

## *Warrants to Purchase ADSs*

In addition to the note, Flamel also issued to Éclat Holdings, two six-year warrants to purchase an aggregate of 3,300,000 ADSs, each representing one ordinary share, of Flamel. One warrant is exercisable for 2,200,000 ADSs at an exercise price of \$7.44 per ADS, and the other warrant is exercisable for 1,100,000 ADSs at an exercise price of \$11.00 per ADS. The warrants may be only be exercised upon approval by the holders of Flamel's ordinary shares. If shareholder approval is not obtained by March 13, 2014, the term of the warrants will extend to seven years, and the warrants may be cash settled if the holder chooses to redeem the warrants at a redemption price based on the intrinsic value of the warrant.

The warrants contain certain limitations that prevent the holder from exercising the warrants during any time that would result in the holder beneficially owning ADSs that exceed more than 19.985% of the total number of Flamel's ordinary shares then issued and outstanding. In addition, upon certain changes in control of Flamel after March 13, 2014 or upon certain defaults under the warrants, the holder has the right to cause Flamel to redeem the warrants in ADSs at a redemption price based on the Black Scholes value of the outstanding ADSs issuable under the warrants.

The sale of the warrants was exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended, or the Securities Act, as a transaction not involving a public offering. The warrants and the securities to be issued upon exercise of the warrants have not been registered under the Securities Act or state securities laws and may not be offered or sold in the United States absent registration with the SEC or an applicable exemption from the registration requirements.

## *Registration Rights Agreement*

In connection with the issuance of the warrants, Flamel entered into a registration rights agreement with Éclat Holdings dated March 13, 2012, pursuant to which Flamel has agreed to file, no later than 30 days after the date of the Shareholder Approval, a registration statement with the SEC covering the resale of the ADSs issuable upon exercise of the warrants.

## **Exchange Controls**

The payment of any dividends to foreign shareholders must be effected through an authorized intermediary bank. All registered banks and credit establishments in the Republic of France are authorized intermediaries. Under current French exchange control regulations, there are no limitations on the amount of cash payments that may be remitted by Flamel to residents of the United States. Laws and regulations concerning foreign exchange controls do require, however, that all payments or transfers of funds made by a French resident to a non-resident be handled by an authorized intermediary bank.

## **Taxation**

The following is a discussion of French and U.S. federal income tax consequences of owning and disposing of Flamel Ordinary Shares or Flamel ADSs. This description is only relevant to holders of Flamel Ordinary Shares or Flamel ADSs who are not residents of France and do not hold their shares in connection with a permanent establishment or a fixed base in France through which the holders carry on a business or perform personal services.

This description may not address all aspects of French tax laws that may be relevant in light of the particular circumstances of individual holders of Flamel Ordinary Shares or Flamel ADSs. It is based on the applicable tax laws, regulations and judicial decisions as of the date of this annual report, and on the Convention between the United States of America and the Republic of France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital dated as of August 31, 1994 entered into force on December 30, 1995, and the 2004 and 2009 Protocols amending the Treaty, all of which are subject to change, possibly with retroactive effect, or different interpretations. This discussion refers to the treaty between the United States and France described above, and the two Protocols together as the 'Treaty'.

The following discussion should be considered only as a summary and does not purport to be a complete analysis of all potential tax effects of the purchase or ownership of the Flamel Ordinary Shares or Flamel ADSs. This summary does not address all potential tax implications that may be relevant as a holder, in light of particular circumstances.

**Tax Consequences to Non-U.S. Holders**

The following discussion applies to holders of Flamel Ordinary Shares that are not ‘U.S. Holders,’ as defined below. Holders of Flamel Ordinary Shares should consult their tax advisor concerning the French tax consequences.

**Taxation on Sale or Disposal of Flamel Ordinary Shares**

Generally, a holder of Flamel Ordinary Shares will not be subject to any French income tax or capital gains tax when the holder sells or disposes of Flamel Ordinary Shares if all of the following cumulative conditions apply:

- the holder is not a French resident for French tax purposes;
- the holder has held not more than 25% of Flamel’s dividend rights, known as *droits aux bénéfices sociaux*, at any time during the preceding five years, either directly or indirectly;
- the holder is not a resident of a non-cooperative jurisdiction as defined below; and
- Flamel is not considered as a real estate company

If a double tax treaty between *France and the country* of residence of a holder of Flamel Ordinary Shares contains more favorable provisions, a holder may not be subject to any French income tax or capital gains tax when the holder sells or disposes of any Flamel Ordinary Shares, even if one or all of the above statements does not apply to the holder.

Subject to various conditions, foreign states, international organizations and a number of foreign public bodies are not considered as French residents for these purposes.

As from January 1, 2012, transfers of a listed company's shares are subject to French registration or transfer taxes when they are documented by a written deed, irrespective of whether that deed is executed in France or outside of France. A tax credit will be available (up to the extent of the transfer taxes triggered in France) in order to shelter the foreign transfer tax liability (if registration is also required under foreign law). From January 1, 2012 to July 31, 2012, the following rates apply to the transfer of listed company shares: (i) 3% for the portion of the value below €200,000; (ii) 0.5% for the portion of the value between €200,000 and €500,000,000 and; (iii) 0.25% for the portion of the value above €500,000,000. As from August 1, 2012, a unique 0.10% tax rate will apply to the transfer of listed company's shares.

**Taxation of Dividends**

In France, companies may only pay dividends out of income remaining after tax has been paid.

French companies must, in principle, deduct a 30% withholding tax from dividends paid to non-residents. As from January 1, 2008, the rate of this withholding tax has been reduced to 21% for dividends paid to EU, Norway Iceland and Liechtenstein residents.

In addition, the French Amended Finance Bill for 2009 provides for new anti-avoidance rules regarding transactions concluded with non-cooperative jurisdictions. As a consequence, dividends distributed to non-cooperative jurisdictions residents as of March 1, 2010, as per the criteria defined by the French tax code, would be subject to a 55% withholding tax.

The following countries were considered by the French tax authorities as non-cooperative jurisdictions in 2011:

Anguilla	Grenada	Montserrat	Oman
Belize	Guatemala	Nauru	Turks and Caicos Islands
Brunei	Cook Islands	Niue	Saint Vincent and the Grenadines
Costa Rica	Marshall Islands	Panama	
Dominica	Liberia	Philippines	

Under most double tax treaties between France and other countries, the rate of this withholding tax may be reduced or eliminated in some circumstances. Generally, if dividends are subject to a French withholding tax, a holder who is a non-French resident is subsequently entitled to a tax credit in that holder's country of residence for the amount of tax actually withheld.

However, France has entered into tax treaties with various countries under which qualifying residents are entitled to obtain from the French tax authorities a reduction (generally to 15% or 5%) or an elimination of the French withholding tax.

If these arrangements apply to a shareholder, Flamel will withhold tax from the dividend at the lower rate, provided that the shareholder has established, before the date of payment of the dividend, that the shareholder is entitled to the lower rate and has complied with the filing formalities. Otherwise, Flamel must withhold tax at the full rate of 30% (for other than European Union, Iceland, Norway or Liechtenstein residents) or 21% (for European Union, Iceland, Liechtenstein or Norway residents), and the shareholder may subsequently claim the excess tax paid.

#### **Estate and Gift Tax**

France imposes estate and gift tax on shares of a French company that are acquired by inheritance or gift, this tax applying without regards to the residence of the transferor. However, France has entered into estate and gift tax treaties with certain countries pursuant to which, provided that certain conditions are met, residents of the treaty country may be exempt from such tax or obtain a tax credit.

Non-residents should consult their own tax advisors regarding whether French estate and gift tax would apply to them and whether they might be able to claim an exemption or tax credit pursuant to an applicable tax treaty.

#### **Wealth Tax**

French individual residents are taxable on their worldwide assets. Non-resident individuals may be subject to French wealth tax (*impôt de solidarité sur la fortune*) only on their assets which are located in France. However, financial investments made by non-resident individuals, other than in real estate companies, are exempt from wealth taxes as long as the individuals own less than 10% of the French company's capital stock, either directly or indirectly, provided that their shares do not enable them to exercise influence on the French company.

Even if these conditions are not satisfied, a non-French resident holder may be exempt from French wealth tax if such holder is entitled to more favourable provisions pursuant to a double tax treaty between France and the holder's country of residence.

#### **Tax Consequences to U.S. Holders**

The following is a discussion of the U.S. federal income tax consequences of the ownership and disposition of Flamel Ordinary Shares or Flamel ADSs by a U.S. Holder. For purposes of this discussion a "U.S. Holder" is a beneficial owner of the Flamel Ordinary Shares or Flamel ADSs who is (i) an individual citizen or resident of the United States; (ii) a corporation created or organized in the United States or under the laws of the United States or any political subdivision thereof; (iii) an estate whose income is includible in gross income for United States federal income tax purposes regardless of its source; or (iv) a trust whose administration is subject to the primary supervision of a United States court and over which one or more United States persons have the authority to control all substantial decisions of the trust. This discussion does not apply to a U.S. Holder who is also a resident of France for French tax purposes.

If an entity that is treated as a partnership for United States federal income tax purposes holds Flamel Ordinary Shares or Flamel ADSs, the tax treatment of a partner of such partnership will generally depend on the status of the partner and upon the activities and organization of the partnership. If you are a partner of such a partnership you are urged to consult your tax advisor.

This summary is based in part upon the representations of the custodian and the assumption that each obligation in the Depositary Agreement with the Bank of New York relating to our ADSs and any related agreement will be performed in accordance with its terms.

The following is a general summary of the principal tax effects on U.S. Holders for purposes of U.S. federal income tax and French tax, if all of the following four points apply:

- the U.S. Holder owns, directly, indirectly, or constructively, less than 10% of Flamel's share capital;
- the U.S. Holder is entitled to the benefits of the Treaty (including under the 'limitations on benefits article of the Treaty);
- the U.S. Holder holds Flamel Shares as capital assets; and
- the U.S. Holder's functional currency is the U.S. dollar.

For purposes of the Treaty and the U.S. Internal Revenue Code of 1986, as amended (the "Internal Revenue Code"), Holders of Flamel ADSs will be treated as the owner of the Flamel Ordinary Shares represented by such ADSs.

Special rules may apply to United States expatriates, insurance companies, pass-through entities and investors in such entities, tax-exempt organizations, financial institutions, persons subject to the alternative minimum tax, securities broker-dealers, persons who use the mark-to-market method of accounting for their securities holdings, and persons holding their Flamel Ordinary Shares or Flamel ADSs as part of a conversion or other integrated transaction, among others. Special rules relevant to those holders are not discussed in herein.

Holders of Flamel Ordinary Shares or Flamel ADSs should consult their own tax advisers as to the particular tax consequences to them of owning Flamel Ordinary Shares or Flamel ADSs, including their eligibility for benefits under the Treaty, the applicability and effect of U.S. federal, state, local, non-U.S. and other tax laws and any possible changes in tax law.

#### ***Taxation of Dividends***

##### ***Withholding Tax***

Dividends paid to non-residents by French companies are subject to a 30% French withholding tax. Under the Treaty, this withholding tax is reduced to 15% if a U.S. Holder's ownership of Flamel Shares is not effectively connected with a permanent establishment or a fixed base that the U.S. Holder has in France.

Dividends paid to a U.S. Holder by French companies are immediately subject to a reduced rate of 15%, provided that such U.S. Holder establishes before the date of payment that he is a U.S. resident under the Treaty by completing and providing the depositary with a simplified certificate (the "*Certificate*") in accordance with the French tax guidelines (4 J-1-05 released on February 25, 2005). Dividends paid to a U.S. Holder that has not filed the Certificate before the dividend payment date will be subject to French withholding tax at the rate of 30%. The tax withheld in excess of 15% can be reclaimed, provided that such U.S. Holder duly completes and provides the French tax authorities with the relevant form described in the tax guidelines mentioned above (the "*Form*") before December 31 of the second calendar year following the year during which the dividend is paid. U.S. Pension Funds (as defined by Sections 401(a), 401(b), 403(b) and 457 of the Internal Revenue Code) and other Tax-Exempt Entities (as defined by Section 501(c) 3) of the Internal Revenue Code) are subject to the same general filing requirements as other U.S. Holders except that they may be required to supply additional documentation evidencing their entitlement to these benefits.

The Certificate and the Form, together with instructions, will be provided by the depositary to all U.S. Holders registered with the depositary. The depositary will arrange for the filing with the French Tax authorities of all Certificates properly completed and executed by U.S. Holders of Shares and returned to the depositary in sufficient time that they may be filed with French Tax authorities before the distribution so as to obtain an immediate reduced withholding tax rate.

## **U.S. Federal Income Tax.**

For U.S. federal income tax purposes, subject to the rules discussed below under the section titled "PFIC Status," the gross amount of a dividend paid by Flamel, including any French tax withheld, will be included in each U.S. Holder's gross income as dividend income when payment is received by them (or the custodian, if the U.S. Holder owns Flamel ADSs), to the extent they are paid or deemed paid out of Flamel's current or accumulated earnings and profits as calculated for U.S. federal income tax purposes.

Dividends paid by Flamel will not give rise to any dividends received deduction. They will generally constitute foreign source "passive" income for "foreign tax credit" purposes. For certain recipients, dividends will constitute foreign source "general" income for foreign tax credit purposes.

Under current U.S. federal tax law, as a general matter, amounts distributed as dividends by Flamel with respect to Flamel Ordinary Shares or Flamel ADSs paid in taxable years beginning before January 1, 2013 will be eligible to be treated as "qualified dividend income" that is subject to a U.S. federal income tax at a maximum rate of 15% provided both that certain minimum holding period and other requirements are met and that Flamel is not treated as a PFIC (as defined below under the section titled "PFIC Status").

For U.S. federal income tax purposes, the amount of any dividend paid in Euros, including any French withholding taxes, will be equal to the U.S. dollar value of the Euro on the date the dividend is included in income, regardless of whether the payment is in fact converted into U.S. dollars. A U.S. Holder will generally be required to recognize foreign currency gain or loss when the U.S. Holder sells or disposes of the Euros. A U.S. Holder may also be required to recognize foreign currency gain or loss if that U.S. Holder receives a refund under the Treaty of tax withheld in excess of the Treaty rate. This foreign currency gain or loss will generally be U.S. source ordinary income or loss.

To the extent that any dividends paid exceed Flamel's current and accumulated earnings and profits as calculated for U.S. federal income tax purposes, the distribution generally will be treated as follows:

- First, as a tax-free return of capital, to be applied against and reduce in the adjusted basis of a U.S. Holder's Flamel Ordinary Shares or Flamel ADSs. Accordingly, this adjustment will increase the amount of gain, or decrease the amount of loss, which a U.S. Holder will recognize if such U.S. Holder later disposes of those Flamel Ordinary Shares or Flamel ADSs, as the case may be.
- Second, the balance of the dividend in excess of the adjusted basis will be taxed as capital gain recognized on a sale or exchange.

French withholding tax (which, as described above), is imposed on at a rate of 15% under the Treaty generally is treated for U.S. federal income tax purposes as payment of a foreign income tax. A U.S. Holder may take this amount as a credit or deduction against the U.S. Holder's U.S. federal income tax liability. The foreign tax credit is subject to various conditions and limitations, including minimum holding period requirements. Special rules apply in determining the foreign tax credit limitation with respect to dividends that are subject to the maximum 15% tax rate applicable to qualified dividend income.

To the extent a refund of French tax withheld with respect to dividends is available under the Treaty or otherwise under French law, the amount of tax withheld that is refundable will not be eligible for credit against your U.S. federal income tax liability.

## **Taxation of Capital Gains**

**French Tax.** A U.S. Holder who is a resident of the United States for purposes of the Treaty will not be subject to French tax on any capital gain if such U.S. Holder sells or exchanges its Flamel Ordinary Shares or Flamel ADSs, unless the U.S. Holder has a permanent establishment or fixed base in France and the Flamel Ordinary Shares or Flamel ADSs the U.S. Holder sold or exchanged were attributable to that permanent establishment or fixed base. Special rules apply to individuals who are residents of more than one country.

**U.S. Income Tax.** In general, for U.S. federal income tax purposes, a U.S. Holder will recognize capital gain or loss if the U.S. Holder sells or exchanges its Flamel Ordinary Shares or Flamel ADSs. Any such gain or loss generally will be U.S. source gain or loss. If a U.S. Holder is an individual, any capital gain will generally be subject to U.S. federal income tax at preferential rates if the U.S. Holder meets applicable minimum holding period requirements.

**PFIC Status.** Flamel believes that it will not be treated as a passive foreign investment company, or PFIC, for U.S. federal income tax purposes, for the current taxable year or for future taxable years. However, an actual determination of PFIC status is factual and cannot be made until the close of the applicable taxable year. Flamel will be a PFIC for any taxable year in which either:

- 75% or more of its gross income is passive income; or
- its assets which produce passive income or which are held for the production of passive income amount to at least 50% of the value of its total assets on average.

If Flamel were to be treated as a PFIC, the tax consequences applicable to distributions on Flamel Ordinary Shares and Flamel ADSs, and any gains a U.S. Holder realizes when the U.S. Holder disposes of such Flamel Ordinary Shares or Flamel ADSs, may be less favorable to the U.S. Holder. In addition, a U.S. Holder would be required to file Form 8621 with respect to its interest in Flamel. Each U.S. Holder should consult its own tax advisors regarding the PFIC rules and their effect on the U.S. Holder if they purchase Flamel Ordinary Shares or Flamel ADSs.

#### **French Estate and Gift Taxes**

Under 'The Convention Between the United States of America and the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates, Inheritance and Gifts of November 24, 1978,' if a U.S. Holder transfers their Flamel Shares by gift, or if they are transferred by reason of the U.S. Holder's death, that transfer will only be subject to French gift or inheritance tax if one of the following applies:

- the U.S. Holder is domiciled in France at the time of making the gift, or at the time of the U.S. Holder's death; or
- the U.S. Holder used the Flamel Ordinary Shares or Flamel ADSs in conducting a business through a permanent establishment or fixed base in France, or the U.S. Holder held the Flamel Ordinary Shares or Flamel ADSs for that use.

#### **French Wealth Tax**

The French wealth tax does not generally apply to Flamel Ordinary Shares or Flamel ADSs if the U.S. Holder is treated as a 'resident' of the United States for purposes of the Treaty. and if the U.S. Holder does not own a substantial interest (*participation substantielle*) in Flamel. Pursuant to article 23 §2 of the Treaty, "an individual is considered to have a substantial interest if he or she owns, alone or with related persons, directly or indirectly, shares, rights, or interests the total of which gives right to at least 25% of the corporate earnings".

#### **Expansion of U.S. Medicare Tax**

The U.S. Health Care and Reconciliation Act of 2010 requires that, in certain circumstances, certain U.S. Shareholders that are individuals, estates, and trusts pay a 3.8% tax on "net investment income," which includes, among other things, dividends on and gains from the sale or other disposition of stock, effective for taxable years beginning after December 31, 2012. Prospective investors should consult their own tax advisors regarding this new legislation.

#### **United States Information Reporting and Backup Withholding**

Dividend payments made by us to a U.S. Holder in respect of Flamel Ordinary Shares or Flamel ADSs and proceeds from the sale or disposal of a U.S. Holder's Flamel Ordinary Shares or Flamel ADSs may be subject to information reporting to the Internal Revenue Service.