00 - 13.50	384,024	3.50 years	9.92	225,987	9.39

</TABLE>

The weighted average fair value of the options granted during 1997 and 1996 is \$4.45 and \$5.23. The fair value of each option grant is estimated on the date of grant using the Black-Scholes options-pricing model with the following weighted-average assumptions used for all grants in 1997 and 1996: zero dividend yield, expected volatility of 54% and 59%, risk-free interest rate of 6.22% and 6.04% and expected lives of 5.09 and 4.52 years.

The Financial Accounting Standards Board issued Statement No. 123 (SFAS 123), "Accounting for Stock Based Compensation," which introduced an alternative method for recognizing compensation costs based upon the fair value of the awards on the date they are granted. SFAS 123 allows entities to continue to account for employee stock option plans using the intrinsic value method, which exists under current accounting literature, provided pro forma net earnings and net earnings per share, as if the fair value based method had been used, are disclosed. The Company has elected to continue using the intrinsic value based method for its employee options.

LECTEC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

YEARS ENDED JUNE 30, 1997, 1996 AND 1995

NOTE F - STOCK OPTIONS - Continued

The Company's net loss and net loss per share for 1997 and 1996 would have been increased to the pro forma amounts indicated below had the fair value method been used for options granted to employees and directors. These effects may not be representative of the future effects of applying this statement.

	1997		1996	
	As reported	Pro forma	As reported	Pro forma
Net loss	\$(2,266,727)	\$(2,620,449)	\$(632,193)	\$(781,467)
Net loss per share	\$(.59)	\$(.68)	\$(.17)	\$(.21)

NOTE G - PHARMADYNE CORPORATION AND RESTRUCTURING CHARGE

During 1993, the Company invested \$175,000 in Pharmadyne Corporation, which represented a 19.5% ownership interest in Pharmadyne. The investment was recorded at cost. During 1994, the Company purchased additional shares of Pharmadyne common stock for \$183,000 and increased the Company's ownership to 51%. The acquisition was accounted for as a purchase and the acquired goodwill of approximately \$590,000 was fully amortized on a straight-line basis over three years.

During 1996 the Company made advances to Pharmadyne and received a warrant to purchase 227,959 additional shares of Pharmadyne at \$1 per share. On September 5, 1996 the Company exercised the warrant and increased its ownership interest in Pharmadyne to 61%.

During the third quarter of 1997, the Company adopted a plan for eliminating the Pharmadyne subsidiary and recorded a nonrecurring restructuring charge of \$1,500,000. The restructuring charge included approximately \$780,000 for the planned acquisition of the minority interests in Pharmadyne in exchange for newly issued shares of LecTec Corporation common stock, \$480,000 for the write-off of Pharmadyne's 15% interest in Natus, L.L.C., an Arizona-based direct marketing company, and \$240,000 for completion of restructuring activities, consisting primarily of fees for professional services. During the fourth quarter of 1997, an additional charge of \$680,000 was recorded as a result of an increase in the cost to acquire the minority interests in Pharmadyne of \$589,000 and an increase in estimated remaining costs associated with the restructuring of \$91,000. The total charge of \$2,180,353 increased the 1997 net loss by \$.57 per share. The Company expects to complete the restructuring during fiscal 1998.

LECTEC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

YEARS ENDED JUNE 30, 1997, 1996 AND 1995

NOTE H - DISPOSITION OF DIRECT MARKETING RELATED ASSETS

On March 12, 1996, the Company contributed the direct marketing related assets of Pharmadyne to Natus L.L.C. (an Arizona limited liability company) in exchange for a 15% interest in Natus L.L.C. This investment has been accounted for using the equity method. The direct marketing related assets contributed consisted of

the following:

Accounts receivable	\$ 32,791
Inventory	384,730
Prepaid expenses and other	135,708
Property and equipment, net	79,938
Other	(27,000)
	-----
	\$606,167
	=====

During 1997 the Company recorded \$126,067 of equity in the losses of Natus L.L.C. The investment in Natus L.L.C. of \$480,100 was fully written off in 1997 as part of the restructuring charge of \$2,180,353 (note G).

**NOTE I - MAJOR CUSTOMERS AND EXPORT SALES**

One customer accounted for 19%, 17% and 15% of total sales for the years ended June 30, 1997, 1996 and 1995. The accounts receivable from this customer represented 27% and 24% of trade receivables at June 30, 1997 and 1996 and the accounts receivable from another customer represented 12% and 15% of trade receivables at June 30, 1997 and 1996. Export sales accounted for approximately 19% of total sales during each of the years ended June 30, 1997 and 1996, and 18% of total sales during the year ended June 30, 1995. Export sales by geographic area were as follows:

	Years ended June 30		
	1997	1996	1995
Canada	\$ 117,966	\$ 80,746	\$ 113,597
Europe	1,456,141	1,652,941	1,171,910
Asia	229,506	466,777	1,122,179
Latin America	484,319	225,440	195,663
	-----	-----	-----
	\$2,287,932	\$2,425,904	\$2,603,349
	=====	=====	=====

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None

**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information required under this item with respect to directors will be included under the heading "Election of Directors" in the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held November 20, 1997, and is incorporated herein by reference.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required under this item will be included under the heading "Executive Compensation" in the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held November 20, 1997, and is incorporated herein by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The information required under this item will be included under the heading "Security Ownership of Certain Beneficial Owners and Management" in the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held November 20, 1997, and is incorporated herein by reference.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

Information required under this item with respect to certain relationships and related transactions will be included under the heading "Certain Relationships and Related Transactions" in the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held on November 20, 1997, and is incorporated herein by reference.

**PART IV**

**ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON**

## (a) Financial Statements, Schedules and Exhibits

## 1. Financial Statements

The following consolidated financial statements of the Company and its subsidiaries are filed as a part of this Form 10-K in Part II, Item 8:

- (i) Report of Independent Certified Public Accountants
- (ii) Consolidated Balance Sheets at June 30, 1997 and 1996
- (iii) Consolidated Statements of Operations for the years ended June 30, 1997, 1996 and 1995
- (iv) Consolidated Statements of Shareholders' Equity for the years ended June 30, 1997, 1996 and 1995
- (v) Consolidated Statements of Cash Flows for the years ended June 30, 1997, 1996 and 1995
- (vi) Notes to the Consolidated Financial Statements

## 2. Financial Statement Schedules :

All schedules have been omitted since the required information is not present or not present in amounts sufficient to require submission of the schedule, or because the information required is included in the financial statements or the notes thereto.

## 3. Exhibits

<TABLE>  
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	Method of Filing
<S>	<C>
3.01 Articles of Incorporation of Registrant, as amended	(1)
3.02 By-laws of Registrant	(1)
10.01 Service Agreement dated July 1, 1986, between LecTec International, Inc., a U.S. Virgin Islands corporation, and LecTec Corporation, relating to the sale, lease or rental of certain property outside the United States.	(1)
10.02 Distribution and Commission Agreement dated July 1, 1986, between LecTec International, Inc., a U.S. Virgin Islands corporation, and LecTec Corporation, relating to the sale, lease or rental of certain property outside the United States.	(1)
10.03 Certificate of Secretary pertaining to Resolution of Board of Directors of LecTec Corporation, dated October 30, 1986, implementing a Profit Sharing Bonus Plan.	(1)
10.04 Research Agreement dated December 31, 1991, between LecTec Corporation and the University of Minnesota, whereby LecTec Corporation received exclusive rights to market and sell a non-nicotine compound to be mutually developed for smoking cessation.	(2)
10.05 Assignment and Mutual Release Agreement dated March 9, 1993 between Pharmaco Behavioral Associates, Inc., Robert M. Keenan, Ph.D., M.D. and the University of Minnesota, whereby the University assigned title, royalty and patent rights associated with the technology to alleviate symptoms of tobacco withdrawal to Pharmaco Behavioral Associates, Inc. and Dr. Keenan. Also included is a mutual release of all parties on all past title, royalty and patent rights.	(2)
10.06 License Agreement dated March 9, 1993 between Pharmaco Behavioral Associates, Inc. and LecTec Corporation, whereby the Company received an exclusive, worldwide license to market, make and sublicense product associated with the technology to alleviate symptoms of tobacco withdrawal.	(2)
10.07 Consultant Contract and Invention Assignment dated March 9, 1993 between Robert Keenan, Ph.D., M.D. and LecTec Corporation, whereby the Company received assignment of patent and invention rights associated	

- with the technology to alleviate symptoms of tobacco withdrawal including provisions that the Company enter into a consulting agreement with Dr. Keenan. (2)
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- 10.09 Stock Investment and Repurchase Agreement dated July 1, 1992, between LecTec Corporation and Pharmadyne Corporation (formerly Natus Corporation), whereby LecTec purchased Common Stock of Pharmadyne Corporation. (2)
- 10.10 Amendments dated March 18, 1993 to the original Research Agreement dated June 30, 1992, between LecTec Corporation and Pharmadyne Corporation (formerly Natus Corporation). (2)
- 10.11 Subscription Agreement dated June 17, 1993 between LecTec Corporation and Pharmadyne Corporation (formerly Natus Corporation). (2)
- 10.12 A Promissory Note dated June 17, 1993 between LecTec Corporation and Pharmadyne Corporation (formerly Natus Corporation). Included in the note is an option for LecTec to receive common stock of Pharmadyne in lieu of payment. (2)
- 10.13 Amended and Restated Stock Option Agreement between LecTec Corporation and Pharmadyne Corporation (formerly Natus Corporation), whereby LecTec has obtained the option to acquire the additional shares required to equal 51% of the Common Stock of Pharmadyne. (3)
- 10.14 Contribution Agreement dated March 12, 1996 between Pharmadyne Corporation (formerly Natus Corporation) and ACM Investments, L.L.C. regarding the acquisition of an equity interest in Natus L.L.C. (4)
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- 10.18 Credit Agreement dated May 1, 1996 between LecTec Corporation and The First National Bank of Saint Paul, a national banking association, whereby LecTec Corporation has an unsecured \$1 million working capital line of credit (4)
- 10.19 Revolving Credit Note dated May 1, 1996 between LecTec Corporation and The First National Bank of Saint Paul, a national banking association (4)
- 10.20 Working Capital Loan Agreement dated September 5, 1995 between LecTec Corporation and Pharmadyne Corporation (formerly Natus Corporation) relating to a loan from LecTec to Pharmadyne Corporation (4)
- 10.21 Form of Working Capital Loan Agreement dated September 5, 1995, between Pharmadyne Corporation (formerly Natus Corporation) and various shareholders relating to loans to Pharmadyne Corporation (4)
- 10.22 LecTec Corporation 1989 Stock Option Plan (5)
- 10.23 LecTec Corporation 1991 Directors' Stock Option Plan (5)
- 10.24 Building lease dated May 24, 1991 between LecTec Corporation and Sierra Development Co. for the lease of the manufacturing and warehouse facility located in Edina, Minnesota (5)
- 10.25 First amendment dated May 5, 1997 between LecTec

Corporation and Rushmore Plaza Partners Limited Partnership for the extension of the previous lease of the manufacturing and warehouse facility located in Edina, Minnesota (5)

10.26 Credit Agreement dated August 22, 1997 between LecTec Corporation and The First National Bank of Saint Paul, a national banking association, whereby LecTec Corporation has an unsecured \$1 million working capital line of credit (5)

10.27 Revolving Credit Note dated August 22, 1997 between LecTec Corporation and The First National Bank of Saint Paul, a national banking association (5)

21.01 Subsidiaries of the Company (3)

23.01 Consent of Grant Thornton LLP (5)

27.01 Financial Data Schedule (5)

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(3) Incorporated herein by reference to the Company's Annual Report on Form 10-K for the year ended June 30, 1994.

(4) Incorporated herein by reference to the Company's Annual Report on Form 10-K for the year ended June 30, 1996.

(5) Filed herewith.

(b) 1. Reports on Form 8-K.

None.

#### SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 26th day of September, 1997.

#### LECTEC CORPORATION

/s/Rodney A. Young  
Rodney A. Young  
Chairman, Chief Executive Officer and President  
(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the date indicated.

/s/Rodney A. Young September 26, 1997  
Rodney A. Young  
Chairman, Chief Executive Officer and President  
(Principal Executive Officer)

/s/Deborah L. Moore September 26, 1997  
Deborah L. Moore  
Chief Financial Officer and Secretary  
(Principal Financial Officer and Accounting Officer)

/s/Alan C. Hymes September 26, 1997  
Alan C. Hymes  
Director

/s/Lee M. Berlin September 26, 1997  
Lee M. Berlin  
Director

/s/Paul O. Johnson September 26, 1997  
Paul O. Johnson  
Director

/s/Donald C. Wegmiller September 26, 1997  
Donald C. Wegmiller

Director

/s/Alan J. Wilensky  
Alan J. Wilensky  
Director

September 26, 1997

EXHIBIT INDEX  
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EXHIBIT 10.22

LECTEC CORPORATION 1989 STOCK OPTION PLAN

SECTION 1. ESTABLISHMENT, PURPOSE, AND EFFECTIVE DATE OF PLAN.

1.1 Establishment. LecTec Corporation, a Minnesota corporation, hereby establishes the "LECTEC CORPORATION 1989 STOCK OPTION PLAN" (the "Plan") for key employees. The Plan permits the grant of stock options which do not qualify as incentive stock options within the meaning of Section 422A of the Internal Revenue Code of 1986, as amended (the "Code"), and Stock Indemnification Rights.

1.2 Purpose. The purpose of the Plan is to advance the interests of the Company and its shareholders by encouraging and providing for the acquisition of an equity interest in the success of the Company by key employees, by providing additional incentives and motivation toward superior performance of the Company, and by enabling the Company to attract and retain the services of key employees upon whose judgment, interest, and special effort the successful conduct of its operations is largely dependent.

1.3 Effective Date. The Plan shall become effective immediately upon adoption by the Board of the Company and shall be subject to ratification by the shareholders of the Company. Any Award made prior to shareholder ratification shall be subject to such ratification.

SECTION 2. DEFINITIONS.

2.1 Definitions. Whenever used herein, the following terms shall have their respective meanings set forth below:

(a) "Award" means any Option and/or Stock Indemnification Right under this Plan.

(b) "Board" means the Board of Directors of the Company.

(c) "Committee" means the committee appointed by the Board pursuant to Section 4.1. The Board shall have the sole continuing authority to appoint members of the Committee both in substitution for members appointed and to fill vacancies, however caused.

(d) "Company" means LecTec Corporation, a Minnesota corporation.

(e) "Disability" means disability as defined in Section 22(e)(3) of the Code.

(f) "Employee" means a salaried employee (including directors who are also employees) of the Company or its domestic or international Subsidiaries or any branch or division thereof.

(g) "Fair Market Value" of the stock means (i) the closing price of the Stock as reported for composite transactions, if the Stock is then traded on a national securities exchange, (ii) the last sale price if the Stock is then quoted on the NASDAQ National Market System or (iii) the average of the closing representative bid and asked prices of the Stock as reported on NASDAQ on the date as of which fair market value is being determined. If on the date of grant of any option granted under the Plan, the Stock is not publicly traded, the Committee shall make a good faith attempt to satisfy the option price requirement and in connection therewith shall take such action as it deems necessary or advisable.

(h) "Option" means the right to purchase Stock at a stated price for a specified period of time. For purposes of the Plan, Option means an option that does not qualify as an Incentive Stock Option within the meaning of Section 422A of the Code.

(i) "Participant" means any Employee designated by the Board to

participate in the Plan.

(j) "Retirement" (including "Early Retirement" and "Normal Retirement") means termination of employment under the terms of the LecTec Corporation Retirement Plan.

(k) "Stock" means the Common Stock of the Company.

(l) "Stock Indemnification Right" and "SIR" mean the right to receive a payment from the Company equal to the decline in value of a specified number of shares of Stock acquired upon exercise of a related Option hereunder and sold during a specified period of time.

(m) "Subsidiary" means any entity of which, at the time such Subsidiary status is to be determined, more than 50% of the combined voting power of such entity is directly or indirectly owned by the Company.

2.2 Gender and Number. Except when otherwise indicated by the context, words in the masculine gender when used in the Plan shall include the feminine gender, the singular shall include the plural, and the plural shall include the singular.

### SECTION 3. ELIGIBILITY AND PARTICIPATION

3.1 Eligibility and Participation. Participants in the Plan shall be selected by the Committee from among Employees who, in the opinion of the Board, are key employees.

### SECTION 4. ADMINISTRATION.

4.1 Administration. The Committee shall be responsible for the general administration of the Plan. The Committee shall consist of three or more persons, none all of whom shall be "disinterested persons" with respect to the Plan within the meaning of Rule 16b-3(d) (3) under the Securities Exchange Act of 1934, as amended. The members of the Committee shall not be eligible to receive options under the Plan. The members of the Committee shall be appointed by and serve at the pleasure of the Board. The authority to grant Awards shall be vested in the Committee. Subject to the provisions of the Plan, the Committee, from time to time, shall determine the individuals to whom and the time or times at which an Award shall be granted, and the number of shares to be subject to each Option or SIR, the Option price per share, the period of each Option, and the other terms and provisions of Awards, which may or may not be identical. The Committee may also interpret the Plan, prescribe, amend and rescind rules and regulations relating to the Plan, and make all other determinations necessary or advisable for the administration of the Plan. The determinations of the Committee shall be made in accordance with its judgment as to the best interests of the Company and its shareholders and in accordance with the purpose of the Plan. The Committee's determination shall be in all cases conclusive. A majority of the members of the Committee shall constitute a quorum, and all determinations of the Committee shall be made by a majority of its members. Any determination of the Committee may be made, without notice or meeting, and may be evidenced by a writing signed by a majority of the Committee members.

### SECTION 5. STOCK SUBJECT TO THE PLAN.

5.1 Number. The total number of shares of Stock subject to Options under the Plan may not exceed 200,000 subject to adjustment upon occurrence of any of the events indicated in Section 5.3. The shares to be delivered under the Plan may consist, in whole or in part, of authorized but unissued Stock or treasury Stock, not reserved for any other purpose.

5.2 Lapsed Options. If any Option granted under the Plan terminates, expires or lapses for any reason, any shares subject to such Option again shall be available for the grant of an Option.

5.3 Adjustment in Capitalization. If there shall be any change in the Stock through merger, consolidation, reorganization, recapitalization, stock dividend (of whatever amount), stock split or other change in the corporate structure, appropriate adjustments in the Plan and outstanding options and SIRs shall be made by the Committee. In the event of any such changes, adjustments

shall include, where appropriate, changes in the aggregate number of shares subject to the Plan, the number of shares and the price per share subject to outstanding Options and SIRs, in order to prevent dilution or enlargement of Option or SIR rights.

#### SECTION 6. DURATION OF PLAN

6.1 Duration of Plan. The Plan shall remain in effect, subject to the Board's right to earlier terminate the Plan pursuant to Section 11.2 hereof, until all Stock subject to it shall have been purchased or acquired pursuant to the provisions hereof. Notwithstanding the foregoing, no Award may be granted under the Plan on or after the tenth (10th) anniversary of the Plan's effective date.

#### SECTION 7. STOCK OPTIONS.

7.1 Grant of Options. Subject to the provisions of Sections 5 and 6, Options may be granted to Participants at any time and from time to time as shall be determined by the Committee. The Committee shall have complete discretion in determining the number of Options granted to each Participant.

7.2 Option Agreement. Each Option shall be evidenced by an Option agreement that shall specify the Option price, the duration of the Option, the number of shares of Stock to which the Option pertains, and such other provisions as the Committee shall determine.

7.3 Option Price. Options granted pursuant to the Plan shall have an Option price that is equal to the Fair Market Value of the Stock on the date the Option is granted.

7.4 Duration of Options. Each Option shall expire at such time as the Committee shall determine at the time it is granted.

7.5 Exercise of Option. Options granted under the Plan shall be exercisable in whole or in part at such times and be subject to such restrictions and conditions as the Committee shall in each instance approve, which need not be the same for all Participants, by the delivery of written notice of exercise to the Company.

7.6 Payment. Except as allowed in the next sentence, payment in full, in cash or other means satisfactory to the Committee, shall be made for all Stock purchased at the time written notice of exercise of an option is given to the Company. The Committee may, in its sole discretion, allow the Optionee, at the time an Option is exercised, to pay the total purchase price of the Stock, or any portion thereof, by means of transfer from the Optionee to the Company of previously acquired shares of the Company's common stock having a then current aggregate Fair Market Value, determined as of the close of business on the day preceding the transfer, equal to such total purchase price, or any portion thereof, or by a combination of cash and such previously acquired shares of the Company's Stock. Shares of Stock owned through employee benefit plans of the Company may be used if no adverse tax consequence to either the Participant or the Company would result.

7.7 Restrictions on Stock Transferability. The Board shall impose such restrictions on any shares of Stock acquired pursuant to the exercise of an option under the Plan as it may deem advisable, including, without limitation, restrictions under applicable Federal securities law, under the requirements of any stock exchange upon which such shares of Stock are then listed and under any blue sky or state securities laws applicable to such shares.

7.8 Termination of Employment Due to Death, Disability, or Retirement. In the event the employment of a Participant is terminated by reason of death, Disability, or Retirement, any outstanding Options then exercisable may be exercised at any time prior to the expiration date of the Options or within twelve (12) months after such date of termination of employment, whichever period is the shorter, except in the case of Retirement or Disability, a three (3) year period shall be substituted for the twelve (12) month period.

7.9 Termination of Employment Other than for Death, Disability, or Retirement. Except as otherwise set forth in the Option agreement, if the employment of the Participant shall terminate for any reason other than death,

Disability, Retirement, or involuntarily for cause, the rights under any then outstanding Option granted pursuant to the Plan shall terminate upon the expiration date of the Option or three months after such date of termination of employment, whichever first occurs. Where termination of employment is involuntary for cause, rights under all Options shall terminate immediately upon termination of employment.

7.10 Nontransferability of Options. No Option granted under the Plan may be sold, transferred, pledged, assigned, or otherwise alienated or hypothecated, otherwise than by will or by the laws of descent and

distribution. Further, all Options granted to a Participant under the Plan shall be exercisable during his lifetime only by such Participant.

7.11 Optionee Transfer or Leave of Absence. For Plan purposes:

(a) A transfer of an Optionee from the Company to a Subsidiary or vice versa, or from one Subsidiary to another; or

(b) A leave of absence, duly authorized by the Company: shall not be deemed a termination of employment.

#### SECTION 8. STOCK INDEMNIFICATION RIGHTS.

8.1 Grant of Stock Indemnification Rights. Stock Indemnification Rights may be granted to Participants at any time and from time to time as shall be determined by the Committee. SIRs may be granted only to persons on whom the Company or the Securities and Exchange Commission places a holding period restriction on Stock acquired upon the exercise of an Option, and shall be granted only in connection with Options, including already existing Options.

8.2 Term of SIR. Except as provided in Section 8.3 hereof, the term of an SIR shall begin on the date the related Option is exercised, and shall end on the last day of the seventh calendar month following such exercise date.

8.3 Lapse of SIRs. In the event that a holding period restriction shall no longer be applicable to a Participant, any SIR granted to such Participant shall lapse 30 days after the receipt of notice by the Participant from the Company of such fact. Notwithstanding anything contained herein to the contrary, in the event that a Participant holding an SIR dies within six months of his exercise of a related Option, the SIR shall expire, and the SIR shall lapse, on the earlier of (i) a date that is 30 days after the Participant's executor or personal representative is duly appointed and qualified or (ii) the last day of the seventh calendar month after the date such Option was exercised.

8.4 Payment of SIRs. Upon the sale of Stock acquired by exercise of an Option accompanied by an SIR at any time during the seventh calendar month following the date such Option is exercised, the Company shall make a payment to the holder of the SIR equal to the difference between (a) the Fair Market Value on the date of exercise of each share of Stock acquired upon exercise of the Option accompanied by the SIR and (b) the Fair Market Value on the date of sale of each share of the Stock acquired upon exercise of the Option, sold by the Participant during the seventh month of the period, if the Fair Market Value of the Stock sold is less than the Fair Market Value of the Stock subject to the Option on the date such Option is exercised.

8.5 Termination of Employment. Termination of employment shall not affect the payment of an SIR, except as provided in Section 8.3 with respect to lapse of an SIR. If recipient dies before receiving payment, any payout due will be paid to the recipient's designated beneficiary or, in the absence thereof, to the recipient's estate.

8.6 Form and Timing of Payment. Payment of an SIR shall be made as soon as practicable after notice by the Participant to the Company of the sale, in cash.

8.7 Nontransferability of SIRs. No SIR granted under the Plan may be sold, transferred, pledged, assigned or otherwise alienated or hypothecated.

8.8 SIR Agreement. Each SIR shall be evidenced by an SIR agreement (which may be included in any agreement with respect to a related Option) specifying the Option to which the SIR relates and containing such other

provisions as the Committee shall determine.

#### SECTION 9. BENEFICIARY DESIGNATION.

9.1 Beneficiary Designation. Each Participant under the Plan may name, from time to time, any beneficiary or beneficiaries (who may be named contingently or successively) to whom any benefit under the Plan is to be paid in case of his death before he receives any or all of such benefit. Each designation will revoke all prior designations by the same Participant, shall be in a form prescribed by the Committee, and will be effective only when filed by the Participant in writing with the Committee during his lifetime. In the absence of any such designation, benefits remaining unpaid at the Participant's death shall be paid to his estate.

#### SECTION 10. RIGHTS OF EMPLOYEES.

10.1 Employment. Nothing in the Plan or in any Option Agreement shall interfere with or limit in any way the right of the Company or any of its Subsidiaries to terminate any Employee's employment at any time, nor confer on any Employee any right to continue in the employ of the Company or any of its Subsidiaries.

10.2 Participation. No Employee shall have a right to be selected as a Participant, or, having been so selected, to be selected again as a Participant.

#### SECTION 11. MISCELLANEOUS.

11.1 Securities Matters. The exercise of an Option shall only be effective at such time as counsel to the Company shall have determined that the issuance and delivery of Stock pursuant to such exercise will not violate any state or federal securities or other laws. The Optionee desiring to exercise an Option may be required by the Company, as a condition of the effectiveness of any exercise of Option, to agree in writing that all shares of Stock to be acquired pursuant to such exercise shall be held for his or her own account without a view to any further distribution thereof, that the certificates for such shares shall bear an appropriate legend to that effect and that such shares will not be transferred or disposed of except in compliance with applicable federal and state laws. The Company may, in its sole discretion, defer the effectiveness of any exercise of an Option in order to allow the issuance of Stock pursuant thereto to be made pursuant to registration or an exemption from registration or other methods for compliance available under the federal or state securities laws. The Company shall inform the Optionee in writing of its decision to defer the effectiveness of the exercise of an Option. During the period that the effectiveness of the exercise of an option has been deferred, the Optionee may, by written notice, withdraw such exercise and obtain the refund of any amount paid with respect thereto. The Company shall be under no obligation to effect the registration pursuant to the Securities Act of 1933 of any Stock to be issued hereunder or to effect similar compliance under any state laws.

11.2 Amendment, Modification, and Termination of Plan. The Board at any time may terminate, and from time to time may amend or modify the Plan. No amendment, modification, or termination of the Plan shall in any manner adversely affect any Award theretofore granted under the Plan, without the consent of the Participant.

11.3 Status of Option. In no event shall Options granted hereunder be deemed to be Incentive Stock Options meeting the requirements of Section 422A of the Code.

#### SECTION 12. TAX WITHHOLDING.

12.1 Tax Withholding. The Company shall have the power to withhold from compensation and other amounts owing to a Participant, or require a Participant to remit to the company, an amount sufficient to satisfy federal, state, and local withholding tax requirements on any Award under the Plan.

12.2 Use of Stock for Tax Withholding. In order to assist Participants in paying federal and state income taxes required to be withheld upon the exercise of an Option, the Committee, in its discretion and subject to such

additional terms and conditions as it may adopt, may permit the Participant to elect to satisfy such income tax withholding obligation by having the Company withhold a portion of the Stock otherwise to be delivered upon exercise of such Option with a fair market value equal to the taxes required to be withheld. If a Participant makes an election to use Stock to pay income tax withholding obligations and the Participant's tax date is deferred for six months from the date of exercise of the Option, the optionee will initially receive the full amount of shares, but will be unconditionally obligated to surrender to the Company on the tax date the proper number of shares to satisfy the withholding obligation, plus cash for any remainder of the withholding obligation, including any fractional share withholding amount. Participants who are "officers" or "directors" of the Company, as those terms are used in Section 16(b) of the Securities Exchange Act of 1934, as amended ("Section 16(b)"), may only elect to use Stock to satisfy income tax withholding obligations in compliance with the rules established by the Committee to comply with Section 16(b).

#### SECTION 13. REQUIREMENTS OF LAW.

13.1 Requirements of Law. The granting of Awards and the issuance of shares of Stock upon the exercise of an Option shall be subject to all applicable laws, rules, and regulations, and to such approvals by any governmental agencies or national securities exchanges as may be required.

13.2 Governing Law. The Plan, and all agreements hereunder, shall be construed in accordance with and governed by the laws of the State of Minnesota.

#### AMENDMENT 1

LecTec Corporation, during a meeting of its Board of Directors on February 26, 1991, approved a resolution to increase the number of shares available for issue to 300,000 from 200,000 as originally stated in Section 5.1 of the 1989 Stock Option Plan.

The Company then proposed and received Shareholder approval for this Amendment during the Regular Shareholders' Meeting convened on November 26, 1991.

#### AMENDMENT 2

LecTec Corporation, during a meeting of its Board of Directors on May 7, 1993, approved a resolution to amend Paragraph 7.8 of Section 7 of the LecTec 1989 Stock Option Plan as follows:

"Termination of employment due to death, disability or retirement. In the event the employment of a participant is terminated by reason of death, disability or retirement, any outstanding options [Note: the words 'then exercisable' have been removed] may be exercised at any time prior to the expiration date of the options or within twelve (12) months after such date of termination of employment, whichever is shorter, except in the case of Retirement or Disability, a three (3) year period shall be substituted for the twelve (12) month period."

The Company then proposed and received Shareholder approval for this Amendment during the Regular Shareholders' Meeting convened on November 19, 1993.

#### AMENDMENT 3

LecTec Corporation, during a meeting of its Board of Directors on July 23, 1993, approved a resolution to increase the number of shares available for issue to 500,000 from 300,000 as previously stated in AMENDMENT 1 of the 1989 LecTec Stock Option Plan.

The Company then proposed and received Shareholder approval for this Amendment during the Regular Shareholders' Meeting convened on November 19,

1993.

**AMENDMENT 4**

*LecTec Corporation, during a meeting of its Board of Directors on March 15, 1996, approved a resolution to increase the number of shares available for issue to 800,000 from 500,000 as previously stated in AMENDMENT 3 of the 1989 LecTec Corporation Stock Option Plan.*

*The Company then proposed and received Shareholder approval for this Amendment during the Regular Shareholders' Meeting convened on November 18, 1996.*

**AMENDMENT 5**

*LecTec Corporation, during a meeting of its Board of Directors on March 15, 1996, approved a resolution to amend Paragraph 7.10 of Section 7 of the LecTec Corporation 1989 Stock Option Plan as follows:*

*"Nontransferability of Options. No option granted under the Plan may be sold, pledged, or otherwise alienated or hypothecated, otherwise than by will or by the laws of descent and distribution, excepting the transfer or assignment of fully vested and exercisable options for gifting purposes."*

*The Company then proposed and received Shareholder approval for this amendment during the Regular Shareholders' Meeting convened on November 18, 1996.*



EXHIBIT 10.23

LECTEC CORPORATION 1991 DIRECTORS' STOCK OPTION PLAN

SECTION 1. ESTABLISHMENT, PURPOSE, AND EFFECTIVE DATE OF PLAN.

1.1 Establishment. LecTec Corporation, a Minnesota Corporation, hereby establishes the "LECTEC CORPORATION 1991 DIRECTORS' STOCK OPTION PLAN" (the "Directors' Plan") for LecTec's Board of Directors who are not full time or part time employees of the company. The Directors' Plan permits the grant of stock options which do not qualify as incentive stock options within the meaning of Section 422A of the Internal Revenue Code of 1986, as amended (the "Code"), and Stock Indemnification Rights.

1.2 Purpose. The purpose of the Directors' Plan is to advance the interests of the Company and its shareholders by encouraging and providing for the acquisition of an equity interest in the success of the Company by Non-Employee Directors, by providing additional incentives and motivation toward superior performance of the Company, and by enabling the Company to attract and retain the services of Non-Employee Directors upon whose judgment, interest, and special effort the successful conduct of its operations is dependent.

1.3 Effective Date. The Directors' Plan shall become effective immediately upon adoption by the Board of the Company and shall be subject to ratification by the shareholders of the Company. Any Award made prior to shareholder ratification shall be subject to such ratification.

SECTION 2. DEFINITIONS.

2.1 Definitions. Whenever used herein, the following terms shall have their respective meanings set forth below:

(a) "Award" means any Option and/or Stock Indemnification Right under this Directors' Plan.

(b) "Board" means the Board of Directors of the Company.

(c) "Committee" means the committee appointed by the Board pursuant to Section 4.1. The Board shall have the sole continuing authority to appoint members of the Committee both in substitution for members appointed and to fill vacancies, however caused.

(d) "Company" means LecTec Corporation, a Minnesota corporation.

(e) "Disability" means disability as defined in Section 22(e)(3) of the Code.

(f) "Non-Employee Directors" means a Director of the Company who is not a full-time employee of the Company or its domestic or international Subsidiaries or any branch or division thereof.

(g) "Fair Market Value" of the stock means (i) the closing price of the Stock as reported for composite transactions, if the Stock is then traded on a national securities exchange, (ii) the last sale price if the Stock is then quoted on the NASDAQ National Market System or (iii) the average of the closing representative bid and asked prices of the Stock as reported on NASDAQ on the date as of which fair market value is being determined. If on the date of grant of any option granted under the Directors' Plan, the Stock is not publicly traded, the committee shall make a good faith attempt to satisfy the option price requirement and in connection therewith shall take such action as it deems necessary or advisable.

(h) "Option" means the right to purchase Stock at a stated price for a specified period of time. For purposes of the Directors' Plan, Option means an option that does not qualify as an Incentive Stock Option within the meaning of Section 422A of the Code.

(i) "Participant" means any Non -Employee Director designated by the Committee to participate in the Directors' Plan.

(j) "Stock" means the Common Stock of the Company.

(k) "Stock Indemnification Right" and "SIR" mean the right to receive a payment from the Company equal to the decline in value of a specified number of shares of Stock acquired upon exercise of a related Option hereunder and sold during a specified period of time.

(i) "Subsidiary" means any entity of which, at the time such Subsidiary status is to be determined, more than 50% of the combined voting power of such entity is directly or indirectly owned by the Company.

2.2 Gender and Number. Except when otherwise indicated by the context, words in the masculine gender when used in the Directors' Plan shall include the feminine gender, the singular shall include the plural, and the plural shall include the singular.

### SECTION 3. ELIGIBILITY AND PARTICIPATION.

3.1 Eligibility and Participation. Participants in the Directors' Plan shall be selected by the Committee from among Non-Employee Directors.

### SECTION 4. ADMINISTRATION.

4.1 Administration. The Committee shall be responsible for the general administration of the Directors' Plan. The Committee shall consist of three or more persons, all of whom shall be "disinterested persons" with respect to the Directors' Plan within the meaning of Rule 16b-3(d) (3) under the Securities Exchange Act of 1934, as amended. The members of the Committee shall not be eligible to receive options under the Directors' Plan. The members of the Committee shall be appointed by and serve at the pleasure of the Board. The authority to grant Awards shall be vested in the Committee. Subject to the provisions of the Directors' Plan, the Committee, from time to time, shall determine the individuals to whom and the time or times at which an Award shall be granted, and the number of shares to be subject to each Option or SIR, the Option price per share, the period of each Option, and the other terms and provisions of Awards, which may or may not be identical. The Committee may also interpret the Directors' Plan, prescribe, amend and rescind rules and regulations relating to the Directors' Plan, and make all other determinations necessary or advisable for the administration of the Directors' Plan. The determinations of the Committee shall be made in accordance with its judgment as to the best interests of the Company and its shareholders and in accordance with the purpose of the Directors' Plan. The Committee's determination shall be in all cases conclusive. A majority of the members of the Committee shall constitute a quorum, and all determinations of the Committee shall be made by a majority of its members. Any determination of the Committee may be made, without notice or meeting, and may be evidenced by a writing signed by a majority of the Committee members.

### SECTION 5. STOCK SUBJECT TO THE DIRECTORS' PLAN.

5.1 Number. The total number of shares of Stock subject to Options under the Directors' Plan may not exceed 50,000 subject to adjustment upon occurrence of any of the events indicated in Section 5.3. The shares to be delivered under the Directors' Plan may consist, in whole or in part, of authorized but unissued Stock or treasury Stock, not reserved for any other purpose.

5.2 Lapsed Options. If any Option granted under the Directors' Plan terminates, expires or lapses for any reason, any shares subject to such Option again shall be available for the grant of any Option.

5.3 Adjustment in Capitalization. If there shall be any change in the Stock through merger, consolidation, reorganization, recapitalization, stock dividend (of whatever amount), stock split or other change in the corporate structure, appropriate adjustments in the Directors' Plan and outstanding options and SIRs shall be made by the Committee. In the event of any such changes, adjustments shall include, where appropriate, changes in the aggregate

number of shares subject to the Directors' Plan, the number of shares and the price per share subject to outstanding Options and SIRs, in order to prevent dilution or enlargement of Option or SIR rights.

#### SECTION 6. DURATION OF DIRECTORS' PLAN.

6.1 Duration of Directors' Plan. The Directors' Plan shall remain in effect, subject to the Board's right to earlier terminate the Directors' Plan pursuant to Section 11.2 hereof, until all Stock subject to it shall have been

purchased or acquired pursuant to the provisions hereof. Notwithstanding the foregoing, no Award may be granted under the Directors' Plan on or after the tenth (10th) anniversary of the Directors' Plan's effective date.

#### SECTION 7. STOCK OPTIONS.

7.1 Grant of Options. Subject to the provisions of Sections 5 and 6, Options may be granted to Participants at any time and from time to time as shall be determined by the Committee. The Committee shall have complete discretion in determining the number of Options granted to each Participant.

7.2 Option Agreement. Each Option shall be evidenced by an Option agreement that shall specify the Option price, the duration of the Option, the number of shares of Stock to which the Option pertains, and such other provisions as the Committee shall determine.

7.3 Option Price. Options granted pursuant to the Directors' Plan shall have an Option price that is equal to the Fair Market Value of the Stock on the date the Option is granted.

7.4. Duration of Options. Each Option shall expire at such time as the Committee shall determine at the time it is granted.

7.5 Exercise of Option. Options granted under the Directors' Plan shall be exercisable in whole or in part at such times and be subject to such restrictions and conditions as the Committee shall in each instance approve, which need not be the same for all Participants, by the delivery of written notice of exercise to the Company.

7.6 Payment. Except as allowed in the next sentence, payment in full, in cash or other means satisfactory to the Committee, shall be made for all Stock purchased at the time written notice of exercise of an Option is given to the Company. The Committee may, in its sole discretion, allow the Optionee, at the time an Option is exercised, to pay the total purchase price of the Stock, or any portion thereof, by means of transfer from the Optionee to the Company of previously acquired shares of the Company's common stock having a then current aggregate Fair Market Value, determined as of the close of business on the day preceding the transfer, equal to such total purchase price, or any portion thereof, or by a combination of cash and such previously acquired shares of the Company's Stock. Shares of Stock owned through employee benefit plans of the Company may be used if no adverse tax consequence to either the Participant or the Company would result.

7.7 Restrictions on Stock Transferability. The Committee may impose such restrictions on any shares of Stock acquired pursuant to the exercise of an Option under the Directors' Plan as it may deem advisable, including, without limitation, restrictions under applicable Federal securities law, under the requirements of any stock exchange upon which such shares of Stock are then listed and under any blue sky or state securities laws applicable to such shares.

7.8 Termination of Directorship. A Participant's rights hereunder or under any outstanding Option, shall not terminate because that Participant ceases to be a Director.

7.9 Nontransferability of Options. No Option granted under the Directors' Plan may be sold, transferred, pledged, assigned, or otherwise alienated or hypothecated, otherwise than by will or by the laws of descent and distribution. Further, all Options granted to a Participant under the Directors' Plan shall be exercisable during his lifetime only by such participant.

#### SECTION 8. STOCK INDEMNIFICATION RIGHT.

8.1 Grant of Stock Indemnification Right. Stock Indemnification Rights may be granted to Participants at any time and from time to time as shall be determined by the Committee. SIRs may be granted only to persons on whom the Company or the Securities and Exchange Commission places a holding period restriction on Stock acquired upon the exercise of an Option, and shall be granted only in connection with Options, including already existing Options.

8.2 Term of SIR, Except as provided in Section 8.3 hereof, the term of an SIR shall begin on the date the related Option is exercised, and shall end on the last day of the seventh calendar month following such exercise date.

8.3 Lapse of SIRs. In the event that a holding period restriction shall no longer be applicable to a Participant, any SIR granted to such participant shall lapse 30 days after the receipt of notice by the Participant from the Company of such fact. Notwithstanding anything contained herein to the contrary, in the event that a Participant holding an SIR dies within six months of his exercise of a related Option, the SIR shall expire, and the SIR shall lapse, on the earlier of (i) a date that is 30 days after the Participants executor or personal representative is duly appointed and qualified or (ii) the last day of the seventh calendar month after the date such Option was exercised.

8.4 Payment of SIRs. Upon the sale of Stock acquired by exercise of an Option accompanied by an SIR at any time during the seventh calendar month following the date such Option is exercised, the Company shall make a payment to the holder of the SIR equal to the difference between (a) the Fair Market Value on the date of exercise of each share of Stock acquired upon exercise of the Option accompanied by the SIR and (b) the Fair Market Value on the date of sale of each share of the Stock acquired upon exercise of the Option, sold by the Participant during the seventh month of the period, if the Fair Market Value of the Stock sold is less than the Fair Market Value of the Stock subject to the Option on the date such Option is exercised.

8.5 Form and Timing of Payment. Payment of an SIR shall be made as soon as practicable after notice by the Participant to the company of the sale, in cash.

8.6 Nontransferability of SIRs. No SIR granted under the Plan may be sold, transferred, pledged, assigned or otherwise alienated or hypothecated.

8.7 SIR Agreement. Each SIR shall be evidenced by an SIR agreement (which may be included in any agreement with respect to a related Option) specifying the Option to which the SIR relates and containing such other provisions as the Committee shall determine.

#### SECTION 9. BENEFICIARY DESIGNATION.

9.1 Beneficiary Designation. Each participant under the Directors' Plan may name, from time to time, any beneficiary or beneficiaries (who may be named contingently or successively) to whom any benefit under the Directors' Plan is to be paid in case of his death before he receives any or all of such benefit. Each designation will revoke all prior designations by the same participant, shall be in a form prescribed by the Committee, and will be effective only when filed by the Participant in writing with the Committee during his lifetime. In the absence of any such designation, benefits remaining unpaid at the Participant's death shall be paid to his estate.

#### SECTION 10. RIGHTS OF DIRECTORS.

10.1 Service on Board. Nothing in the Directors' Plan or in any Option Agreement shall interfere with or limit in any way the right of the Company or any of its Subsidiaries to terminate any Director's service on the Board at any time, nor confer on any Director any right to service on the Board of the Company or any of its Subsidiaries.

10.2 Participation. No Director shall have a right to be selected as a Participant, or, having been so selected, to be selected again as a Participant.

#### SECTION 11. MISCELLANEOUS.

11.1 Securities Matters. The exercise of an Option shall only be effective at such time as counsel to the Company shall have determined that the

issuance and delivery of Stock pursuant to such exercise will not violate any state or federal securities or other laws. The Optionee desiring to exercise an Option may be required by the Company, as a condition of the effectiveness of any exercise of Option, to agree in writing that all shares of Stock to be acquired pursuant to such exercise shall be held for his or her own account without a view to any further distribution thereof, that the certificates for such shares shall bear an appropriate legend-end to that effect and that such shares will not be transferred or disposed of except in compliance with applicable federal and state laws. The Company may, in its sole discretion, defer the effectiveness of any exercise of an Option in order to allow the issuance of Stock pursuant thereto to be made pursuant to registration or an exemption from registration or other

methods for compliance available under the federal or state securities laws. The Company shall inform the Optionee in writing of its decision to defer the effectiveness of the exercise of an Option. During the period that the effectiveness of the exercise of an Option has been deferred, the Optionee may, by written notice, withdraw such exercise and obtain the refund of any amount paid with respect thereto. The Company shall be under no obligation to effect the registration pursuant to the Securities Act of 1933 of any Stock to be issued hereunder or to effect similar compliance under any state laws.

11.2 Amendment, Modification, and Termination of Directors' Plan. The Board at any time may terminate, and from time to time may amend or modify the Directors' Plan. No amendment, modification, or termination of the Directors' Plan shall in any manner adversely affect any Award theretofore granted under the Directors' Plan, without the consent of the Participant.

11.3 Status of Option. In no event shall Options granted hereunder be deemed to be Incentive Stock Options meeting the requirements of Section 422A of the Code.

#### SECTION 12. TAX WITHHOLDING.

12.1 Tax Withholding . The Company shall have the power to withhold from Director fees and other amounts owing to a Participant, or require a Participant to remit to the company, an amount sufficient to satisfy federal, state, and local withholding tax requirements on any Award under the Directors' Plan.

12.2 Use of Stock for Tax Withholding. In order to assist participants in paying federal and state income taxes required to be withheld upon the exercise of an Option, the Committee, in its discretion and subject to such additional terms and conditions as it may adopt, may permit the Participant to elect to satisfy such income tax withholding obligation by having the company withhold a portion of the Stock otherwise to be delivered upon exercise of such Option with a fair market value equal to the taxes required to be withheld. If a Participant makes an election to use Stock to pay income tax withholding obligations and the Participants tax date is deferred for six months from the date of exercise of the Option, the optionee will initially receive the full amount of shares, but will be unconditionally obligated to surrender to the Company on the tax date the proper number of shares to satisfy the withholding obligation, plus cash for any remainder of the withholding obligation, including any fractional share withholding amount. Participants who are "officers" or "directors" of the Company, as those terms are used in Section 16(b) of the Securities Exchange Act of 1934, as amended ("Section 16(b)"), may only elect to use Stock to satisfy income tax withholding obligations in compliance with the rules established by the Committee to comply with Section 16(b).

#### SECTION 13. REQUIREMENTS OF LAW.

13.1 Requirements of Law. The granting of Awards and the issuance of shares of Stock upon the exercise of an Option shall be subject to all applicable laws, rules, and regulations, and to such approvals by any governmental agencies or national securities exchanges as may be required.

13.2 Governing Law. The Directors' Plan, and all agreements hereunder, shall be construed in accordance with and governed by the laws of the State of Minnesota.

LecTec Corporation, during a meeting of its Board of Directors on February 26, 1991, approved a resolution to increase the number of shares available for issue to 100,000 from 50,000 as originally stated in Section 5.1 of the 1991 Directors' Stock Option Plan.

**AMENDMENT 2**

LecTec Corporation, during a meeting of its Board of Directors on March 15, 1996, approved a resolution to amend Paragraph 7.9 of Section 7 of the LecTec Corporation 1991 Directors' Stock Option Plan as follows:

"Nontransferability of Options. No option granted under the Directors' Plan may be sold, pledged, or otherwise alienated or hypothecated, otherwise than by will or by the laws of descent and distribution, excepting the transfer or assignment of fully vested and exercisable options for gifting purposes."

The Company then proposed and received Shareholder approval for this Amendment during the Regular Shareholders' Meeting convened on November 18, 1996.

OFFICE/WAREHOUSE LEASE

This Indenture of lease, dated this 24th day of May 1991 by and between Sierra Development (A Minnesota General Partnership) hereinafter referred to as "Lessor", and LecTec Corporation (A Minnesota Corporation) hereinafter referred to as "Lessee".

DEFINITIONS:

"Premises" -That certain real property located in the City of Edina, County of Hennepin and State of Minnesota and legally described on Exhibit 'A' attached hereto and made a part hereof, including all buildings and site improvements located thereon.

"Building" -That certain office/warehouse building containing approximately 45,800-square feet located upon the Premises and commonly described as 7401-7415 Cahill Road, Edina, Minnesota 55435

"Demised Premises" -That certain portion of the Building located at 7401 Cahill Road and designated as Bays - - - through - - - , consisting of approximately 29,187 - square feet ( 2,629 square feet of office space and 26,558 square feet of warehouse space), as measured from the outside walls of the Demised Premises to the center of the partition wall, as shown on the floor plan attached hereto as Exhibit 'B' and made a part hereof. The Demised Premises include a non-exclusive easement for access to common areas, as hereinafter defined, and all licenses and easements appurtenant to the Demised Premises.

"Common Areas" -The term "common area" means the entire areas to be used for the non-exclusive use by Lessee and other lessees in the Building, including, but not limited to, corridors, lavatories, driveways, truck docks, parking lots and landscaped areas. Subject to reasonable rules and regulations to the promulgated by Lessor, the common areas are hereby made available to Lessee and its employees, agents, customers, and invitees for reasonable use in common with other lessees, their employees, agents, customers and invitees.

WITNESSETH:

TERM: See Article 42, 45

1. For and in consideration of the rents, additional rents, terms, provisions and covenants herein contained, Lessor hereby lets, leases and demises to Lessee the Demised Premises for the term of 72 months commencing on the first day of July, 1991 (sometimes called 'the Commencement Date') and expiring the last day of June 1997 (sometimes called 'Expiration Date'), unless sooner terminated as hereinafter provided.

BASE RENT:

2. Lessor reserves and Lessee shall pay Lessor, a total rental of Seven Hundred Forty-four Thousand Nine Hundred Eighty-five & 20/100 dollars (\$ 744,985.20), payable in advance, in equal monthly installments of See Article 43 Dollars (\$ See Art. 43 ), commencing on the Commencement Date and continuing on the first day of each and every month thereafter for the next succeeding months during the balance of the term (sometimes called 'Base Rent'). In the event the Commencement Date falls on a date other than the first of a month the rental for that month shall be prorated and adjusted accordingly

ADDITIONAL RENT.- See Articles 43 & 48

3. Lessee shall pay to Lessor throughout the term of this Lease the following:

a. Lessee shall pay a sum equal to sixty-three and 73/100 percent ( 63.73%) of the Real Estate taxes. The term 'Real Estate Taxes' shall mean all real estate taxes, all assessments and any taxes in lieu

thereof which may be levied upon or assessed against the Premises of which the Demised Premises are a part. Lessee, in addition to all other payments to Lessor

by Lessee required hereunder shall pay to Lessor, in each year during the term of this Lease and any extension or renewal thereof, Lessee's proportionate share of such real estate taxes and assessments paid in the first instance by Lessor.

Any tax year commencing during any lease year shall be deemed to correspond to such lease year. In the event the taxing authorities include in such real estate taxes and assessments the value of any improvements made by Lessee, or of machinery, equipment, fixtures, inventory or other personal property or assets of Lessee, then Lessee shall pay all the taxes attributable to such items in addition to its proportionate share of said aforementioned real estate taxes and assessments. A photostatic copy of the tax statement submitted by Lessor to Lessee shall be sufficient evidence of the amount of taxes and assessments assessed or levied against the Premises of which the Demised Premises are a part, as well as the items taxed.

b. A sum equal to sixty-three and 73/100 percent (63.73 %) of the annual aggregate operating expenses incurred by Lessor in the operation, maintenance and repair of the Premises. The term 'Operating Expenses' shall include but not be limited to maintenance, repair, replacement and care of all common area lighting, common area plumbing and roofs, parking and landscaped areas signs, snow removal, non-structural repair and maintenance of the exterior of the Building, insurance premiums, management fee, wages and fringe benefits of personnel employed for such work, costs of equipment purchased and used for such purposes, and the cost or portion thereof properly allocable to the Premises (amortized over such reasonable period as lessor shall determine together with the interest at the rate of 12 % per annum on the unamortized balance) of any capital improvements made to the Building by Lessor after the Base Year which result in a reduction of Operating Expenses or made to the Building by Lessor after the date of this Lease that are required under any governmental law or regulation that was not applicable to the Building at the time it was constructed.

c. In no event shall the total adjusted monthly rent be less than See Article 43 Dollars (\$ See Art 43 ) per month during the term of this Lease.

The payment of the sums set forth in this Article 3 shall be in addition to the Base Rent payable pursuant to Article 2 of this Lease. All sums due hereunder shall be due and payable within thirty (30) days of delivery of written certification by Lessor setting forth the computation of the amount due from Lessee. In the event the lease term shall begin or expire at any time during the calendar year, the Lessee shall be responsible for his prorated share of Additional Rent under subdivisions a. and b. during the Lease and/or occupancy time.

Prior to commencement of this Lease, and prior to the commencement of each calendar year thereafter commencing during the term of this Lease or any renewal or extension thereof, Lessor may estimate for each calendar year (i) the total amount of Real Estate Taxes; (ii) the total amount of Operating Expenses; (iii) Lessee's share of Real Estate Taxes for such calendar year; (iv) Lessee's share of Operating Expenses for such calendar year; and (v) the computation of the annual and monthly rental payable during such calendar year as a result of increases or decreases in Lessee's share of Real Estate Taxes, and Operating Expenses. Said estimates will be in writing and will be delivered or mailed to Lessee at the Premises.

The amount of Lessee's share of Real Estate Taxes, and Operating Expenses for each calendar year, so estimated, shall be payable as Additional Rent, in equal monthly installments, in advance, on the first day of each month during such calendar year at the option of Lessor. In the event that such estimate is delivered to Lessee before the first day of January of such calendar year, said amount, so estimated, shall be payable as additional rent in equal monthly installments, in advance, on the first day of each month during such calendar year. In the event that such estimate is delivered to Lessee after the first day of January of such calendar year, said amount, so estimated, shall be payable as additional rent in equal monthly installments, in advance, on the first day of each month over the balance of such calendar year, with the number of installments being equal to the number of full calendar months remaining in such calendar year.

Upon completion of each calendar year during the term of this Lease or any renewal or extension thereof, Lessor shall cause its accountants to determine the actual amount of the Real Estate Taxes, and Operating Expenses payable in such calendar year and Lessee's share thereof and deliver a written



certification of the amounts thereof to Lessee. If Lessee has underpaid its share of Real Estate Taxes, or Operating Expenses for such calendar year, Lessee shall pay the balance of its share of same within ten

(10) days after the receipt of such statement. If Lessee has overpaid its share of Real Estate Taxes, or Operating Expenses for such calendar year, Lessor shall either (i) refund such excess, or (ii) credit such excess against the most current monthly installment or installments due Lessor for its estimate of Lessee's share of Real Estate Taxes, and Operating Expenses for the next following calendar year. A prorata adjustment shall be made for a fractional calendar year occurring during the term of this Lease or any renewal or extension thereof based upon the number of days of the term of the Lease during said calendar year as compared to three hundred sixty-five (365) days and all additional sums payable by Lessee or credits due Lessee as a result of the provisions of this Article 3 shall be adjusted accordingly.

**COVENANT TO PAY RENT:**

4. The covenants of Lessee to pay the Base Rent and the Additional Rent are each independent of any other covenant, condition, provision or agreement contained in this Lease. All rents are payable to Lessor at Welsh Companies, Inc., 11200 West 78th Street, Eden Prairie, Minnesota 55344

**UTILITIES:**

5. Lessor shall provide mains and conduits to supply water, gas, electricity and sanitary sewage to the Premises. Lessee shall pay, when due, all charges for sewer usage or rental, garbage, disposal, refuse removal, water, electricity, gas, fuel oil, L.P. gas, telephone and/or other utility services or energy source furnished to the Demised Premises during the term of this Lease, or any renewal or extension thereof. In Lessor elects to furnish any of the foregoing utility services or other services furnished or caused to be furnished to Lessee, then the rate charged by Lessor shall not exceed the rate Lessee would be required to pay to a utility company or service company furnishing any of the foregoing utilities or services. The charges thereof shall be deemed additional rent in accordance with Article 3.

**CARE AND REPAIR OF DEMISED PREMISES:**

6. Lessee shall, at all times throughout the term of this Lease, including renewals and extension, and at its sole expense, keep and maintain the Demised Premises in a clean, safe, sanitary and first class condition and in compliance with all applicable laws, codes, ordinances, rules and regulations. Lessee's obligations hereunder shall include but not be limited to the maintenance, repair and replacement, if necessary, of heating, air conditioning fixtures, equipment, and systems, all lighting and plumbing fixtures and equipment, fixtures, motors and machinery, all interior walls, partitions, doors and windows, including the regular painting thereof, all exterior entrances, windows, doors and docks and the replacement of all broken glass. When used in this provision, the term 'repairs' shall include replacements or renewals when necessary, and all such repairs made by the Lessee shall be equal in quality and class to the original work. The Lessee shall keep and maintain all portions of the Demised Premises and the sidewalk and areas adjoining the same in a clean and orderly condition, free of accumulation of dirt, rubbish, snow and ice.

If Lessee falls, refuses or neglects to maintain or repair the Demised Premises as required in this Lease after notice shall have been given Lessee, in accordance with Article 33 of this Lease, Lessor may make such repairs without liability to Lessee for any loss or damage that may accrue to Lessee's merchandise, fixtures or other property or to Lessee's business by reason thereof, and upon completion thereof, Lessee shall pay to Lessor all costs plus 15% for overhead incurred by Lessor in making such repairs upon presentation to Lessee of bill therefor.

Lessor shall repair, at its expense, the structural portions of the Building, provided however where structural repairs are required to be made by reason of the acts of Lessee, the costs thereof shall be borne by Lessee and payable by Lessee to Lessor upon demand.

The Lessor shall be responsible for all outside maintenance of the Demised Premises, including grounds and parking areas. All such maintenance which is the

responsibility of the Lessor shall be provided as reasonably necessary to the comfortable use and occupancy of Demised Premises during business hours, except Saturdays, Sundays and holidays, upon the condition that the Lessor shall not be liable for damages for failure to do so due to causes beyond its control.

SIGNS: See Exhibit "C"

7. Any sign, lettering, picture, notice or advertisement installed on or in any part of the Premises and visible from the exterior of the Building, or visible from the exterior of the Demised Premises, shall be approved and installed by Lessor at Lessee's expense. In the event of a violation of the foregoing by Lessee, Lessor may remove the same without any liability and may charge the expense incurred by such removal to Lessee.

ALTERATIONS, INSTALLATION, FIXTURES:

8. Except as hereinafter provided, Lessee shall not make any alteration, additions, or improvements in or to the Demised Premises or add, disturb or in any way change any plumbing or wiring therein without the prior written consent of the Lessor. In the event alterations are required by any governmental agency by reason of the use and occupancy of the Demised Premises by Lessee, Lessee shall make such alterations at its own cost and expense after first obtaining Lessor's approval of plans and specifications therefor and furnishing such indemnification as Lessor may reasonably require against liens, costs, damages and expenses arising out of such alterations. Alterations or additions Lessee must be built in compliance with all laws, ordinances and governmental regulations affecting the Premises and Lessee shall warrant to Lessor that all such alterations, additions, or improvements shall be in strict compliance with all relevant laws, ordinances, governmental regulations, and insurance requirements. Construction of such alterations or additions shall commence only upon Lessee obtaining and exhibiting to Lessor the requisite approvals, licenses and permits and indemnification against liens. All alterations, installations, physical additions or improvements to the Demised Premises made by Lessee shall at once become the property of Lessor and shall be surrendered to Lessor upon the termination of this Lease; provided, however, this clause shall not apply to movable equipment or furniture owned by Lessee which may be removed by Lessee at the end of the term of this Lease if Lessee is not then in default.

POSSESSION: See Article 43

9. Except as hereinafter provided Lessor shall deliver possession of the Demised Premises to Lessee in the condition required by this Lease on or before the Commencement Date, but delivery of possession prior to or later than such Commencement Date shall not affect the expiration date of this Lease. The rentals herein reserved shall commence on the date when possession of the Demised Premises is delivered by Lessor to Lessee. Any occupancy by Lessee prior to the beginning of the term shall in all respects be the same as that of a Lessee under this Lease. Lessor shall have no responsibility or liability for loss or damage to fixtures, facilities or equipment installed or left on the Demised Premises. If Demised Premises are not ready for occupancy by Commencement Date and possession is later than Commencement Date, rent shall begin on date of possession.

SECURITY AND DAMAGE DEPOSIT-

10. Lessee contemporaneously with the execution of this Lease, has deposited with Lessor the sum of Eleven Thousand Five Hundred Forty-eight and 70/100 Dollars (\$ 11,548.70 ), receipt of which is acknowledged hereby by Lessor, which deposit is to be held by Lessor, without liability for interest, as a security and damage deposit for the faithful performance by Lessee during the term hereof or any extension hereof. Prior to the time when Lessee shall be entitled to the return of this security deposit, Lessor may commingle such deposit with Lessor's own funds and to use such security deposit for such purpose as Lessor may determine. In the event of the failure of Lessee to keep and perform any of the terms, covenants and conditions of this Lease to be kept and performed by Lessee during the term hereof or any extension hereof, then Lessor, either with or without terminating this Lease, may (but shall not be required to) apply such portion of said deposit as may be necessary to compensate or repay Lessor for all losses or damages sustained or to be sustained by Lessor due to such breach on the part of Lessee, including, but not limited to overdue and unpaid rent, any other sum payable by Lessee to Lessor pursuant to the provisions of this

*Lease, damages or-deficiencies in the reletting of Demised Premises, and*

*reasonable attorney's fees incurred by Lessor. Should the entire deposit or any portion thereof, be appropriated and applied by Lessor, in accordance with the provisions of this paragraph, Lessee upon written demand by Lessor, shall remit forthwith to Lessor a sufficient amount of cash to restore said security deposit to the original sum deposited, and Lessee's failure to do so within five (5) days after receipt of such demand shall constitute a breach of this Lease. Said security deposit shall be returned to Lessee, less any depletion thereof as the result of the provisions of this paragraph, at the end of the term of this Lease or any renewal thereof, or upon the earlier termination of this Lease. Lessee shall have no right to anticipate return of said deposit by withholding any amount required to be paid pursuant to the provision of this Lease or otherwise.*

*In the event Lessor shall sell the Premises, or shall otherwise convey or dispose of its interest in this Lease, Lessor may assign said security deposit or any balance thereof to Lessor's assignee, whereupon Lessor shall be released from all liability for the return or repayment of such security deposit and Lessee shall look solely to the said assignee for the return and repayment of said security deposit. Said security deposit shall not be assigned or encumbered by Lessee without such consent of Lessor, and any assignment or encumbrance without such consent shall not bind Lessor. In the event of any rightful and permitted assignment or this Lease by Lessee, said security deposit shall be deemed-to be held by Lessor as a deposit made by the assignee, and Lessor shall have no further liability with respect to the return of said security deposit to the Lessee.*

*USE:*

*11. The Demised Premises shall be used and occupied by Lessee solely for the purposes of office, production, and storage of medical products so long as such use is in compliance with all applicable laws, ordinances and governmental regulations affecting the Building and Premises. The Demised Premises shall not be used in such manner that, in accordance with any requirement of law or of any public authority, Lessor shall be obliged on account of the purpose or manner of said use to make any addition or alteration to or in the Building. The Demised Premises shall not be used in any manner which will increase the rates required to be paid for public liability or for fire and extended coverage insurance covering the Premises. Lessee shall occupy the Demised Premises conduct its business and control its agents, employees, invitees and visitors in such a way as is lawful and reputable and will not permit or create any nuisance, unreasonable noise for a manufacturing company, odor, or otherwise interfere with annoy or disturb any other Lessee in the Building in its normal business operations or Lessor in its management of the Building. Lessee's use of the Demised Premises shall conform to all the Lessor's rules and regulations relating to the use of the Premises. Outside storage on the Premises of any type of equipment, property or materials owned or used on the Premise by Lessee or its customers and suppliers shall not be premitted.*

*ACCESS TO DEMISED PREMISES:*

*12. The Lessee agrees to permit the Lessor and the authorized representatives of the Lessor to enter the Demised Premises at all times during usual business hours for the purpose of inspecting the same and making any necessary repairs to the Demised Premises and performing any work therein that may be necessary to comply with any laws, ordinances, rules, regulations or requirements of any public authority or of the Board of Fire Underwriters or any similar body or that the Lessor may deem necessary to prevent waste or deterioration in connection with the Demised Premises. Nothing herein shall imply any duty upon the part of the Lessor to do any such work which, under any provision of this Lease, the Lessee may be required to perform and the performance thereof by the Lessor shall not constitute a waiver of the Lessee's default in failing to perform the same. The Lessor may, during the progress of any work in the Demised Premises, keep and store upon the Demised Premises all necessary materials, tools and equipment. The Lessor shall not in any event be liable for inconvenience, annoyance, disturbance, loss of business, or other damage of the Lessee by reason of making repairs or the performance or any work in the Demised Premises, or on account of bringing materials, supplies and equipment into or through the Demised Premises during the course thereof and the obligations of the Lessee under this Lease shall not thereby be affected in any manner whatsoever.*

Lessor reserves the right to enter upon the Demised Premises at any time in the event of an emergency and at reasonable hours to exhibit the Demised Premises to prospective purchasers or others; and to exhibit the Demised Premises to prospective Lessees and to the display "For Rent" or similar signs on windows or doors in the Demised Premises during the last ninety (90) days of the term of this Lease, all without hindrance or molestation by Lessee. However such access may require a security escort.

#### EMINENT DOMAIN

13. In the event of any eminent domain or condemnation proceeding or private sale in lieu thereof in respect to the Premises during the term thereof, the following provisions shall apply:

a. If the whole of the Premises shall be acquired or condemned by eminent domain for any public or quasipublic use or purpose, then the term of this Lease shall cease and terminate as of the date shall be taken in such proceeding and all rentals shall be paid up to that date.

b. If any part constituting less than the whole of the Premises shall be acquired or condemned as aforesaid, and in the event that such partial taking or condemnation shall materially affect the Demised Premises so as to render the Demised Premises unsuitable for the business of the Lessee, in the reasonable opinion of Lessor and Lessee, then the term of this Lease shall cease and terminate as of the date possession shall be taken by the condemning authority and rent shall be paid to the date of such termination.

In the event of a partial taking or condemnation of the Premises which shall not materially affect the Demised Premises so as to render the Demised Premises unsuitable for the business of the Lessee, the reasonable opinion of the Lessor and Lessee, this Lease shall continue in full force and effect but with a proportionate abatement of the Base Rent and Additional Rent based on the portion, if any, of the Demised Premises taken. Lessor reserves the right, at its option, to restore the Building and the Demised Premises to substantially the same condition as they were prior to such condemnation. In such event, Lessor shall give written notice to Lessee, within thirty (30) days following the date possession shall be taken by the condemning authority, of Lessor's intention to restore. Upon Lessor's notice of election to restore, Lessor shall commence restoration and shall restore the Building and the Demised Premises with reasonable promptness, subject to delays beyond Lessor's control and delays in the making of condemnation or sale proceeds adjustments by Lessor; and Lessee shall have no right to terminate this Lease except as herein provided. Upon completion of such restoration, the rent shall be adjusted based upon the portion, if any, of the Demised Premises restored.

c. In the event of any condemnation or taking as aforesaid, whether whole or partial, the Lessee shall not be entitled to any part of the award paid for such condemnation and Lessor is to receive the full amount of such award, the Lessee hereby expressly waiving any right to claim to any part thereof.

d. Although all damages in the event of any condemnation shall belong to the Lessor whether such damages are awarded as compensation for diminution in value of the leasehold or to the fee of the Demised Premises, Lessee shall have the right to claim and recover from the condemning authority, but not from Lessor, such compensation as may be separately awarded or recoverable by Lessee in Lessee's own right on account of any and all damage to Lessee's business by reason of the condemnation and for or on account of any cost or loss to which Lessee might be put in removing Lessee's merchandise, furniture, fixtures, leasehold improvements and equipment. However, Lessee shall have no claim against Lessor or make any claim with the condemning authority for the loss of its leasehold estate, any unexpired term or loss of any possible renewal or extension of said lease or loss of any possible value of said lease, any unexpired term, renewal or extension of said Lease.

#### DAMAGE OR DESTRUCTION:

14. In the event of any damage or destruction to the Premises by fire or other cause during the term hereof, the following provisions shall apply:

a. If the Building is damaged by fire or any other cause to such extent

that the cost of restoration, as reasonably estimated by Lessor, will equal or exceed thirty percent (30%) of the replacement value of the Building (exclusive of foundations) just prior to the occurrence of the damage, then Lessor may, no later than the sixtieth (60th) day following the damage, give Lessee written notice of Lessor's election to terminate this Lease.

b. If the cost of restoration as estimated by Lessor will equal or exceed fifty percent (50%) of said replacement value of the Building and if the Demised Premises are not suitable as a result of said damage—for the purposes for which they are demised hereunder, in the reasonable opinion of Lessee, then Lessee may, no later than the sixtieth (60th) day following the damage, give Lessor a written notice of election to terminate this Lease.

c. If the cost of restoration as estimated by Lessor shall amount to less than thirty percent (30%) of said replacement value of the Building, or if, despite the cost, Lessor does not elect to terminate this Lease, Lessor shall restore the Building and the Demised Premises with reasonable promptness, subject to delays beyond Lessor's control and delays in the making of insurance adjustments by Lessor; and Lessee shall have no right to terminate this Lease except as herein provided. Lessor shall not be responsible for restoring or repairing leasehold improvements of this Lessee

d. In the event of either of the elections to terminate, this Lease shall be deemed to terminate on the date of the receipt of the notice of election and all rentals shall be paid up to that date. Lessee shall have no claim against Lessor for the value of any unexpired term of this Lease.

e. In any case where damage to the Building shall materially affect the Demised Premises so as to render them unsuitable in whole or in part for the purposes for which they are demised hereunder, then, unless such destruction was wholly or partially caused by the negligence or breach of the terms of this Lease by Lessee, its employees, contractors or licensees, a portion of the rent based upon the amount of the extent to which the Demised Premises are rendered unsuitable shall be abated until repaired or restored. If the destruction or damage was wholly or partially caused by negligence or breach of the terms this Lease by Lessee as aforesaid and if Lessor shall elect to rebuild, the rent shall not abate and the Lessee shall remain liable for the same.

#### CASUALTY INSURANCE:

15. a. Lessor shall at all times during the term of this Lease, at its expense, maintain a policy or policies of insurance with premiums paid in advance issued by an insurance company licensed to do business in the State of Minnesota insuring the Building against loss or damage by fire, explosion or other insurable hazards and contingencies for the full replacement value, provided that Lessor shall not be obligated to insure any furniture, equipment, machinery, goods or supplies not covered by this Lease which Lessee may bring upon the Demised Premises or any additional improvements which Lessee may construct or install on the Demised Premises.

b. Lessee shall not carry any stock of goods or do anything in or about the Demised Premises which will in any way impair or invalidate the obligation of the insurer under any policy of insurance required by this Lease.

c. Lessor hereby waives and releases all claims, liabilities and causes of action against Lessee and its agents, servants and employees for loss or damage to, or destruction of, the Premises or any portion thereof, including the buildings and other improvements situated thereon, resulting from fire, explosion and other perils included in standard extended coverage insurance, whether caused by the negligence of any of said persons or otherwise. Likewise, Lessee hereby waives and releases all claims, liabilities and causes of action against Lessor and its agents, servants and employees for loss or damage to, or destruction of, any of the improvements, fixtures, equipment, supplies, merchandise and other property, whether that of Lessee or of others in, upon or about the Premises resulting from fire, explosion or the other perils included in standard extended coverage insurance, whether caused by the negligence of any of said persons or otherwise. The waiver shall remain in force whether or not the Lessee's insurer shall consent thereto.

d. In the event that the use of the Demised Premises by Lessee increases the premium rate for insurance carried by Lessor on the improvements of which

the Demised Premises are a part, Lessee shall pay Lessor, upon demand, the amount of such premium increase. If Lessee installs any electrical equipment that overloads the power lines to the building or its wiring, Lessee shall, at its own expense, make whatever changes are necessary to comply with the requirements of the insurance underwriter, insurance rating bureau and governmental authorities having jurisdiction.

**PUBLIC LIABILITY INSURANCE:**

16. Lessee shall during the term hereof keep in full force and effect at its expense a policy or policies of public liability insurance with respect to the Demised Premises and the business of Lessee, on terms with companies approved in writing by Lessor, in which both Lessee and Lessor shall be covered by being named as insured parties under reasonable limits of liability not less than: \$500,000 for injury/death to any one person; \$1,000,000 for injury/death to more than one person, and \$500,000 with respect to damage to property. Such policy or policies shall provide that ten (10) days written notice must be given to Lessor prior to cancellation thereof. Lessee shall furnish evidence satisfactory to Lessor at the time this Lease is executed that such coverage is in full force and effect.

**DEFAULT OF LESSEE:**

17. a. In the event of any failure of Lessee to pay any rental due hereunder within ten (10) days after the same shall be due, or any failure to perform any other of the terms, conditions or covenants of this Lease to be observed or performed by Lessee for more than thirty (30) days after written notice of such failure shall have been given to Lessee, or if Lessee or an agent of Lessee shall falsify any report required to be furnished to Lessor pursuant to the terms of this Lease, or if Lessee or any guarantor of this Lease shall become bankrupt or insolvent, or file any debtor proceedings or any person shall take or have against Lessee or any guarantor of this Lease in any court pursuant to any statute either of the United States or of any state a petition in bankruptcy or insolvency or for reorganization or for the appointment of a receiver or trustee of all or a portion of Lessee's or any such guarantor's property, or if Lessee or any such guarantor makes an assignment for the benefit of creditors, or petitions for or enters into an arrangement, or if Lessee shall abandon the Demised Premises or suffer this Lease to be taken under any writ of execution, then in any such event Lessee shall be in default hereunder, and Lessor, in addition to other rights of remedies it may have, shall have the immediate right of re-entry and may remove all persons and property from the Demised Premises and such property may be removed and stored in a public warehouse or elsewhere at the cost of, and for the account of Lessee, all without service of notice or resort to legal process and without being guilty of trespass, or becoming liable for any loss or damage which may be occasioned thereby.

b. Should Lessor elect to re-enter the Demised Premises, as herein provided, or should it take possession of the Demised Premises pursuant to legal proceedings or pursuant to any notice provided for by law, it may either terminate this Lease or it may from time to time, without terminating this Lease, make such alterations and repairs as may be necessary in order to relet the Demised Premises, and relet the Demised Premises or any part thereof such term or terms (which may be for a term extending beyond the term of this Lease) and at such rental or rentals and upon such other terms and conditions as Lessor in its sole discretion may deem advisable. Upon each such subletting all rentals received by the Lessor from such reletting shall be applied first to the payment of any indebtedness other than rent due hereunder from Lessee to Lessor; second, to the payment of any costs and expenses of such reletting, including brokerage fees and attorney's fees and costs of such alterations and repairs; third, to the payment of the rent due and unpaid payment of future rent as the same may become due and payable hereunder. If such rentals received from such reletting during any month be less than that to be paid during that month by Lessee hereunder, Lessee, upon demand, shall pay tiny such deficiency to Lessor. No such re-entry or taking possession of the Demised Premises by Lessor shall be construed as an election on its part to terminate this Lease unless a written notice of such intention be given to Lessee or unless the termination thereof be decreed by a court of competent jurisdiction. Notwithstanding any such reletting without termination, Lessor may at any time after such re-entry and reletting elect to terminate this Lease for any such breach, in addition to any other remedies it may have, it may recover from Lessee all damages it may incur by reason of such breach, including the cost of recovering the Demised Premises,

reasonable attorney's fees, and including the worth at the time of such termination of the excess, if any, of the amount of rent and charges equivalent to rent reserved in this Lease for the remainder of the stated term over the then reasonable rental value of the Demised Premises for the remainder of the stated term, all of which amounts shall be immediately due and payable from Lessee to Lessor.

c. Lessor may, at its option, instead of exercising any other rights or remedies available to it in this Lease or otherwise by law, statute or equity, spend such money as is reasonably necessary to cure any default of Lessee herein and the amount so spent, and costs incurred, including attorney's fees in curing such default, shall be paid by Lessee, as additional rent, upon demand.

d. In the event suit shall be brought for recovery of possession of the Demised Premises, for the recovery of rent or any other amount due under the provisions of this Lease, or because of the breach of any other covenant herein contained on the part of Lessee to be kept or performed, and a breach shall be established, Lessee shall pay to Lessor all expenses incurred therefor, including a reasonable attorney's fee, together with interest on all such expenses at the rate of twelve percent (12%) per annum from the date of such breach of the covenants of this Lease.

e. Lessee hereby expressly waives any and all rights of redemption granted by or under any present or future laws in the event of Lessee being evicted or dispossessed for any cause, or in the event of Lessor obtaining possession of the Demised Premises, by reason of the violation by Lessee of any of the covenants or conditions of this Lease, or otherwise. Lessee also waives any demand for possession of the Demised Premises, and any demand for payment of rent and any notice of intent to re-enter the Demised Premises, or of intent to terminate this Lease, other than the notices above provided in this Article, and waives any and every other notice or demand prescribed by any applicable statutes or laws.

f. No remedy herein or elsewhere in this Lease or otherwise by law, statute or equity, conferred upon or reserved to Lessor or Lessee shall be exclusive of any other remedy, but shall be cumulative, and may be exercised from time to time and as often as the occasion may arise.

#### COVENANTS TO HOLD HARMLESS:

18. Unless the liability for damage or loss is caused by the negligence of Lessor, its agents or employees. Lessee shall hold harmless Lessor from any liability for damages to any person or property in or upon the Demised Premises and the Premises, including the person and the property of Lessee and its employees and all persons in the Building at its or their invitation or sufferance, and from all damages resulting from Lessee's failure to perform the covenants of this Lease. All property kept, maintained or stored on the Demised Premises shall be so kept, maintained or stored at the sole risk of Lessee. Lessee agrees to pay all sums of money in respect of any labor, service, materials, supplies or equipment furnished or alleged to have been furnished to Lessee in or about the Premises, and not furnished on order of Lessor, which may be secured by any Mechanic's Materialmen's or other lien to be discharged at the time performance of any obligation secured thereby matures, provided that Lessee may contest such lien, but if such lien is reduced to final judgment and if such judgment or process thereon is not stayed, or if stayed and said stay expires, then and in each such event, Lessee shall forthwith pay and discharge said judgment. Lessor shall have the right to post and maintain on the Demised Premises, of non-responsibility under the laws of the State of Minnesota.

#### NON-LIABILITY:

19. Subject to the terms and conditions of Article 14 hereof, Lessor shall not be liable for damage to any property of Lessee or of others located on the Premises, nor for the loss of or damage to any property of Lessee or of others by theft or otherwise. Lessor shall not be liable for any injury or damage to persons or property resulting from fire, explosion, falling plaster, steam, gas, electricity, water, rain or snow or leaks from any part of the Premises or from the pipes, appliances, or plumbing works or from the roof, street or subsurface or from any other place or by dampness or by any other cause of whatsoever nature. Lessor shall not be liable for any such damage caused by other Lessees or persons in the Premises, occupants of adjacent property, of the buildings, or

the public or caused by operations in construction of any private, public or quasipublic work. All property of Lessee kept or stored on the Demised Premises shall be so kept or stored at the risk of Lessee only and Lessee shall hold Lessor harmless from any claims arising out of damage to the same, including subrogation claims by Lessee's insurance carrier.

**SUBORDINATION:**

20. This Lease shall be subordinated to any mortgages that may now exist or that may hereafter be placed upon the Demised Premises and to any and all advances made thereunder, and to the interest upon the indebtedness evidenced by such mortgages, and to all renewals, replacements and extensions thereof. In the event of execution by Lessor after the date of this Lease of any such mortgage, renewal,

replacement or extension, Lessee agrees to execute a subordination agreement with the holder thereof which agreement shall provide that:

a. Such holder shall not disturb the possession and other rights of Lessee under this Lease so long as Lessee is not in default hereunder,

b. In the event of acquisition of title to the Demised Premises by such holder, such holder shall accept the Lessee as Lessee of the Demised Premises under the terms and conditions of this Lease and shall perform all the obligations of Lessor hereunder, and

c. The Lessee shall recognize such holder as Lessor hereunder. Lessee shall, upon receipt of a request from Lessor therefor, execute and deliver to Lessor or to any proposed holder of a mortgage or trust deed or to any proposed purchaser of the Premises, a certificate in recordable form, certifying that this Lease is in full force and effect, and that there are no offsets against rent nor defenses to Lessee's performance under this Lease, or setting forth any such offsets or defenses claimed by Lessee, as the case may be.

**ASSIGNMENT OR SUBLETTING:**

21. Lessee agrees to use and occupy the Demised Premises throughout the entire term hereof for the purpose of purposes herein specified and for no other purposes, in the manner and to substantially the extent now intended, and not to transfer or assign this Lease or sublet said Demised Premises, or any part thereof, whether by voluntary act, operation of law, or otherwise, without obtaining the prior consent of Lessor in each instance. Lessee shall seek such consent of Lessor by a written request therefor, setting forth such information as Lessor may deem necessary. Lessor agrees not to withhold consent unreasonably. Consent by Lessor to any assignment of this Lease or to any subletting of the Demised Premises shall not be a waiver of Lessor's rights under this Article as to any subsequent assignment or subletting. Lessor's rights to assign this Lease are and shall remain unqualified. No such assignment or subleasing shall relieve the Lessee from any of Lessee's obligations in this Lease contained, nor shall any assignment or sublease or other transfer of this Lease be effective unless the assignee, sublessee or transferee shall at the time of such assignment, sublease or transfer, assume in writing for the benefit of Lessor, its successors or assigns, all of the terms, covenants and conditions of this Lease thereafter to be performed by Lessee and shall agree in writing to be bound thereby. Should Lessee sublease in accordance with the terms of this Lease, fifty percent (50%) of any increase in rental received by Lessee over the per square foot rental rate which is being paid by Lessee shall be forwarded to and retained by Lessor, which increase shall be in addition to the Base Rent and Additional Rent due Lessor under this Lease.

**ATTORNTMENT:**

22. In the event of a sale or assignment of Lessor's interest, in the Premises, or the Building in which the Demised Premises are located, or this Lease, or if the Premises come into custody or possession of a mortgagee or any other party whether because of a mortgage foreclosure, or otherwise, Lessee shall attorn to such assignee or other party a) and recognize such party as Lessor hereunder; provided, however, Lessee's peaceable possession will not be disturbed so long as Lessee faithfully performs its obligations under this Lease. Lessee shall execute, on demand, any attornment agreement required by any such party to be executed, containing such provisions and such other provisions as such party may



require.

NOVATION IN THE EVENT OF SALE: See Article 49

23. In the event of the sale of the Demised Premises, Lessor shall be and hereby is relieved of all of the covenants and obligations created hereby accruing from and after the date of sale, and such sale shall result automatically in the purchaser assuming and agreeing to carry out all the covenants and obligations of Lessor herein. Notwithstanding the foregoing provisions of this Article, Lessor, in the event of a sale of

the Demised Premises, shall cause to be included in this agreement of sale and purchase a covenant whereby the purchaser of the Demised Premises assumes and agrees to carry out all of the covenants and obligations of Lessor herein.

The Lessee agrees at any time and from time to time upon not less than ten (10) days prior written request by the Lessor to execute, acknowledge and deliver to the Lessor a statement in writing certifying that this Lease is unmodified and in full force and effect as modified and stating the modifications, and the dates to which the basic rent and other charges have been paid in advance, if any, it being intended that such statement delivered pursuant to this paragraph may be relied upon by any prospective purchaser of the fee or mortgagee or assignee of any mortgage upon the fee of the Demised Premises.

SUCCESSORS AND ASSIGNS:

24. The terms, covenants and conditions hereof shall be binding upon and inure to the successors and assigns of the parties hereto.

REMOVAL OF FIXTURES:

25. Notwithstanding anything contained in Article 8, 29 or elsewhere in this Lease, if Lessor requests then Lessee will promptly remove at the sole cost and expense of Lessee all fixtures, equipment and alterations made by Lessee simultaneously with vacating the Demised Premises and Lessee will promptly restore said Demised Premises to the condition that existed immediately prior to said fixtures, equipment and alterations having been made all at the sole cost and expense of Lessee.

QUIET ENJOYMENT:

26. Lessor warrants that it has full right to execute and to Lease and to grant the estate demised, and that Lessee, upon payment of the rents and other amounts due and the performance of all the terms, conditions, covenants and agreements on Lessee's part to be observed and performed under this Lease, may peaceably and quietly enjoy the Demised Premises for the business uses permitted hereunder, subject, nevertheless, to the terms and conditions of this Lease.

RECORDING:

27. Lessee shall not record this Lease without the written consent of Lessor. However, upon the request of either party hereto, the other party shall join in the execution of the Memorandum lease for the purposes of recordation. Said Memorandum lease shall describe the parties, the Demised Premises and the term of the Lease and shall incorporate this Lease by reference. This Article 27 shall not be construed to limit Lessor's right to file this Lease under Article 22 of this Lease.

OVERDUE PAYMENTS:

28. All monies due under this Lease from Lessee to Lessor shall be due on demand, unless otherwise specified and if not paid when due, shall result in the imposition of a service charge for such late payment in the amount of ten percent (10%) of the amount due.

SURRENDER:

29. On the Expiration Date or upon the termination hereof upon a day other than the Expiration Date, Lessee shall peaceably surrender the Demised premises broom-clean in good order, condition and repair, reasonable wear and tear only

excepted. On or before the Expiration Date or upon termination of this Lease on a day other than the Expiration Date, Lessee shall, at its expense, remove all trade fixtures, personal property and equipment and signs from the Demised Premises and any property not removed shall be deemed to have been abandoned. Any damage caused in the removal of such items shall be

repaired by Lessee and at its expense. All alterations, additions, improvements and fixtures (other than trade fixtures) which shall have been made or installed by Lessor or Lessee upon the Demised Premises and all floor covering so installed shall remain upon and be surrendered with the Demised Premises as a part thereof, without disturbance, molestation or injury, and without charge, at the expiration or termination of this Lease. If the Demised Premises are not surrendered on the Expiration Date or the date of termination, Lessee shall indemnify Lessor against loss or liability, claims, without limitation, made by any succeeding Lessee founded on such delay. Lessee shall promptly surrender all keys for the Demised Premises to Lessor at the place then fixed for payment of rent and shall inform Lessor of combinations of any locks and safes on the Demised Premises.

**HOLDING OVER:**

30. In the event of a holding over by Lessee after expiration or termination of this Lease without the consent in writing of Lessor, Lessee shall be deemed a lessee at sufferance and shall pay rent for such occupancy at the rate of 150% the last-current aggregate Base and Additional Rent, prorated for the entire holdover period, plus all attorney's fees and expenses incurred by Lessor in enforcing its rights hereunder, plus any other damages occasioned by such holding over. Except as otherwise agreed, any holding over with the written consent of Lessor shall constitute Lessee a month-to-month lessee.

**ABANDONMENT:**

31. In the event Lessee shall remove its fixtures, equipment or machinery or shall vacate the Demised Premises or any part thereof prior to the Expiration Date of this Lease, or shall discontinue or suspend the operation of its business conducted on the Demised Premises for a period of more than thirty (30) consecutive days (except during any time when the Demised Premises may be rendered untenable by reason of fire or other casualty), then in any such event Lessee shall be deemed to have abandoned the Demised Premises and Lessee shall be in default under the terms of this Lease. However, Lessee shall not be deemed to have abandoned the Demised Premises or to be in default under the terms of this Lease if the Lessee makes the rental payments as required herein not withstanding the other provisions of this section.

**CONSENTS BY LESSOR:**

32. Whenever provision is made under this Lease for Lessee securing the consent or approval by Lessor, such consent or approval shall only be in writing. and such consent or approval shall not be unreasonably withheld.

**NOTICES:**

33. Any notice required or permitted under this Lease shall be deemed sufficiently given or secured if sent by registered or certified return receipt mail to Lessee at 10701 Red Circle Drive, Minnetonka, Minnesota 55343 and to Lessor at the address then fixed for the payment of rent as provided in Article 4 of this Lease, and either party may by like written notice at any time designate a different address to which notices shall subsequently be sent or rent to be paid.

**RULES AND REGULATIONS:**

34. Lessee shall observe and comply with the rules and regulations hereinafter set forth in "Exhibit C", and with such further reasonable rules and regulations as Lessor may prescribe, on written notice to Lessee for the safety, care and cleanliness of the Building.

**INTENT OF PARTIES:**

35. Except as otherwise provided herein, the Lessee covenants and agrees that if it shall any time fail to pay any such cost or expense, or fail to take out, pay

for, maintain or deliver any of the insurance policies

above required, or fail to make any other payment or perform any other act on its part to be made or performed as in this Lease provided, then the Lessor may, but shall not be obligated so to do, and without notice to or demand upon the Lessee and without waiving or releasing the Lessee from any obligations of the Lessee in this Lease contained, pay any such cost or expense, effect any such insurance coverage and pay premiums therefor, and may make any other payment or perform any other act on the part of the Lessee to be made and performed as in this Lease provided, in such manner and to such extent as the Lessor may deem desirable, and in exercising any such right, to also pay all necessary and incidental costs and expenses, employ counsel and incur and pay reasonable attorneys' fees. All sums so paid by Lessor and all necessary and incidental costs and expenses in connection with the performance of any such act by the Lessor, together with interest thereon at the rate of twelve percent (12%) per annum from the date of making of such expenditure, by Lessor, shall be deemed additional rent hereunder, and shall be payable to Lessor on demand. Lessee covenants to pay any such sum or sums with interest as aforesaid and the Lessor shall have the same rights and remedies in the event of the non-payment thereof by Lessee as in the case of default by Lessee in the payment of the Base Rent payable under this Lease.

**GENERAL:**

36. The Lease does not create the relationship of principal and agent or of partnership or of joint venture or of any association between Lessor and Lessee, the sole relationship between the parties hereto being that of Lessor and Lessee. No waiver of any default of Lessee hereunder shall be implied from any omission by Lessor to take any action on account of such default if such default persists or is repeated, and no express waiver shall affect any default other than the default specified in the express waiver and that only for the time and to the extent therein stated. One or more waivers by Lessor shall not then be construed as a waiver of a subsequent breach of the same covenant, term or condition. The consent to or approval by Lessor of any act by Lessee requiring Lessor's consent or approval shall not waive or render unnecessary Lessor's consent to or approval of any subsequent similar act by Lessee shall be construed to be both a covenant and a condition. No action required or permitted to be taken by or on behalf of Lessor under the terms or provisions of this Lease shall be deemed to constitute an eviction or disturbance of Lessee's possession of the Demised Premises. All preliminary negotiations are, merged into and incorporated in this Lease. The laws of the State of Minnesota shall govern the validity, performance and enforcement of this Lease.

a. This Lease and the exhibits, if any, attached hereto and forming a part hereof, constitute the entire agreement between Lessor and Lessee affecting the Demised Premises and there are no other agreements, either oral or written, between them other than are herein set forth. No subsequent alteration, amendment, change or addition to this Lease shall be binding upon Lessor or Lessee unless reduced to writing and executed in the same form and manner in which this Lease is executed.

b. If any agreement, covenant or condition of this Lease or the application thereof to any person or circumstances shall, to any extent, be invalid or unenforceable, the remainder of this Lease, or the application of such agreement, covenant or condition to persons or circumstances other than those as to which it is held invalid or unenforceable, shall not be affected thereby and each agreement, covenant or condition of this Lease shall be valid and be enforced to the fullest extent permitted by law.

**HAZARDOUS MATERIAL:** See Article 50

37. a. The Premises hereby leased shall be used by and/or at the sufferance of Lessee only for the purpose set forth in Article 11 above and for no other purposes. Lessee shall not use or permit the use of the Premises in any manner that will tend to create waste or a nuisance, or will tend to unreasonably disturb other Lessees in the Building or the Project. Lessee, its employees and all persons visiting or doing business with Lessee in the Premises shall be bound by and shall observe the Building Rules and Regulations attached to this Lease as Exhibit 'C', and such further and other reasonable rules and regulations made hereafter by Lessor relating to the Premises, the Building or the Project of which notice in writing shall be given to the Lessee, and all

such rules and regulations shall be deemed to be incorporated into and form a part of this Lease.

b. Lessee covenants throughout the Lease Term, at Lessee's sole cost and expense, promptly to comply with all laws and ordinances and the orders, rules and regulations and requirements of all federal,

state and municipal governments and appropriate departments, commissions, boards, and officers thereof, and the orders, rules and regulations of the Board of Fire Underwriters where the Premises are situated, or any other body now or hereafter well as extraordinary, and whether or not the same require structural repairs or alterations, which may be applicable to the Premises, or the use or manner of use of the Premises. Lessee will likewise observe and comply with the requirements of all policies of public liability, fire and all other policies of insurance at any time in force with respect to the buildings and improvements on the Premises and the equipment thereof.

c. In the event any Hazardous Material (hereinafter defined) is brought or caused to be brought into or onto the Premises, the Building or the Project by Lessee, Lessee shall handle any such material in compliance with all applicable federal, state and/or local regulations. For purposes of this Article, 'Hazardous Material' means and includes any hazardous, toxic or dangerous waste, substance or material defined as such in (or for purposes of) the Comprehensive Environmental Response, Compensation, and Liability Act, any so-called 'Superfund' or 'Superlien' law, or any federal, state or local statute, law, ordinance, code, rule, regulation, order decree regulating, relating to, or imposing liability or standards of conduct concerning, any hazardous, toxic or dangerous waste, substance or material, as now or at any time hereafter in effect. Lessee shall submit to Lessor on an annual basis copies of its approved hazardous materials communication plan, OSHA monitoring plan, and permits required by the Resource Recovery and Conservation Act of 1976, if Lessee is required to prepare, file or obtain any such plans or permits. Lessee will indemnify and hold harmless Lessor from any losses, liabilities, damages, costs or expenses (including reasonable attorneys' fees) which Lessor may suffer or incur as a result of Lessee's introduction into or onto the Premises of any Hazardous Material. This Article shall survive the expiration or sooner termination of this Lease.

**CAPTIONS:**

38. The captions are inserted only as a matter of convenience and for reference, and in no way define, limit or describe the scope of this Lease nor the intent or any provision thereof.

**EXHIBITS:**

39. Reference is made to Exhibits A through D, inclusive, which Exhibits are attached hereto and made a part hereof.

EXHIBIT	DESCRIPTION
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Exhibit A	Legal Description
Exhibit B	Demised Premises
Exhibit C	Building Rules and Regulations
Exhibit D	Improvements

40. Submission of this instrument to Lessee or proposed Lessee or his agents or attorneys for examination, review, consideration or signature does not constitute or imply an offer to lease, reservation of space, or option to lease, and this instrument shall have no binding legal effect until execution hereof by both Lessor/Owner and Lessee or its agents.

41. It is agreed and understood that Scott Frederiksen agent or broker with Welsh Companies, Inc. is representing Sierra Development, Lessor, and Mike Smith/Steve Faber, agent or broker with Towle Real Estate is representing LecTec Corporation (A Minnesota Corporation) Lessee.

SEE ALSO THE RIDER ATTACHED HERETO AND MADE A PART HEREOF, AND CONTAINING ARTICLES 42 THROUGH 50, INCLUSIVE

IN WITNESS WHEREOF, the Lessor and the Lessee have caused these presents to be

executed in form and manner sufficient to bind them at law, as of the day and year first above written.

Lessee:

LecTec Corporation  
(A Minnesota Corporation)

Lessor:

Sierra Development  
(A Minnesota General Partnership)

By: /s/ George B. Ingebrand

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George B. Ingebrand  
Its President and CEO

By: /s/ Dennis J. Doyle

-----  
Dennis J. Doyle  
Its Partner

REV 6/89

Printed in U.S.A.

RIDER TO LEASE  
DATED MAY 24, 1991  
BY AND BETWEEN  
SIERRA DEVELOPMENT (A MINNESOTA GENERAL PARTNERSHIP), LESSOR  
AND  
LECTEC CORPORATION (A MINNESOTA CORPORATION), LESSEE

Article 42 - Early Occupancy:

In the event the Premises become available and ready for occupancy prior to the Commencement Date, Lessor may elect to permit Lessee to take occupancy of all or part of the Premises prior to such date. In such event, it is agreed that all the terms and conditions of this Lease shall be in full force and effect except Base Rent and Additional Rent shall be abated until the Commencement Date.

Article 43 - Base Rent:

The following is hereby added to and made a part of Article 2, Base Rent, and Article 3, Additional Rent of this Lease:

Period	Monthly Base Rent	Total Period Base Rent
July 1, 1991 through and including October 31, 1991	\$0.00	\$0.00
November 1, 1991 through and including June 30, 1994	\$10,288.50	\$329,232.00
July 1, 1994 through and including June 30, 1997	\$11,548.70	\$415,753.20
TOTAL		\$744,985.20

All other terms and conditions of this Lease, including Article 3, Additional Rent, shall be in full force and effect July 1, 1991.

Article 44 - Improvements:

The Lessor agrees, at no expense to the Lessee, to provide all of the improvements detailed in Exhibit "D". Any additional improvements shall be approved by the Lessor and completed at the sole cost and expense of the Lessee.

*Article 45 - Right To Terminate:*

*Provided the Lessee is not in default and performed all of its obligations hereunder it shall have the one time right to terminate this Agreement on July 1, 1996. To exercise this Right To Terminate the Lessee shall notify the Lessor in writing of its intent no later than 120 days prior to*

*July 1, 1996. Such notification shall also be accompanied by a termination fee of \$11,548.70. This Right To Terminate is personal to LecTec Corporation and is not transferable; and in the event of any assignment or subletting shall automatically terminate and shall thereafter become null and void.*

*Article 46 - Parking:*

*The Lessor agrees to provide the Lessee with 65 parking stalls. In the event the balance of the Building is leased and parking becomes a problem, the Lessor agrees to use its commercially reasonable best efforts to correct such parking problems.*

*Article 47 - First Opportunity to Lease Additional Space:*

- A. Provided Lessee is not in default and has performed all of its obligations hereunder, Lessee shall have the first opportunity to lease such other contiguous space in their entirety, or at Lessor's direction, some portion thereof, as they become available for leasing during the first four (4) years of the Term ("First Opportunity") for a term coterminous with this Lease and, at the same square foot rental rates and upon such other terms and conditions, as are then being paid by Lessee for the Demised Premises.*
- B. Upon notification in writing by Lessor that such space is available, Lessee shall have three (3) business days in which to elect in writing so to lease such space, in which event the lease for same shall commence not more than thirty (30) days after such space becomes vacant and shall be coterminous with this Lease.*
- C. In the event Lessee declines or fails to elect so to lease such space, then the First Opportunity hereby granted so at to such space shall automatically terminate and shall thereafter be null and void as to such space.*
- D. It is understood that this First Opportunity shall not be construed to prevent any other lessee in the Building from extending or renewing its lease.*

*Rider To Lease  
LecTec Corporation  
Page Three*

- E. The First Opportunity hereby granted is personal to LecTec Corporation and is not transferable; in the event of any assignment or subletting under this Lease, this First Opportunity shall automatically terminate and shall thereafter be null and void.*

*Article 48 - Additional Rent:*

*The following is hereby added to and made a part of Article 3, Additional Rent of this Lease:*

- A. The Lessee shall not be responsible for paying delinquency penalties imposed upon Lessor for Lessor's late payment of real estate taxes.*
- B. The Lessee shall have the right to inspect Lessor's records relating to the operating costs on the building which are billed back to the Lessee as Additional Rent.*

**Article 49 - Lessee's Approval of Sale:**

In the event that Lessor shall elect to sell, assign or transfer its interest in the Building to a "Competitor" (as hereinafter defined) Lessor shall disclose the identity of the Competitor in writing

to Lessee (the "Notice of Intended Sale"). If Lessee reasonably determines that leasing by the Lessee of the Demised Premises from the Competitor would (i) cause material harm to the Lessee's business or (ii) violate any law, rule or regulation applicable to Lessee, Lessee shall have thirty (30) days after receipt of the Notice of Intended Sale to elect to terminate this Lease effective ninety (90) days from the date of such election. Election to terminate shall be made by written notice to Lessor as provided herein. Such election to terminate shall be accompanied by (i) an affidavit from an officer of Lessee setting forth the factual basis justifying termination and (ii) payment of a termination premium in an amount equal to fifty percent (50%) of the then present value (using a 10% interest rate assumption) of the remaining base rental obligation of Lessee under the lease term. For purposes hereof, a "Competitor" shall be any entity which derives more than fifty percent (50%) of its revenues from the sale or manufacture of products which are substantially the same as, and in direct competition with, products sold or manufactured by Lessee as of the date hereof.

**Article 50 - Hazardous Material:**

Lessor warrants and covenants that it did not, and will not in the future, install, use, generate, store or dispose of on or about the Premises (or the Building) any hazardous substances, toxic chemicals, pollutants or other materials regulated

Rider To Lease  
LecTec Corporation  
Page Four

pursuant to the Federal Comprehensive Environmental Response Compensation and Liability Act ("CERCLA"), the Federal Resource Conservation and Recovery Act ("RCRA") and the Minnesota Environmental Response and Liability Act ("MERLA"), or any similar statutes or regulations, including without limitation any materials containing asbestos, polychlorinated biphenyls ("PCB's"), petroleum, crude oil or natural gas (collectively, "Hazardous Substances"), except for immaterial quantities of any Hazardous Substances customarily used in the construction and maintenance of like properties which have been used in accordance with applicable laws, statutes, regulations and ordinances then in effect. Lessor further agrees to indemnify and hold Lessee harmless from and against any claim, damage, fine or any other expense (including court costs, attorney's fees and any other cost of defense) arising out of Lessor's installation, use, generation, storage or disposal of any Hazardous Substances in or about the Premises (or the Building).

Lessor has not, and to the best of its knowledge without independent verification, no prior owner or occupant has installed in, on or about the Premises any underground storage tank containing Hazardous Substances (as defined elsewhere in Lease), including, but not limited to, petroleum, crude oil or by-products of petroleum or crude oil.

Lessor hereby warrants that, to the best of its knowledge without independent verification, no asbestos containing materials have been used or installed upon the Premises, or, if at any time asbestos containing materials were located on the Premises, such materials have been removed prior to the date of this Lease.

LESSEE:

LECTEC CORPORATION  
(A MINNESOTA CORPORATION)

LESSOR:

SIERRA DEVELOPMENT  
(A MINNESOTA GENERAL PARTNERSHIP)

BY: /s/ George B. Ingebrand

BY: /s/ Dennis J. Doyle

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George B. Ingebrand

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Dennis J. Doyle

ITS: President and CEO

ITS: Partner

DATE: May 24, 1991

DATE: May 24, 1991

**EXHIBIT "A"**

**LEGAL DESCRIPTION**

Lot 1, Block 1, Edina Interchange Center, Fifth Addition

**EXHIBIT "B"**

**Floor Plan**

Exhibit "B" (which is a schematic of the leased building and grounds) has been omitted from this electronic filing.

**EXHIBIT "C"**

**Rules and Regulations**

**THESE RULES ARE FOR THE MUTUAL BENEFIT OF ALL USERS  
PLEASE COOPERATE**

Tenant agrees to be bound by and comply with the Rules and Regulations, as follows:

(a) **Trash.** Each Tenant shall provide its own dumpster for trash and agrees not to leave or store any materials, litter or trash on the grounds or parking areas.

(b) **Parking.** Parking shall fully comply with the City of Edina ordinances.

(c) **Signs.** No sign, advertisement, or other lettering shall be painted, affixed, or exposed on the windows or doors or any part of the outside of the building or property without the prior written consent of the Landlord, which consent shall not be unreasonably withheld. All identification signs shall be per the building standards and fully comply with the City of Edina ordinances.

(d) **Fixture Movement.** Tenant agrees that any and all furniture, fixtures and goods will be moved by the Tenant whenever such moving is necessary for purpose of building repair and/or maintenance by Landlord.

(e) **Access.** Landlord or authorized agent, has the right to enter the Leased Premises at any reasonable time to inspect, make repairs or alterations as needed, and three (3) months prior to the termination of this Agreement to display the Leased Premises to prospective tenants, and to place on doors and windows appropriate notice that the premises are for rent.

(f) **Locks.** No additional locks will be placed on any of the doors in the building without Landlord's prior written approval, which approval shall not be unreasonably withheld, and unless Landlord receives an access key to such locks.

(g) **Storage.** Storage and installation of any machinery, parts, materials, equipment, shelving or furniture of any type whatsoever, constitutes occupancy.

Tenant has read and agrees to abide by all Landlord's Rules and Regulations and acknowledges that violation of any provision of this Agreement or Rules constitutes a breach of this Lease Agreement.



Edina Facility Lease

FIRST AMENDMENT TO LEASE

THIS FIRST AMENDMENT TO LEASE ("First Amendment") is made as of May 5, 1997, by and between Rushmore Plaza Partners Limited partnership, a South Dakota limited partnership ("Lessor"), and LecTec Corporation, a Minnesota Corporation ("Lessee").

RECITALS:

A. Pursuant to Office/Warehouse Lease dated May 24, 1991 (the "Lease"), Sierra Development Co., also known as Sierra Development, a Minnesota general partnership, leased certain premises (the "Demised Premises") located in the building (the "Building") at 7401 Cahill Road, Edina, Minnesota, to Lessee for a lease term expiring June 30, 1997.

B. Lessor purchased the Premises described in the Lease from Sierra Development Co., on December 20, 1994 through a third-party intermediary, namely, Eberhardt Properties, Inc., which subsequently assigned and conveyed the Premises to Lessor. As part of the purchase and assignment, Lessor was assigned the landlord's interest in the Lease, and is now the owner of the Premises and Building in which the Demised Premises are located, and it is now also the Lessor under the Lease.

C. Lessor and Lessee desire to amend the Lease so as to extend the term thereof, and so as to make certain other amendments thereto as are hereinafter set forth.

NOW, THEREFORE, Lessor and Lessee agree, for valuable consideration, the receipt and sufficiency of which are hereby acknowledged, as follows:

1 Term. Article I of the Lease is hereby amended to provide for an additional five (5) year term (the "Extension Term"). The Extension Term shall commence July 1, 1997 and shall expire June 30, 2002. Accordingly, the definition of "Expiration Date" is hereby amended to mean July 30, 2002, and the term of the Lease shall mean and include the Extension Term. All of the terms and provisions of the Lease shall apply to the Extension Term, except as the same may be modified, supplemented or otherwise amended by this First Amendment.

2. BaseRent. Effective July 1, 1997, Article 2 of the Lease shall be deleted in its entirety, and the following inserted in place thereof:

BASE RENT:

2. Lessee shall pay Lessor, in advance, monthly Base Rent in the following installments, commencing on July 1, 1997, and continuing on the first day of each and every month thereafter during the balance of the Extension Term (the "Base Rent"):

Extension Term	Annual Rate Per Sq. Foot	Monthly Base Rate
7/1/97 - 6/30/99	\$5.08	\$12,355.83
7/1/99 - 6/30/00	\$5.40	\$13,134.15
7/1/00 - 6/30/01	\$5.60	\$13,620.60
7/1/01 - 6/30/02	\$5.85	\$14,228.66

3. Address for Payment of Rent. Article 4 of the Lease is hereby amended to provide that all rents are payable to the Lessor at c/o Northcrest Corporation, 3914 IDS Center, 80 South 8th Street, Minneapolis, Minnesota 55402, or such other address as Lessor may designate in writing from time to time.

4. Use. Article 11 of the Lease is hereby amended by deleting the word "medical" in that sentence thereof which reads: "The Demised Premises shall be used and occupied by Lessee solely for the purpose of office, production, and storage of medical products so long as such use is in compliance with all applicable laws,

ordinances and government regulations affecting the Building and Premises."

5. *Public Liability Insurance.* Article 16 of the Lease is hereby amended by deleting the entirety thereof, and by inserting in place thereof the following:

16. Lessee shall during the term hereof keep in full force and effect at its expense a policy or policies of public liability insurance with respect to the Demised Premises and the business of Lessee, on terms and with companies approved in writing by Lessor, in which policy or policies Lessee, Lessor and the additional parties named below shall be covered by being named as insured parties, and which policy or policies shall have a minimum combined single limit of liability of at least \$2,000,000 per occurrence and a general aggregate limit of at least \$3,000,000. All such policies shall be written to apply to all bodily injury, property damage and personal injury losses and shall be endorsed to include Lessor and its partners, directors, officers, agents, employees and any mortgagee of Lessor or any ground lessor of the Premises as additional insureds. Such liability insurance shall be written as primary policies, not excess, or contributing with, or secondary to, any other insurance as may be available to the Lessor or the additional insureds. Such policy or policies shall provide that Thirty (30) days written notice must be given to Lessor prior to cancellation thereof. Lessee shall furnish evidence satisfactory to Lessor within thirty (30) days of the date hereof that such coverage is in full force and effect.

6. *Assignment or Subletting.* Article 21 of the Lease is hereby amended by deleting that sentence thereof which reads: "Lessor agrees not to withhold consent unreasonably.", and by inserting in place thereof the following:

Lessor's consent shall not be unreasonably withheld, but, in addition to any other grounds for denial, Lessor's consent shall be deemed reasonably withheld if, in Lessor's judgment: (i) the net worth of the assignee/subtenant is reasonably determined to be inadequate; (ii) the proposed use of the Demised Premises is incompatible with the use clause in the Lease; or (iii) such assignment or sublease relieves Tenant of any of its obligations under this Lease.

7. *Brokers.* Article 41 of the Lease is hereby deleted in its entirety. Each party represents to the other party that no broker has participated in this First Amendment.

8. *Rider to Lease.* The Rider appended to the Lease is hereby amended by deleting Articles 42 through 47 and Article 49 thereof. Articles 48 and 50 shall be the sole remaining Articles of the Rider.

9. *Affirmation.* Except as specifically amended by this First Amendment, the terms and conditions of the Lease shall remain in full force and effect throughout the Extension Term, and the same are hereby ratified and confirmed by Lessor and Lessee.

IN AGREEMENT, the parties hereto have signed this First Amendment as of the date first set forth above.

LESSOR:

LESSEE:

Rushmore Plaza Partners Limited  
Partnership

LecTec Corporation

By: Churchill Rushmore Plaza Civic  
Center, Inc., its General Partner

By /s/ Rodney A Young  
-----  
Its Chairman, CEO

By /s/ James Phelps  
-----  
Its Vice President



## CREDIT AGREEMENT

THIS CREDIT AGREEMENT is made and entered into as of August 22, 1997, by and between LECTEC CORPORATION, a Minnesota corporation (the "Borrower"), whose address is 10701 Red Circle Drive, Minnetonka, Minnesota 55343, and FIRST BANK NATIONAL ASSOCIATION, a national banking association (the "Lender"), whose address is 300 Prairie Center Drive, Eden Prairie, Minnesota 55344.

### RECITALS

FIRST: Pursuant to one or more agreements ("Prior Loan Agreements"), the Lender has made available to the Borrower a revolving line of credit ("Line of Credit") in the maximum principal amount of One Million and No/100 Dollars (\$1,000,000.00) evidenced by a promissory note dated May 1, 1996 made by the Borrower payable to the order of the Lender ("Prior Revolver").

SECOND: The Prior Revolver has expired by its terms and has been terminated by the Lender. The Borrower has requested that the Lender reinstate the Line of Credit and make certain modifications thereto, and the Lender has indicated its willingness to accommodate such request, subject, however, to certain terms and conditions.

NOW, THEREFORE, for and in consideration of the loans and advances to be made by the Lender to the Borrower hereunder, the mutual covenants, promises and agreements contained herein, and other good and valuable consideration the receipt and sufficiency of which are hereby acknowledged, the Borrower and the Lender agree as follows:

The following terms when used in this Credit Agreement shall, except where the context otherwise requires, have the following meanings both in the singular and plural forms thereof:

### 1. DEFINITIONS

"Account" means any right of the Borrower to payment for goods sold or services rendered.

"Advance" means any advance by the Lender made under the Revolving Credit Commitment. The face amount of any Letter of Credit shall be deemed an Advance hereunder.

"Affiliate" means any corporation, association, partnership, joint venture or other business entity directly or indirectly controlling or controlled by, or under direct or indirect common control of, the Borrower or any of its Subsidiaries.

"Borrower" means Lectec Corporation, a Minnesota corporation.

"Business Day" means any day (other than a Saturday, Sunday or legal holiday in the State of Minnesota) on which national banks are permitted to be open in Minneapolis, Minnesota and, with respect to Advances to bear interest at the Eurodollar Rate, a day on which dealings in United States dollars may be carried on by the Lender in the interbank eurodollar market.

"Credit Agreement" means this Credit Agreement, as originally executed and as may be amended, modified, supplemented, or restated from time to time by written agreement between the Borrower and the Lender.

"Current Assets" means, at any date, the aggregate amount of all assets of the Borrower that are classified as current assets in accordance with GAAP.

"Current Liabilities" means, at any time, the aggregate amount of all liabilities of the Borrower that are classified as current liabilities in accordance with GAAP (including taxes and other proper accruals and the matured portion of any indebtedness).

"Current Ratio" means, at any date, the ratio of the Borrower's Current

Assets to its Current Liabilities.

"Daily Eurodollar Advance" means an Advance designated as such in a notice of borrowing under Section 2.5(a) or a notice of continuation or conversion under Section 2.5(b).

"Debt" means (i) all items of indebtedness or liability that, in accordance with GAAP, would be included in determining total liabilities as shown on the liabilities side of a balance sheet as at the date of which Debt is to be determined; (ii) indebtedness secured by any mortgage, pledge, lien or security interest existing on property owned by the Person whose Debt is being determined, whether or not the indebtedness secured thereby shall have been assumed; and (iii) guaranties, endorsements (other than for purposes of collection in the ordinary course of business) and other contingent obligations in respect of, or to purchase or otherwise acquire indebtedness of others.

"Default" means any event which if continued uncured would, with notice or lapse of time or both, constitute an Event of Default.

"ERISA" means the Employee Retirement Income Security Act of 1974, as amended and as may be further amended from time to time, and the rules and regulations promulgated thereunder by any governmental agency or authority, as from time to time in effect.

"ERISA Affiliate" means, with respect to any person, any entity (whether or not incorporated) which is a member of a Controlled Group, within the meaning of Section 412(n) of the Internal Revenue Code, as amended from time to time, and the regulations promulgated and ruling issued thereunder, of which such person is a member.

"ERISA Event" means (i) a "reportable event," as such term is described in Section 4043 of ERISA (other than a "reportable event" not subject to the provision for a thirty (30) day notice to the PBGC), or an event described in Section 4068(f) of ERISA, or (ii) the withdrawal of Borrower or any ERISA Affiliate thereof from a multiple employer plan during a plan year in which it was a "substantial employer," as such term is defined in Section 4001(a)(2) of ERISA, or the incurrence of liability by Borrower or any ERISA Affiliate thereof under Section 4064 of ERISA upon the termination of a multiple employer plan, or (iii) the distribution of a notice of intent to terminate a Plan pursuant to Section 4041(a)(2) of ERISA or the treatment of a plan amendment as a termination under Section 4041 of ERISA, or (iv) the institution of proceedings to terminate a Plan by the PBGC under Section 4042 of ERISA, or (v) any other event or condition which is reasonably likely to constitute grounds under Section 4042 of ERISA for the termination of, or the appointment of a trustee to administer, any Plan.

"Eurocurrency Reserve Percentage" means the aggregate maximum reserve requirements, including all basic, supplemental, marginal and other reserves (expressed as a decimal) for such interest determination date prescribed by the Board of Governors of the Federal Reserve System (or any successor) for determining reserve requirements applicable to "Eurocurrency liabilities" pursuant to Regulation D or any other applicable regulation of the Board of Governors which prescribes such reserve requirements or is applicable to extensions of credit by the Lender, the rate of interest on which is determined with regard to rates applicable to "Eurocurrency liabilities," and the amount outstanding under the Revolving Credit Note shall be deemed to be a "Eurocurrency liability" as defined in Regulation D. Without limiting the generality of the foregoing, the Eurocurrency Reserve Percentage shall reflect any reserves required to be maintained by the Lender against (i) any category of liabilities that includes deposits by reference to which the Eurodollar Rate is to be determined or (ii) any category of extensions of credit or other assets that includes Eurodollar advances. The Eurocurrency Reserve Percentage shall be the reserve requirement percentage for the "computation period" in which the interest determination date

falls, as reflected in a publication of the Board of Governors of the Federal Reserve System (or any successor thereto).

"Eurodollar Advance" means an Advance designated as such in a notice of borrowing under Section 2.5(a) or a notice of continuation or conversion under Section 2.5(b).

"Eurodollar Interbank Rate" means the offered rate for deposits in United States Dollars (rounded upward, if necessary, to the nearest 1/16 of 1%) for delivery of such deposits on the first day of an Interest Period of a Eurodollar Advance, for the number of days comprised therein which appears on the Reuters Screen LIBO Page as of 11:00 a.m. London time, on a day that is two Business Days preceding the first day of the Interest Period of such Eurodollar Advance. If at least two rates appear on the Reuters Screen LIBO Page, the rate for such Interest Period shall be the arithmetic mean of such rates (rounded as provided above). If fewer than two rates appear, the rate for each Interest Period shall be determined by the Lender based on rates offered to the Lender for United States Dollar deposits in the interbank eurodollar market.

"Eurodollar Rate" means a rate per annum (rounded upward, if necessary, to the nearest 1/16 of 1%) determined on each interest determination date pursuant to the following formula:

$$\text{Eurodollar Rate} = \frac{[\text{LIBOR Rate}]}{[1.00 - \text{Eurocurrency Reserve Percentage}]}$$

In such formula, capitalized terms have the meanings provided in the other definitions in this Agreement.

"Eurodollar Rate (Reserve Adjusted)" means a rate per annum (rounded upward, if necessary, to the nearest 1/16 of 1%) calculated for the Interest Period of a Eurodollar Advance in accordance with the following formula:

$$\text{ERRA} = \frac{\text{Eurodollar Interbank Rate}}{1.00 - \text{ERR}}$$

in such formula, "ERR" means "Eurodollar Reserve Rate" and "ERRA" means "Eurodollar Rate (Reserve Adjusted)", in each instance as determined by the Lender for the applicable Interest Period. The Lender's determination of all such rates for any Interest Period shall be conclusive in the absence of manifest error.

"Eurodollar Reserve Rate" means a percentage equal to the daily average during such Interest Period for the aggregate maximum reserve requirements (including all basic, supplemental, marginal and other reserves), as specified under Regulation D of the Federal Reserve Board or any other applicable regulation applying generally to all banks of the same type and classification as the Lender or any Person controlling the Lender that prescribes reserve requirements applicable to Eurocurrency liabilities (as presently defined in Regulation D) or applicable to extensions of credit by the Lender the rate of interest on which is determined with regard to rates applicable to Eurocurrency liabilities. Without limiting the generality of the foregoing, the Eurodollar Reserve Rate shall reflect any reserves required to be maintained by the Lender against (i) any category of liabilities that includes deposits by reference to which the LIBOR Rate is to be determined, or (ii) any category of extensions of credit or other assets that includes Daily Eurodollar Advances.

"Event of Default" means any event of default described in Section 8.1 hereof.

"GAAP" means the generally accepted accounting principles in the United States in effect from time to time including, but not limited to, Financial Accounting Standards Board (FASB) Standards and Interpretations, Accounting Principles Board (APB) Opinions and Interpretations, Committee on

Accounting Procedure (CAP) Accounting Research Bulletins, and certain other accounting principles which have substantial authoritative support.

"Interest Period" means, for any Eurodollar Advance, the period commencing on the borrowing date of such Eurodollar Advance or the date a Reference Rate Advance or Daily Eurodollar Advance is converted into such Eurodollar Advance, or the last day of the preceding Interest Period for such Eurodollar Advance as the case may be and ending on the numerically corresponding day which is thirty (30), sixty (60) or ninety (90) days

thereafter, as selected by the Borrower pursuant to Section 2.5(a) or Section 2.5(b), provided that:

(a) any Interest Period which would otherwise end on a day which is not a Business Day shall end on the next succeeding Business Day unless such next succeeding Business Day falls in another calendar month, in which case such Interest Period shall end on the next preceding Business Day; and

(b) any Interest Period which begins on the last Business Day of a calendar month (or a day for which there is no numerically corresponding day in the calendar month at the end of such Interest Period) shall end on the last Business Day of the calendar month at the end of such Interest Period; and

(c) no Interest Period shall extend beyond the Maturity of the Revolving Credit Note.

"Lender" means First Bank National Association, a national banking association, its successors and assigns.

"Letter of Credit" means any letter of credit issued by the Lender for the account of the Borrower, together with all amendments, modifications, replacements or restatements thereof.

"LIBOR Rate" means a rate per annum (rounded upwards, if necessary, to the nearest 1/16 of 1%), on the interest determination date for a period of one month, as such offered rate appears on the Reuters Screen LIBO Page as of 11:00 a.m., London time, on the interest determination date. If at least two rates appear on the Reuters Screen LIBO Page, the rate for the interest determination date shall be the arithmetic mean of such rates (rounded as provided above). If fewer than two rates appear, the rate for such interest determination date shall be determined by the Lender based on rates offered to the Lender for United States Dollar deposits in the interbank eurodollar market.

"Lien" means any lien, security interest, pledge, mortgage, statutory or tax lien, or other encumbrance of any kind whatsoever (including without limitation, the lien or retained security title of a conditional vendor), whether arising under a security instrument or as a matter of law, judicial process or otherwise or by an agreement of the Borrower to grant any lien or security interest or to pledge, mortgage or otherwise encumber any of its assets.

"Loan Documents" means this Credit Agreement, the Notes and such other documents as the Lender may reasonably require as security for, or otherwise executed in connection with, any loan hereunder, all as originally executed and as may be amended, modified or supplemented from time to time by written agreement between the parties thereto.

"Material Adverse Occurrence" means any occurrence which materially adversely affects the present or prospective financial condition or operations of the Borrower, or which impairs, or may impair the ability of the Borrower to perform its obligations under the Loan Documents.

"Maturity" of the Revolving Credit Note means the earlier of (a) the date on which the Revolving Credit Note becomes due and payable upon the occurrence of an Event of Default; or (b) the Termination Date.

"Net Worth" means the aggregate of capital and surplus (and Subordinated Debt) of the Borrower, all determined in accordance with GAAP.

"Note(s)" means the Revolving Credit Note and any and all promissory notes and other evidences of indebtedness and repayment obligations of the Borrower to the Lender delivered in connection with a Letter of Credit, in each case as originally executed and as may be amended, modified, restated or replaced pursuant to written agreement signed by the Lender.

"Person" means any natural person, corporation, firm, association, government, governmental agency or any other entity, whether acting in an individual fiduciary or other capacity.

"Reference Rate" means the rate of interest established and publicly announced by the Lender from time to time as its "reference rate". The Lender may lend to its customers at rates that are at, above or below the Reference Rate.

"Reference Rate Advance" means an Advance designated as such in a notice of borrowing under Section 2.5(a) or a notice of continuation or conversion under Section 2.5(b).

"Regulatory Change" means any change after the date hereof in any (or the adoption after the date hereof of any new) (a) Federal or state law or foreign law applying to the Lender; or (b) regulation, interpretation, directive or request (whether or not having the force of law) applying or in the reasonable opinion of the Lender applicable to, the Lender of any court or governmental authority charged with the interpretation or administration of any law referred to in clause (a) of this definition or of any fiscal, monetary, or other authority having jurisdiction over the Lender.

"Resetting Eurodollar Rate" means, for each day that any amount is outstanding under the Revolving Credit Note (each such day being an "interest determination date"), a rate per annum at all times equal to the Eurodollar Rate for such interest determination date, plus two hundred fifty (250) basis points. The Resetting Eurodollar Rate shall be adjusted automatically each Business Day.

"Reuters Screen LIBO Page" means the display designated as page "LIBO" on the Reuter Monitor Money Rates Service (or such other page as may replace the LIBO Page on that service for the purpose of displaying London interbank offered rates of major banks for United States dollar deposits).

"Revolving Credit Commitment" means the sum of One Million and No/100 Dollars (\$1,000,000.00) or the Lender's obligation to extend Advances to the Borrower under Section 2, as the context may require.

"Revolving Credit Loan" means, at any date, the aggregate amount of all Advances made by the Lender to the Borrower pursuant to Section 2 hereof.

"Revolving Credit Note" means the Revolving Credit Note of even date herewith in the original principal amount of One Million and No/100 Dollars (\$1,000,000.00) made by the Borrower payable to the order of the Lender, together with all extensions, renewals, modifications, substitutions and changes in form thereof effected by written agreement between the Borrower and the Lender.

"Subsidiary" means any corporation of which more than fifty percent (50%) of the outstanding capital stock having ordinary voting power to elect a majority of the board of directors of such corporation (irrespective of whether, at the time, stock of any other class or classes of such corporation shall have or might have voting power by reason of the happening of any contingency) is at the time, directly or indirectly, owned by the Borrower and/or one or more Subsidiary or Affiliate.

"Tangible Net Worth" shall have the meaning ascribed to such term under GAAP (and shall be reduced by all proper reserves) except that in no event shall it include any receivables due from officers, directors, shareholders, partners, or entities affiliated with the Borrower, any leasehold improvements,

patents, copyrights, or trademarks, any goodwill, or any organizational costs, nor shall it include any prepaid expenses or any investment by the Borrower in Natus, LLC.

"Termination Date" means the earlier of (a) September 1, 1998; or (b) the date upon which the obligation of the Lender to make Advances is terminated pursuant to Section 2.8.

"Working Capital" means, as of any date of determination the Borrower's Current Assets minus its Current Liabilities.

## 2. THE REVOLVING CREDIT LOAN

2.1. Commitment for Revolving Credit. Subject to the Conditions of Lending set forth in Section 4 hereof and as long as no Event of Default has



occurred hereunder, the Lender agrees to make Advances to the Borrower from time to time from the date of this Credit Agreement through the Termination Date, provided, however, that the Lender shall not be obligated to make any Advance, if after giving effect to such Advance, the aggregate outstanding principal amount of all Advances would exceed the Revolving Credit Commitment. Within the limits set forth above, the Borrower may borrow, repay and reborrow amounts under the Revolving Credit Note.

2.2. Purpose of Loan/Use of Proceeds. The Borrower will use the proceeds of any Advance hereunder and any Letters of Credit issued hereunder for the Borrower's general corporate purposes.

2.3. The Revolving Credit Note. All Advances shall be evidenced by, and the Borrower shall repay such Advances to the Lender in accordance with, the terms of the Revolving Credit Note, including without limitation the provision of the Revolving Credit Note that the principal amount payable thereunder at any time shall not exceed the then unpaid principal amount of all Advances made by the Lender.

2.4. Records of Advances and Payments. The Borrower hereby irrevocably authorizes the Lender to make or cause to be made, at or about the time each Advance is made by the Lender, an appropriate notation on the Lender's records of the principal amount of such Advance and the Lender shall make or cause to be made, on or about the time a payment of any principal or interest of the Revolving Credit Note is received an appropriate notation of such payment on its records. The aggregate amount of all unpaid Advances set forth on the records of the Lender shall be rebuttable presumptive evidence of the principal amount owing and unpaid on the Revolving Credit Note.

2.5. Interest on the Revolving Credit Note. The Borrower agrees to pay interest on the unpaid balance of the Revolving Credit Note outstanding from time to time at the following rates: (i) the Reference Rate as to all Reference Rate Advances; (ii) the Resetting Eurodollar Rate, as to all Daily Eurodollar Advances; and (iii) the Eurodollar Rate (Reserve Adjusted) plus 250 basis points as to all Eurodollar Advances, all in accordance with the terms of this Credit Agreement. All Advances outstanding under the Revolving Credit Note shall be deemed Daily Eurodollar Advances, unless the Borrower elects to designate, continue or convert such Advances to Reference Rate Advances or Eurodollar Advances pursuant to procedures outlined in Section 2.6 below. Upon the occurrence and continuation of an Event of Default interest shall accrue on all amounts outstanding under the Revolving Credit Note at an annual rate equal to the greater of (i) the rate applicable prior to such Event of Default plus two hundred (200) basis points, or (ii) the Reference Rate plus two hundred (200) basis points.

2.6. Borrowing, Continuing or Converting Advances.

(a) Manner of Borrowing. Any request by the Borrower for an Advance shall be by telephone (or, in the case of all Eurodollar Advances, in writing or by telephone promptly confirmed in writing) and must be given so as to be received by the Lender not later than:

- (1) 1:00 p.m. (Minneapolis time) on the date of the requested Advance if the Advance shall be a Reference Rate Advance or Daily Eurodollar Advance; or
- (2) 9:30 a.m. (Minneapolis time) two (2) Business Days prior to the date of the requested Advance, if the Advance shall be a Eurodollar Advance.

Each request for an Advance shall specify: (i) the borrowing date (which shall be a Business Day), (ii) the amount of the Advance and the type of Advance, subject to the limitations elsewhere in this Credit Agreement, and (iii) if the Advance is to be a Eurodollar Advance, the Interest Period for such Advance. Unless the Lender determines that conditions set forth in this Credit Agreement have not been satisfied, each Advance shall be deposited into the Borrower's account number 1-801-2060-0150 with the Lender.

(b) Manner of Continuation or Conversion. The Borrower may elect to (i) continue any outstanding Eurodollar Advance from one

Interest Period into a subsequent Interest Period to begin on the last day of the earlier Interest Period, or (ii) convert any outstanding Advance into another type of Advance (on the last day of an Interest Period only, in the instance of a Eurodollar Advance), by giving the Lender notice by telephone (or, in the case of continuations of or conversions to Eurodollar Advances, in writing or by telephone promptly confirmed in writing) given so as to be received by the Lender not later than:

(1) 1:00 p.m. (Minneapolis time) on the date of the requested continuation or conversion if the continuing or converted shall be a Reference Rate Advance or Daily Eurodollar Advance; or

(2) 9:30 a.m. (Minneapolis time) two (2) Business Days prior to the date of the requested continuation or conversion, if the continuing or converted Advance shall be a Eurodollar Advance.

Each notice of continuation or conversion of an Advance shall specify: (i) the effective date of the continuation or conversion (which shall be a Business Day), (ii) the amount and the type or types of Advances following such continuation or conversion (subject to limitations contained elsewhere in this Credit Agreement), and (iii) for continuation as, or conversion into, Eurodollar Advances, the Interest Periods for such Advances. Absent timely notice of continuation or conversion, each Eurodollar Advance shall automatically convert into a Daily Eurodollar Advance on the last day of an applicable Interest Period, unless paid in full on such last day. No Advance shall be continued as, or converted into, a Eurodollar Advance if the shortest Interest Period for such Advance may not transpire prior to the Maturity of the Revolving Credit Note or if a Default or Event of Default shall exist.

2.7. *Payments.* All principal outstanding under the Revolving Credit Note shall be due and payable on the Maturity thereof. The Borrower shall pay interest accrued on amounts outstanding under the Revolving Credit Note as follows:

(a) as to Reference Rate Advances and Daily Eurodollar Advances, accrued interest shall be due and payable on the first day of each month, beginning September 1, 1997, and at Maturity; and

(b) as to Eurodollar Advances, accrued interest shall be due and payable on the last day of each Interest Period.

Any other provision of this Credit Agreement to the contrary notwithstanding, the Borrower shall make all payments of interest on and principal of the Revolving Credit Note in immediately available funds to the Lender at its office shown on the first page hereof. The Borrower authorizes the Lender to charge from

time to time against the Borrower's account no. 1-801-2060-0150 with the Lender any payments on the Revolving Credit Note when due.

2.8. *Termination.* The obligation of the Lender to make Advances shall terminate:

(a) Upon receipt by the Lender of three (3) days' written notice of termination from the Borrower given at any time when no amount is outstanding under the Revolving Credit Note;

(b) Immediately and without further action upon the occurrence of an Event of Default of the nature referred to in Subsection 8.1(c) or

(c) Immediately when any Event of Default (other than of the nature specified in Subsection 8.1(c)) shall have occurred and be continuing and either (i) the Lender shall have demanded payment of the Revolving Credit Note or (ii) the Lender shall so elect to terminate its obligation to make Advances by giving notice to Borrower.

2.9. *Additional Terms Regarding Eurodollar Advances.* No portion of the principal outstanding under the Revolving Credit Note may be designated as, converted into, or continued as, a Eurodollar Advance unless such portion is in increments of \$100,000.00. No Advance to be designated as, converted into, or continued as, a Eurodollar Advance shall include principal to be paid under the terms of the Revolving Credit Note during the Interest Period applicable to such Advance. Notwithstanding anything to the contrary contained in this Credit Agreement, the Borrower may only designate, convert to or continue Eurodollar Advances for Interest Periods of thirty (30), sixty (60) or ninety (90) days.

2.10. *Voluntary Repayments of Reference Rate Advances and Daily Eurodollar Advances.* The Borrower may, at any time, repay all or any part of any Reference Rate Advance or Daily Eurodollar Advance. The Borrower may also, upon at least two (2) Business Days prior written or telephonic notice received by the Lender, repay the total outstanding principal of one or more Eurodollar Advances, subject to the provisions of Section 2.11 of this Credit Agreement. Any repayment of principal outstanding under the Revolving Credit Loan shall be accompanied by the interest accrued thereon through such date, together with any additional amounts due under Section 2.11.

2.11. *Funding Losses.* The Borrower will indemnify the Lender upon demand against any loss or expense which the Lender may sustain or incur (including, without limitation, any loss or expense sustained or incurred in obtaining, liquidating or employing deposits or other funds acquired to effect, fund or maintain any Advance) as a consequence of (i) any failure of the Borrower to make any payment when due of any amount due hereunder or under the Revolving Credit Note, (ii) any failure by the Borrower to borrow, continue or convert an Advance on a date specified therefor in a notice thereof, or (iii) any payment (including without limitation any payment pursuant to Section 2.10), prepayment or conversion of any Eurodollar Advance on a date other than the last day of the Interest Period for such Advance. Determinations by the Lender for purposes of this Section 2.11 of the amount required to indemnify the Lender shall be conclusive in the absence of manifest error.

### 3. ADDITIONAL PROVISIONS REGARDING EURODOLLAR ADVANCES

#### 3.1. Funding.

(a) *Discretion of the Bank as to Manner of Funding.* Notwithstanding any provision of this Credit Agreement to the contrary, the Bank shall be entitled to fund and maintain its funding of all or any part of the Advances in any manner it elects; it being understood, however, that for purposes of this Credit Agreement, all determinations hereunder shall be made as if the Bank had actually funded and maintained each Eurodollar Advances during the Interest Period applicable to such Advance through the purchase of deposits having a term corresponding to such Interest Period and bearing an interest rate equal to the Eurodollar Interbank Rate for such Interest Period (whether or not the Bank shall have granted any participations in any such Advances).

(b) *Funding Through the Sale of Participations.* Notwithstanding any provision of this Credit Agreement to the contrary, the Company acknowledges that the Bank may fund all or any part of the Advances by sales of participations to various participants and agrees that the Bank may, in invoking its rights under Article 2 and specifically including Section 2.11, demand and receive payment for costs and other amounts incurred by, or allocable to, any such participant, or take any other action arising from circumstances applicable to any such participant, to the same extent that such participant could demand and receive payments or take any other action under such Section 2.11 or otherwise under Article 2 if such participant were the Bank under this Credit Agreement.

(c) *Funding Through Branch or Affiliate.* At the Bank's sole option it may fulfill its commitment to make Eurodollar Advances by causing a foreign branch or an affiliate to make or continue such Eurodollar Advances; provided, that in such instance such Eurodollar Advances shall be deemed for purposes of this Credit Agreement to have been made by the Bank and the obligation of the Company to repay such

*Eurodollar Advances shall be to the Bank and shall be deemed held by the Bank for the account of such branch or affiliate.*

*3.2. Increased Costs. If, as a result of any law, rule, regulation, treaty or directive, or any change therein or in the interpretation or administration thereof, or compliance by the Bank with any request or directive (whether or not having the force of law) from any court, central bank, governmental authority, agency or instrumentality, or comparable agency:*

*(a) any tax, duty or other charge with respect to any Advance, the Revolving Credit Note, or the Revolving Credit Commitment is imposed, modified or deemed applicable, or the basis of taxation of payments to the Bank of interest or principal of the Advances or any fees with respect to the Revolving Credit Commitment (other than taxes imposed on the overall net income of the Bank by any applicable governmental authority) is changed;*

*(b) any reserve, special deposit, special assessment or similar requirement against assets of, deposits with or for the account of, or credit extended by, the Bank is imposed, modified or deemed applicable;*

*(c) any increase in the amount of capital required or expected to be maintained by the Bank or any Person controlling the Bank is imposed, modified or deemed applicable; or*

*(d) any other condition affecting this Credit Agreement or the Revolving Credit Commitment is imposed on the Bank or the relevant funding markets;*

*and the Bank determines that, by reason thereof, the cost to the Bank of making or maintaining the Advances or the Revolving Credit Commitments is increased, or the amount of any sum receivable by the Bank hereunder or under the Revolving Credit Note is reduced; then the Company shall pay to the Bank upon demand such additional amount or amounts as will compensate the Bank (or the controlling Person in the instance of (c) above) for such additional costs or reduction (provided that the Bank has not been compensated for such additional cost or reduction in the calculation of the Eurodollar Reserve Rate or the Eurocurrency Reserve percentage). Determinations by the Bank for purposes of this Section of the additional amounts required to compensate the Bank shall be conclusive in the absence of manifest error. In determining such amounts, the Bank may use any reasonable averaging, attribution and allocation methods.*

*3.3. Changes in Law Rendering Eurodollar Advances Unlawful. If at any time due to the adoption of any law, rule, regulation, treaty or directive, or any change therein or in the interpretation or administration thereof by any court, central bank, governmental authority, agency or instrumentality, or comparable agency charged with the interpretation or administration thereof, or for any other reason arising subsequent to the date of this Credit Agreement, it shall become unlawful or impossible for the Bank to fund any Daily Eurodollar Advance or Eurodollar Advance, the obligation of the Bank to make any Advance for Daily Eurodollar Advances or Eurodollar Advances to provide such Advance shall, upon the*

*happening of such event, forthwith be suspended for the duration of such illegality or impossibility. If any such event shall make it unlawful or impossible for the Bank to continue any Daily Eurodollar Advance or Eurodollar Advance previously made by it hereunder the Bank shall, upon the happening of such event, notify the Company thereof in writing, and the Company shall, at the time notified by the Bank, either convert such unlawful Advance to an Advance of another type or repay such Advance in full, together with accrued interest thereon, subject to the provisions of Section 2.11.*

*3.4. Interest Rate Not Ascertainable, Etc. If the Bank determines (which determination shall be conclusive and binding on the parties hereto) that:*

*(a) Deposits of the necessary amount for the relevant Interest Period for any Eurodollar Advance are not available to the Bank in the relevant markets or that, by reason of circumstances affecting such market, adequate and reasonable means do not exist for ascertaining the*

*Eurodollar Interbank Rate or the LIBOR Rate, as the case may be, for such Interest Period;*

*(b) The Eurodollar Rate (Reserve Adjusted) or Eurodollar Rate, as the case may be, will not adequately and fairly reflect the cost to the Bank of making or funding the Eurodollar Advances or Daily Eurodollar Advances, as the case may be, for a relevant Interest Period; or*

*(c) The making or funding of Eurodollar Advances or Daily Eurodollar Advances, as the case may be, has become impracticable as a result of any event occurring after the date of this Credit Agreement which, in the opinion of the Bank, materially and adversely affects such Advances or the Bank's Commitment to make such Advances or the relevant market;*

*then the Bank shall promptly give notice of such determination to the Company and (i) any notice of a new Eurodollar Advance or Daily Eurodollar Advance, as the case may be, previously given by the Company and not yet borrowed or converted shall be deemed to be a notice to make an Advance of another type, as selected by the Company, and (ii) the Company shall be obligated to either prepay in full any outstanding Eurodollar Advances or Daily Eurodollar Advances, as the case may be, without premium or penalty on the last day of the current Interest Period with respect thereto, or convert any such Advance to an Advance of another type, as selected by the Company, on such last day.*

#### **4. CONDITIONS OF LENDING**

*4.1. Conditions Precedent. This Credit Agreement and the Lender's obligations hereunder are subject to receipt by the Lender of the following, each to be in form and substance satisfactory to the Lender, unless the Lender waives receipt of any of the following in writing:*

*(a) This Credit Agreement and the Revolving Credit Note each appropriately completed and duly executed by the Borrower;*

*(b) A current UCC secured transaction search, reflecting results satisfactory to the Lender, on the Borrower from the appropriate filing offices as required by the Lender;*

*(c) Certification by the Borrower's corporate secretary that copies of the Borrower's Bylaws and Articles of Incorporation, and all amendments to both, have been previously delivered by the Borrower to the Lender and that neither has been further amended since such time and that the most recent incumbency certificate delivered by the Borrower to the Lender remains in full force and effect and the officers listed therein remain in the offices listed and remain authorized to execute this Credit Agreement, the Notes and all related documents and agreements on behalf of the Borrower;*

*(d) A copy of the resolutions of the Board of Directors of the Borrower authorizing or ratifying the transactions contemplated hereby, and the execution, delivery and performance of*

*the Loan Documents, and designating the officers authorized to execute the Loan Documents to which the Borrower is a party and to perform the obligations of the Borrower thereunder; and*

*(e) Such other documents, information and actions as the Lender may reasonably request.*

*4.2. Conditions Precedent to all Advances. The obligation of the Lender to make any Advance hereunder, including the initial Advance, is subject to the satisfaction of each of the following, unless waived in writing by the Lender:*

*(a) The representations and warranties set forth in Section 5 are true and correct in all material respects on the date hereof and on the date of any Advance.*

*(b) No Default or Event of Default shall have occurred and be continuing.*

(c) No litigation, arbitration or governmental investigation or proceeding shall be pending, or, to the knowledge of the Borrower, threatened, against the Borrower or affecting the business or operations of the Borrower which was not previously disclosed to the Lender and which, if determined adversely to the Borrower, would have a material adverse effect on the operation or financial condition of the Borrower.

(d) No Default or Event of Default shall result from the making of any such Advance.

(e) No Material Adverse Occurrence shall have occurred and be continuing.

## 5. REPRESENTATIONS AND WARRANTIES

The Borrower represents and warrants to the Lender as follows:

5.1. Organization, etc. The Borrower is corporation validly organized and existing and in good standing under the laws of the State of Minnesota, has full power and authority to own its property and conduct its business substantially as presently conducted by it and is duly qualified to do business and is in good standing as a foreign corporation in each other jurisdiction where the nature of its business makes such qualification necessary. The Borrower has full power and authority to enter into and perform its obligations under the Loan Documents and to obtain the loans and Advances hereunder.

5.2. Due Authorization. The execution, delivery and performance by the Borrower of the Loan Documents have been duly authorized by all necessary corporate action, do not require any approval or consent of, or any registration, qualification or filing with, any governmental agency or authority or any approval or consent of any other Person (including, without limitation, any stockholder), do not and will not conflict with, result in any violation of or constitute any default under, any provision of the Borrower's Articles of Incorporation or Bylaws, any agreement binding on or applicable to the Borrower or any of its property, or any law or governmental regulation or court decree or order, binding upon or applicable to the Borrower or of any of its property and will not result in the creation or imposition of any Lien on any of its property pursuant to the provisions of any agreement binding on or applicable to the Borrower or any of its property except pursuant to the Loan Documents.

5.3. Validity of the Loan Documents. The Loan Documents to which the Borrower is a party are the legal, valid and binding obligations of the Borrower and are enforceable in accordance with their terms, subject only to bankruptcy, insolvency, reorganization, moratorium or similar laws, rulings or decisions at the time in effect affecting the enforceability of rights of creditors generally and to general equitable principles which may limit the right to obtain equitable remedies.

5.4. Financial Information. The financial statements of the Borrower furnished to the Lender have been and will be prepared in accordance with GAAP consistently applied by the Borrower and present fairly the financial condition of the Borrower as of the dates thereof and for the periods

covered thereby. The Borrower is not aware of any contingent liabilities or obligations which would, upon becoming non-contingent liabilities or obligations, be a Material Adverse Occurrence. Since the date of the most recent such statements, neither the condition (financial or otherwise), the business nor the properties of the Borrower have been materially and adversely affected in any way.

5.5. Litigation, Other Proceedings. Except as previously disclosed to and approved of in writing by the Lender, there is no action, suit or proceeding at law or equity, or before or by any governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign, pending or, to the knowledge of the Borrower, threatened, against the Borrower or any of its property, which, if determined adversely would be a Material Adverse Occurrence; and the Borrower is not in default with respect to any final judgment, writ, injunction, decree, rule or regulation of any court or governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign, where

such default would be a Material Adverse Occurrence.

5.6. *Title to Assets.* Except for Liens permitted by Section 7.2, the Borrower has good and marketable title to all of its assets, real and personal.

5.7. *Guarantees and Indebtedness.* Except as disclosed on financial statements of the Borrower furnished to the Lender, the Borrower is not a party to any contract of guaranty or suretyship and none of its assets is subject to any contract of that nature and the Borrower is not indebted to any other party, except the Lender.

5.8. *Margin Stock.* No part of any loan or Advance hereunder shall be used at any time by the Borrower to purchase or carry margin stock (within the meaning of Regulation U promulgated by the Board of Governors of the Federal Reserve System) or to extend credit to others for the purpose of purchasing or carrying any margin stock. The Borrower is not engaged principally, or as one of its important activities, in the business of extending credit for the purposes of purchasing or carrying any such margin stock. No part of the proceeds of any loan or Advance hereunder will be used by the Borrower for any purpose which violates, or which is inconsistent with, any regulations promulgated by the Board of Governors of the Federal Reserve System.

5.9. *Taxes.* The Borrower has filed all federal, state and other income tax returns which are required to be filed through the date of this Credit Agreement and has paid all taxes as shown on said returns, and all taxes due or payable without returns and all assessments received to the extent such taxes and assessments have become due. All tax liabilities of the Borrower are adequately provided for on its books, including interest and penalties. No income tax liability of a material nature has been asserted by taxing authorities for taxes in excess of those already paid. The Borrower has made all required withholding deposits.

5.10. *Accuracy of Information.* All factual information furnished by or on behalf of the Borrower to the Lender for purposes of or in connection with this Credit Agreement or any transaction contemplated by this Credit Agreement is, and all other such factual information furnished by or on behalf of the Borrower to the Lender in the future, will be true and accurate in every material respect on the date as of which such information is dated or certified. No such information contains any material misstatement of fact or omits any material fact or any fact necessary to prevent such information from being misleading.

5.11. *Material Agreements.* The Borrower is not a party to any agreement or instrument or subject to any restriction that materially and adversely affects its business, property or assets, operations or condition (financial or otherwise).

5.12. *Defaults.* The Borrower is not in default in the performance, observance or fulfillment of any of the obligations, covenants or conditions contained in any: (a) agreement to which such entity is a party, which default might have a material adverse effect on the business, properties or assets, operations, or condition (financial or otherwise) of the Borrower; or (b) instrument evidencing any indebtedness or under any agreement relating to such indebtedness.

5.13. *ERISA.* (a) No Reportable Event has occurred and is continuing with respect to any Plan; (b) the Pension Benefit Guaranty Corporation or any successor entity has not instituted proceedings to terminate any Plan; and (c) each Plan of the Borrower has been maintained and funded in all material respects in accordance with its terms and with ERISA. All undefined capitalized terms used in this Section shall have the meanings ascribed to them in ERISA.

5.14. *Financial Status.* The Borrower is not insolvent (as such term is defined in Section 101(29) of the United States Bankruptcy Code of 1978, as amended or Minnesota Statutes Section 513.42, as amended) and will not be rendered insolvent (as such term is defined in Section 101(29) of the United States Bankruptcy Code of 1978, as amended or Minnesota Statutes Section 513.42, as amended) by execution of this Credit Agreement or any other of the Loan Documents, or consummation of the transactions contemplated thereby.

5.15. *Survival of Representations.* All representations and warranties

contained in this Section 5 shall survive the delivery of the Notes and the making of the loans and Advances evidenced thereby and any investigation at any time made by or on behalf of Lender shall not diminish its rights to rely thereon.

## 6. AFFIRMATIVE COVENANTS

As long as there remains any amount outstanding under the Notes or the Lender has any obligation to make Advances under the Revolving Loan Commitment, the Borrower shall, unless waived in writing by the Lender:

6.1. *Financial Statements and Reports.* Furnish to the Lender, at the times set forth below, the following financial statements, reports and information:

(a) As soon as available, but in any event within one hundred twenty (120) days after each fiscal year end, audited financial statements of the Borrower including without limitation a balance sheet, income statement and sources of income certified by certified public accountants satisfactory to the Lender to have been prepared in accordance with GAAP consistently applied;

(b) As soon as available but in any event within one hundred twenty (120) days after each fiscal year end a copy of the form 10K Report filed for such year by the Borrower with the Securities and Exchange Commission or other governmental entity;

(c) As soon as available, but in any event within sixty (60) days after the last day of each quarterly fiscal period a copy of the form 10-Q Report for such quarter filed by the Borrower with the Securities and Exchange Commission or other governmental entity;

(d) With the year-end report delivered pursuant to 6.1(b) above and with the quarterly financial report delivered pursuant to 6.1(c) above, a compliance certificate executed by the Chief Financial Officer of the Borrower in the form of Exhibit A hereto, whereby the Borrower demonstrates its compliance with its covenants and undertakings under this Credit Agreement;

(e) With the year-end report delivered pursuant to 6.1(b) above and with the quarterly financial report delivered pursuant to 6.1(c) above, a copy of any and all shareholder reports delivered in connection therewith; and

(f) Such other information concerning the business, operations and condition (financial or otherwise) of the Borrower as the Lender may reasonably request.

6.2. *Maintenance of Corporate Existence.* Maintain and preserve its corporate existence.

6.3. *Taxes.* Pay and discharge as the same shall become due and payable, all taxes, assessments and other governmental charges and levies against or on any of its property, as well as

claims of any kind which, if unpaid, might become a Lien upon any of its properties, unless such tax, levy, charge assessment or Lien is being contested in good faith by the Borrower and is supported by an adequate book reserve. The Borrower shall make all required withholding deposits.

6.4. *Notices.* As soon as practicable, give notice to the Lender of:

(a) The commencement of any litigation relating to the Borrower involving claimed damages in excess of \$100,000.00 or relating to the transactions contemplated by this Credit Agreement;

(b) The commencement of any material arbitration or governmental proceeding or investigation not previously disclosed to the Lender which has been instituted or, to the knowledge of the Borrower, is threatened against the Borrower or its property which, if determined adversely to the Borrower, would have a material adverse



effect on the business, operations or condition (financial or otherwise) of the Borrower;

(c) Any Reportable Event or "prohibited transaction" or the imposition of a Withdrawal Liability, within the meaning of ERISA, in connection with any Plan and, when known, any action taken by the Internal Revenue Service, Department of Labor or Pension Benefit Guaranty Corporation with respect thereto, and any adverse development which occurs in any litigation, arbitration or governmental investigation or proceeding previously disclosed to the Lender which if determined adversely to the Borrower would constitute a Material Adverse Occurrence; and

(d) Any Default or Event of Default under this Credit Agreement.

6.5. *Compliance with Laws.* Carry on its business activities in substantial compliance with all applicable federal or state laws and all applicable rules, regulations and orders of all governmental bodies and offices having power to regulate or supervise its business activities. The Borrower shall maintain all material rights, liens, franchises, permits, certificates of compliance or grants of authority required in the conduct of its business.

6.6. *Books and Records.* Keep books and records reflecting all of its business affairs and transactions in accordance with GAAP consistently applied and permit the Lender, and its representatives, at reasonable times and intervals, to visit all of its offices, discuss its financial matters with officers of the Borrower and its independent public accountants (and by this provision the Borrower authorizes its independent public accountants to participate in such discussions) and examine any of its books and other corporate records.

6.7. *Insurance.* The Borrower shall keep its business adequately insured and maintain the insurance coverages required under any document securing the Notes or this Credit Agreement.

6.8. *Conduct of Business.* Continue to engage primarily in the business being conducted on the date of this Credit Agreement.

6.9. *Working Capital.* Maintain at all times Working Capital of not less than Three Million and No/100 Dollars (\$3,000,000.00).

6.10. *Tangible Net Worth; Net Worth.* Maintain at all times Tangible Net Worth in an amount not less than Eight Million Dollars (\$8,000,000) and maintain at all times Net Worth in an amount not less than Eight Million Five Hundred Thousand Dollars (\$8,500,000).

6.11. *Current Ratio.* Maintain at all times a Current Ratio of not less than 2.5 to 1.0.

6.12. *Debt to Tangible Net Worth Ratio.* Maintain at all times a ratio of its Debt to its Tangible Net Worth of not more than .50 to 1.0.

6.13. *Zero Balance.* Maintain a zero balance under the Revolving Credit Note for at least thirty (30) days during the term thereof.

6.14. *Further Assurances.* The Borrower agrees upon reasonable request by the Lender to execute and deliver such further instruments, deeds and assurances, and do such further acts as may be necessary or proper to carry out more effectively the purposes of this Credit Agreement and the other Loan Documents.

6.15. *ERISA Compliance.* Comply at all times with all applicable provisions of ERISA and the regulations and published interpretations thereunder.

6.16. *Letters of Credit.* The Borrower agrees that if it wishes from time to time to have the Lender issue for the Borrower's account one or more Letters of Credit, the Lender shall only be obligated to issue any such Letter of Credit upon completion of all applications, agreements for repayment and other documentation deemed necessary by the Lender for such Letter of Credit in

accordance with its standard practices. The Borrower further agrees that (i) any repayment agreement or other evidence of the Borrower's obligation to repay amounts outstanding under a Letter of Credit will be deemed one of the "Notes" for purposes of this Credit Agreement; (ii) the Borrower will pay to the Lender in connection with Letters of Credit all fees and costs in accordance with the Lender's customary and standard practices for letters of credit of the same type and amount and interest accrued on amounts advanced thereunder at the rate or rates described in the documents executed in connection with each such Letter of Credit; and (iii) no Letter of Credit shall expire later than the maturity date of the Revolving Credit Note stated thereon.

#### 7. NEGATIVE COVENANTS

As long as there remains any amount outstanding under the Notes or the Lender has any obligation to make Advances under the Revolving Loan Commitment, the Borrower shall not, unless waived in writing by the Lender:

7.1. Consolidation; Merger; Sale of Assets; Acquisitions. Consolidate with or merge into or with any other entity; or sell (other than sales of inventory in the ordinary course of business), transfer, lease or otherwise dispose of all or a substantial part of its assets; or acquire a substantial interest in another Person either through the purchase of all or substantially all of the assets of that Person or the purchase of a controlling equity interest in that Person.

7.2. Liens. Create, incur, assume or suffer to exist any Lien on any of its property, real or personal, except (a) Liens in favor of the Lender; (b) Liens disclosed to and approved of in writing by the Lender; (c) Liens for current taxes and assessments which are not yet due and payable; and (d) purchase money security interests to secure the indebtedness permitted under Section 7.3(d) below.

7.3. Additional Indebtedness. Create, incur, assume or suffer to exist any indebtedness except: (a) indebtedness in favor of the Lender; (b) current liabilities incurred in the ordinary course of business; (c) indebtedness existing on the date of this Credit Agreement and disclosed to and approved of in writing by the Lender; and (d) purchase money indebtedness incurred in connection with the acquisition of fixed assets not to exceed \$350,000.00 in the aggregate during any fiscal year of the Borrower.

7.4. Guaranties. Assume, guarantee, endorse or otherwise become liable in connection with the indebtedness of any other person or entity except endorsements of negotiable instruments for deposit or collection in the ordinary course of business.

7.5. Change in Ownership. Permit a material change in the ownership or management of the Borrower as in effect on the date of this Credit Agreement.

#### 8. EVENTS OF DEFAULT AND REMEDIES

8.1. Events of Default. The term "Event of Default" shall mean any of the following events:

(a) The Borrower shall default in the payment when due, or if payable on demand, upon demand, of any principal or interest on any of the Notes; or

(b) The Borrower shall default (other than a default in payment under subsection (a) above) in the due performance and observance of any of the covenants contained in any of the Loan Documents and such default shall continue unremedied for a period of fifteen (15) days after notice from the Lender to the Borrower thereof; or

(c) The Borrower shall become insolvent or generally fail to pay or admit in writing its inability to pay its debts as they become due; or the Borrower shall apply for, consent to, or acquiesce in the appointment of a trustee, receiver or other custodian for itself or any of its property, or make a general assignment for the benefit of its creditors; or trustee, receiver or other custodian shall otherwise be appointed for the Borrower or any of its assets; or any bankruptcy,

reorganization, debt arrangement, or other case or proceeding under any bankruptcy or insolvency law, or any dissolution or liquidation proceeding shall be commenced by or against the Borrower or the Borrower shall take any corporate action to authorize, or in furtherance of, any of the foregoing; or

(d) Any judgments, writs, warrants of attachment, executions or similar process (not undisputedly covered by insurance) in an aggregate amount in excess of \$25,000.00 shall be issued or levied against the Borrower or any of its assets and shall not be released, vacated or fully bonded prior to any sale and in any event within forty-five (45) days after its issue or levy; or

(e) Any garnishment summons, writ of attachment, or other legal paper referring to the Borrower or any Guarantor shall be served on the Lender; or

(f) Any representation or warranty set forth in this Credit Agreement or any other Loan Document shall be untrue in any material respect on the date as of which the facts set forth are stated or certified; or

(g) The occurrence of any Material Adverse Occurrence; or

(h) A Reportable Event (as defined under ERISA) shall have occurred.

8.2. Remedies. If an Event of Default described in Section 8.1(c) shall occur, the full unpaid balance of the Notes (outstanding balance plus accrued interest) and all other obligations of the Borrower to the Lender shall automatically be due and payable without declaration, notice, presentment, protest or demand of any kind (all of which are hereby expressly waived) and the obligation of the Lender to make additional Advances shall automatically terminate. If any other Event of Default shall occur and be continuing, the Lender may terminate its obligation to make additional Advances and may declare the outstanding balance of the Notes and all other obligations of the Borrower to the Lender to be due and payable without further notice, presentment, protest or demand of any kind (all of which are hereby expressly waived), whereupon the full unpaid amount of Notes and all other obligations of the Borrower to the Lender shall become immediately due and payable. Upon any Event of Default, the Lender shall be entitled to exercise any and all rights and remedies available under any of the Loan Documents or otherwise available at law or in equity to collect Notes and all other obligations of the Borrower to the Lender and to realize upon or otherwise pursue any and all Collateral and other security (including without limitation any and all guarantees) for the loans under this Credit Agreement.

## 9. MISCELLANEOUS

9.1. Waivers, Amendments. The provisions of the Loan Documents may from time to time be amended, modified, or waived, if such amendment, modification or waiver is in writing and signed by the Lender. No failure or delay on the part of the Lender or the holder(s) of the Notes in exercising any power or right under any of the Loan Documents shall operate as a waiver thereof, nor shall any single or partial exercise of any such power or right preclude any other or further exercise thereof or the exercise of any other power or right. No notice to or demand on the Borrower in any case shall entitle it to any notice or demand in similar or other circumstances.

9.2. Notices. All communications and notices provided under this Credit Agreement shall be in writing and addressed or delivered to the Borrower or the Lender at their respective addresses shown on the first page hereof, or to any party at such other address as may be designated by such party in a written notice to the other parties. Such notices shall be delivered by any of the following means: (i) mailing through the United States Postal Service, postage prepaid, by registered or certified mail, return receipt requested; (ii) delivery by reputable overnight delivery service including without limitation, and by way of example only: Federal Express, DHL, Airborne Express and Express Mail; or (iii) delivery by reputable private personal delivery service. Notices delivered in accordance with (i) above shall be deemed delivered the second Business Day after deposit in the mail; notices delivered in accordance with

(ii) above shall be deemed delivered the first Business Day after delivery to the delivery service; and notices delivered in accordance with (iii) above shall be deemed delivered the same Business Day as that specified by the notifying party to the delivery service.

9.3. *Costs and Expenses.* The Borrower agrees to pay all expenses for the preparation of this Credit Agreement, including exhibits, and any amendments to this Credit Agreement as may from time to time hereafter be required, and the reasonable attorneys fees and legal expenses of counsel for the Lender, from time to time incurred in connection with the preparation and execution of this Credit Agreement and any document relevant to this Credit Agreement, any amendments hereto or thereto, and the consideration of legal questions relevant hereto and thereto. The Borrower agrees to reimburse Lender upon demand for, all reasonable out-of-pocket expenses (including attorneys fees and legal expenses) in connection with the Lender's enforcement of the obligations of the Borrower hereunder or under the Note or any other of the Loan Documents, whether or not suit is commenced including, without limitation, attorneys fees, and legal expenses in connection with any appeal of a lower court's order or judgment. The obligations of the Borrower under this Section 9.3 shall survive any termination of this Credit Agreement.

9.4. *Interest Limitation.* All agreements between the Borrower and the Lender are hereby expressly limited so that in no contingency or event whatsoever, whether by reason of acceleration of maturity of the indebtedness evidenced or secured thereby or otherwise, shall the rate of interest charged or agreed to be paid to the Lender for the use, forbearance, loaning or detention of such indebtedness exceed the maximum permissible interest rate under applicable law ("Maximum Rate"). If for any reason or in any circumstance whatsoever fulfillment of any provision of this Credit Agreement and/or the Notes, any document securing or executed in connection herewith or therewith, or any other agreement between the Borrower and the Lender, at any time shall require or permit the interest rate applied thereunder to exceed the Maximum Rate, then the interest rate shall automatically be reduced to the Maximum Rate, and if the Lender should ever receive interest at a rate that would exceed the Maximum Rate, the amount of interest received which would be in excess of the amount receivable after applying the Maximum Rate to the balance of the outstanding obligation shall be applied to the reduction of the principal balance of the outstanding obligation for which the amount was paid and not to the payment of interest thereunder. This provision shall control every other provision of any and all agreements between the Borrower and the Lender and shall also be binding upon and applicable to any subsequent holder of the Notes.

9.5. *Severability.* Any provision of this Credit Agreement or any other of the Loan Documents executed pursuant hereto which is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such portion or unenforceability without invalidating the remaining provisions of this Credit Agreement or such Loan Document or affecting the validity or enforceability of such provisions in any other jurisdiction.

9.6. *Cross-References.* References in this Credit Agreement or in any other of the Loan Documents executed pursuant hereto to any Section are, unless otherwise specified, to such Section of this Credit Agreement or such Loan Document, as the case may be.

9.7. *Headings.* The various headings of this Credit Agreement or of any other of the Loan Documents executed pursuant hereto are inserted for convenience only and shall not affect the meaning or interpretation of this Credit Agreement or such Loan Document or any provisions hereof or thereof.

9.8. *Governing Law; Venue.* Each of the Loan Documents shall be deemed to be a contract made under and governed by the laws of the State of Minnesota. The Borrower hereby consents to the personal jurisdiction of the state and federal courts located in the State of Minnesota in connection with any controversy related to this Credit Agreement and any other of the Loan Documents, waives any argument that venue in such forums is not convenient and agrees that any litigation instigated by the Borrower against the Lender in connection herewith or therewith shall be venued in the federal or state court that has jurisdiction over matters arising in Minneapolis, Minnesota.

9.9. *Successors and Assigns.* This Credit Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective

successors and assigns, except that Borrower may not assign or transfer its rights hereunder without the prior written consent of Lender.

9.10. *Recitals Incorporated.* The recitals to this Credit Agreement are incorporated into and constitute an integral part of this Credit Agreement.

9.11. *Multiple Counterparts.* This Credit Agreement may be executed in one or more counterparts, each of which shall be deemed to be an original and all of which shall constitute one and the same instrument.

9.12. *Prior Loan Agreements Superseded.* This Credit Agreement amends, restates, and supersedes in their entirety the Prior Loan Agreements and all obligations, liabilities and indebtedness of the Borrower incurred or arising thereunder shall be deemed to have been incurred and arising hereunder.

IN WITNESS WHEREOF, the parties hereto have caused this Credit Agreement to be executed by their respective officers thereunto duly authorized as of the day and year first above written.

LECTEC CORPORATION,  
A MINNESOTA CORPORATION

By: /s/Deborah L. Moore

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Its: Chief Financial Officer  
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FIRST BANK NATIONAL ASSOCIATION,  
A NATIONAL BANKING ASSOCIATION

By: /s/Jason Wandersee

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Its: Assistant Vice President  
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\$1,000,000.00

MINNEAPOLIS, MINNESOTA

Due: SEPTEMBER 1, 1998

AUGUST 22, 1997

1. **LOAN AMOUNT AND INTEREST RATE.** FOR VALUE RECEIVED, LECTEC CORPORATION, a Minnesota corporation ("Maker") promises to pay to the order of FIRST BANK NATIONAL ASSOCIATION, a national banking association ("Lender"), its successors and assigns, at its office at 300 Prairie Center Drive, Eden Prairie, Minnesota 55344, or such other place as the holder hereof may designate in writing from time to time, the principal sum of One Million and No/100 Dollars (\$1,000,000.00), or so much thereof as may be advanced from time to time pursuant to that certain Credit Agreement dated of even date herewith between the Maker and the Lender, as the same may be amended, modified, restated or replaced from time to time as agreed upon in writing by the Lender ("Credit Agreement"), in lawful money of the United States, together with interest from the date hereof on the unpaid balance hereof from time to time outstanding at one of the following rates to be selected from time to time by the Maker in accordance with and subject to the terms of the Credit Agreement: (i) a variable annual rate at all times equal to the prevailing Reference Rate of interest established and announced by the Lender as the same may change from time to time, as to all Reference Rate Advances; or (ii) the Resetting Eurodollar Rate, as defined in the Credit Agreement, as to all Daily Eurodollar Advances; or (iii) the Eurodollar Rate (Reserve Adjusted) as defined in the Credit Agreement, plus 250 basis points, as to all Eurodollar Advances. The Lender may make loans to its customers or any other person or entity at, above or below the Reference Rate. In the event that the Lender ceases to establish and announce a Reference Rate at any time during the term of this Note, the Lender shall be entitled to designate a reasonably comparable substitute index for the calculation of the interest rate hereon so long as any amount remains outstanding hereunder. All changes in the rate of interest applicable hereto shall become effective on the same day that the change in said Reference Rate is announced.

2. **PAYMENT SCHEDULE.** This Note shall be payable in the following manner:

2.1 As to Reference Rate Advances and Daily Eurodollar Advances, accrued interest shall be due and payable on the first day of each month, beginning September 1, 1997, and at Maturity, and as to Eurodollar Advances, accrued interest shall be due and payable on the last day of each Interest Period, until all indebtedness evidenced hereby is paid in full. All outstanding principal and accrued and unpaid interest shall be due and payable on September 1, 1998.

2.2 Each payment made under this Note shall be applied, first, to the amount then due for any expenses, costs or other expenditures incurred by the Lender in connection with this Note and payable by the Maker, and then applied to any accrued interest then due under this Note, and any balance thereafter remaining shall be applied against principal outstanding under this Note.

2.3 Any payment due on any non-business day of the Lender shall be due upon (and interest shall accrue to) the next business day.

3. **DEFAULT INTEREST RATE.** Upon the occurrence and during the continuation of an Event of Default as defined in the Credit Agreement, the interest rate shall thereafter increase and shall be payable on the whole of the unpaid principal balance, interest and other charges at a rate equal to the greater of (i) two percent (2.00%) per annum in excess of the rate of interest then in effect under the terms

of this Note or (ii) two percent (2.00%) per annum plus the Reference Rate (as defined in the Credit Agreement) in effect from time to time. This provision shall not be deemed to excuse an Event of Default not be deemed a waiver of any other rights the Lender may have including the right to declare the entire unpaid principal and interest under this Note immediately due and payable.

4. CREDIT AGREEMENT. This Note is the Revolving Credit Note issued pursuant to the terms and provisions of the Credit Agreement and this Note and the holder hereof are entitled to all of the benefits provided for in the Credit Agreement, or referred to therein. Reference is made to the Credit Agreement for a statement of the terms and conditions under which this indebtedness was incurred and is to be repaid and under which the due date of this Note may be accelerated. The provisions of the Credit Agreement are hereby incorporated by reference with the same force and effect as if fully set forth herein.

5. DEFAULT AND ACCELERATION. If an Event of Default, as defined in the Credit Agreement or any other agreement made by any party in connection with this Note, shall occur, and/or if any portion of the indebtedness evidenced hereby is not paid when due, the Lender or other holder of this Note may, without notice, demand, presentment for payment and/or notice of nonpayment, all of which Maker hereby expressly waives, declare the indebtedness evidenced hereby and all other indebtedness and obligations of the Maker to the Lender or holder hereof immediately due and payable and the Lender or other holder hereof may, without notice, immediately exercise any right of setoff and enforce any lien or security interest securing payment hereof. The foregoing shall be in addition to the rights of acceleration that may be provided in any loan agreement, security agreement, mortgage and/or other writing relating to the indebtedness evidenced hereby. If this Note is placed with any attorney(s) for collection upon any default, the Maker agrees to pay to the Lender or holder, its reasonable attorneys fees and all lawful costs and expenses of collection, whether or not a suit is commenced.

6. WAIVER. Time is of the essence. No delay or omission on the part of the Lender or other holder hereof in exercising any right or remedy hereunder shall operate as a waiver of such right or of any other right or remedy under this Note or any other document or agreement executed in connection herewith. All waivers by the Lender must be in writing to be effective and a waiver on any occasion shall not be construed as a bar to or a waiver of any similar right or remedy on a future occasion. The makers, endorsers, sureties, guarantors and all other persons liable for all or any part of the indebtedness evidenced by this Note jointly and severally waive presentment for payment, protest and notice of nonpayment. Such parties hereby consent without affecting their liability to any extension or alteration of the time or terms of payment hereon, any renewal, any release of all or any part of the security given for the payment hereof, any acceptance of additional security of any kind, and any release of, or resort to any party liable for payment hereof and such parties shall remain bound in the same capacities as prior thereto upon each such event.

7. JURISDICTION. This Note represents a loan negotiated, executed and to be performed in the State of Minnesota and shall be construed, interpreted and governed by the law of said state. The Maker hereby consents to the personal jurisdiction of the state and federal courts located in the State of Minnesota in connection with any controversy related to this Note, waives any argument that venue in such forums is not convenient and agrees that any litigation instigated by the Maker against the Lender in connection with this Note shall be venued in the federal or state court that has jurisdiction over matters arising in Minneapolis, Minnesota.

8. INTEREST LIMITATION. All agreements between the Maker and the Lender are hereby expressly limited so that in no contingency or event whatsoever, whether by reason of acceleration of maturity of the indebtedness evidenced or secured thereby or otherwise, shall the rate of interest charged or agreed to be paid to the Lender for the use, forbearance, loaning or detention of such indebtedness exceed the maximum permissible interest rate under applicable law ("Maximum Rate"). If for any reason or in any circumstance whatsoever fulfillment of any provision of this Note, any document securing or executed in connection with this Note, or any other agreement between the Maker and the Lender, at any time shall require or permit the interest rate applied thereunder to exceed the Maximum Rate, then the interest rate shall automatically be reduced to the Maximum Rate, and if the Lender should ever receive

interest at a rate that would exceed the Maximum Rate, the amount of interest received which would be in excess of the amount receivable after applying the Maximum Rate to the balance of the outstanding obligation shall be applied to the reduction of the principal balance of the outstanding obligation for which the amount was paid and not to the payment of interest thereunder. This

*provision shall control every other provision of any and all agreements between the Maker and the Lender and shall also be binding upon and available to any subsequent holder of this Note.*

*IN WITNESS WHEREOF, the Maker has executed and delivered this Note to the Lender as of the day and year first above written.*

*LECTEC CORPORATION,  
A MINNESOTA CORPORATION*

*By /s/Deborah L. Moore*

*Its Chief Financial Officer*



*CONSENT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS*

*We have issued our report dated August 22, 1997 accompanying the consolidated financial statements included in the Annual Report of LecTec Corporation on Form 10-K for the year ended June 30, 1997. We hereby consent to the incorporation by reference of said report in the Registration Statements of LecTec Corporation on Forms S-8 (File No. 33-121780, effective April 21, 1987 and No. 33-45931, effective February 21, 1992.)*

*GRANT THORNTON LLP*

*Minneapolis, Minnesota  
September 23, 1997*

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