

[Table of Contents](#)

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2005

OR

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

For the transition period from _____ to _____

Commission file number 000-31615

DURECT CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

**(State or other jurisdiction of
incorporation or organization)**

94-3297098

**(I.R.S. Employer
Identification No.)**

10240 Bubb Road

Cupertino, California 95014

(Address of principal executive offices, including zip code)

(408) 777-1417

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO “

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). YES x NO “

As of July 31, 2005, there were 52,308,220 shares of the registrant's Common Stock outstanding.

Table of Contents

INDEX

	<u>Page</u>
 <u>PART I. FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets</u> <i><u>As of June 30, 2005 (unaudited) and December 31, 2004</u></i>	3
<u>Condensed Consolidated Statements of Operations</u> <i><u>For the three and six months ended June 30, 2005 and 2004 (unaudited)</u></i>	4
<u>Condensed Consolidated Statements of Cash Flows</u> <i><u>For the six months ended June 30, 2005 and 2004 (unaudited)</u></i>	5
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	11
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	37
Item 4. <u>Controls and Procedures</u>	37
 <u>PART II. OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	38
Item 2. <u>Unregistered Sales of Equity Securities</u>	38
Item 3. <u>Defaults Upon Senior Securities</u>	38
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	38
Item 5. <u>Other Information</u>	38
Item 6. <u>Exhibits</u>	39
<u>(a) Exhibits</u>	39
<u>Signatures</u>	40
<u>Certifications</u>	

[Table of Contents](#)

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

DURECT CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS (in thousands, except per share amounts)

	June 30, 2005	December 31, 2004
	(unaudited)	(Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 30,269	\$ 20,032
Short-term investments	18,918	21,765
Short-term restricted investments	1,024	—
Accounts receivable, net of allowances of \$227 and \$208, respectively	6,166	2,481
Inventories	1,911	1,929
Prepaid expenses and other current assets	1,139	1,364
Total current assets	59,427	47,571
Property and equipment, net	7,258	7,112
Goodwill	6,399	6,399
Intangible assets, net	1,138	1,745
Long-term investments	8,926	17,218
Long-term restricted investments	1,401	2,798
Other long-term assets	2,310	2,625
Total assets	\$ 86,859	\$ 85,468
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,242	\$ 1,658
Accrued liabilities	3,045	2,549
Contract research liability	940	554
Interest payable on convertible notes	167	167
Deferred revenue, current portion	2,218	78
Term loan and equipment financing obligations, current portion	176	293
Bonds payable, current portion	190	190
Total current liabilities	7,978	5,489
Term loan and equipment financing obligations, noncurrent portion	31	60
Bonds payable, noncurrent portion	875	875
Convertible subordinated notes	60,000	60,000
Deferred revenue, noncurrent portion	7,110	—
Other long-term liabilities	631	654
Commitments		
Stockholders' equity:		
Common stock, \$0.0001 par value: 110,000 shares authorized at June 30, 2005 and December 31, 2004 respectively; 52,156 and 51,870 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively	5	5
Additional paid-in capital	196,934	196,065
Note receivable from a stockholder		

Deferred compensation	—(2)	(34)
Deferred royalties and commercial rights	(13,480)	(13,480)
Accumulated other comprehensive loss	(257)	(268)
Accumulated deficit	(172,966)	(163,891)
	<u> </u>	<u> </u>
Total stockholders' equity	10,234	18,390
	<u> </u>	<u> </u>
Total liabilities and stockholders' equity	\$ 86,859	\$ 85,468
	<u> </u>	<u> </u>

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

[Table of Contents](#)

DURECT CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Product revenue, net	\$ 1,889	\$ 1,760	\$ 3,646	\$ 3,125
Collaborative research and development and other revenue	6,930	1,320	10,527	3,340
Total revenues	8,819	3,080	14,173	6,465
Operating expenses:				
Cost of revenues	689	867	1,360	1,432
Research and development	7,613	6,040	14,231	11,449
Selling, general and administrative	2,812	2,339	5,316	4,563
Amortization of intangible assets	303	308	606	643
Stock-based compensation(1)	343	135	393	170
Total operating expenses	11,760	9,689	21,906	18,257
Loss from operations	(2,941)	(6,609)	(7,733)	(11,792)
Other income (expense):				
Interest and other income	407	289	892	593
Interest expense	(1,114)	(1,113)	(2,234)	(2,224)
Net other income (expense)	(707)	(824)	(1,342)	(1,631)
Net loss	\$ (3,648)	\$ (7,433)	\$ (9,075)	\$ (13,423)
Net loss per common share, basic and diluted	\$ (0.07)	\$ (0.14)	\$ (0.17)	\$ (0.26)
Shares used in computing basic and diluted net loss per share	52,047	51,396	51,967	51,260
(1) Stock-based compensation related to the following:				
Cost of revenues	\$ —	\$ (2)	\$ —	\$ 1
Research and development	—	126	46	153
Selling, general and administrative	343	11	347	16
	\$ 343	\$ 135	\$ 393	\$ 170

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

[Table of Contents](#)

DURECT CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (in thousands) (unaudited)

	Six months ended June 30,	
	2005	2004
Cash flows from operating activities		
Net loss	\$ (9,075)	\$(13,423)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,672	2,236
Non-cash charges related to stock-based compensation	393	170
Changes in assets and liabilities:		
Accounts receivable	(3,685)	(353)
Inventories	18	(12)
Prepaid expenses and other assets	540	393
Accounts payable	(416)	250
Accrued liabilities and other long-term liabilities	473	(408)
Contract research liability	386	(63)
Deferred revenue	9,250	246
Total adjustments	8,631	2,459
Net cash and cash equivalents used in operating activities	(444)	(10,964)
Cash flows from investing activities		
Purchases of property and equipment	(1,212)	(527)
Purchases of available for sale securities	(5,350)	(35,744)
Proceeds from maturities of available-for-sale securities	16,873	33,261
Net cash and cash equivalents provided by (used in) investing activities	10,311	(3,010)
Cash flows from financing activities		
Payments on term loan and equipment financing obligations	(145)	(142)
Net proceeds from issuances of common stock	478	543
Proceeds from notes receivable from stockholders	37	50
Net cash and cash equivalents provided by financing activities	370	451
Net increase (decrease) in cash and cash equivalents	10,237	(13,523)
Cash and cash equivalents, beginning of the period	20,032	21,203
Cash and cash equivalents, end of the period	\$30,269	\$ 7,680

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

[Table of Contents](#)

DURECT CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Nature of Operations and Basis of Presentation

DURECT Corporation (the Company) was incorporated in the state of Delaware on February 6, 1998. The Company is an emerging specialty pharmaceuticals systems company focused on the development of pharmaceutical systems based on its proprietary drug delivery technology platforms. The Company has several product candidates under development by itself and with third-party collaborators in the areas of pain and other chronic diseases and disorders. The Company also manufactures and sells osmotic pumps used in laboratory research. In addition, the Company conducts research and development of pharmaceutical product candidates with third-party pharmaceutical and biotechnology company partners.

The Company also designs, develops and manufactures a wide range of standard and custom biodegradable polymers for pharmaceutical and medical device clients for use as raw materials in their products. Until December 31, 2004, this business was conducted by the Company's wholly owned subsidiary, Absorbable Polymers International Corporation (API), formerly known as Birmingham Polymers Inc., an Alabama corporation. API was merged with and into the Company on December 31, 2004.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its subsidiary, if applicable. All significant intercompany accounts and transactions during the periods the Company had a subsidiary prior to December 31, 2004, have been eliminated. These financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission, and therefore, do not include all the information and footnotes necessary for a complete presentation of the Company's results of operations, financial position and cash flows in conformity with accounting principles generally accepted in the United States. The unaudited financial statements reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position at June 30, 2005, the operating results for the three and six months ended June 30, 2005 and 2004, and cash flows for the six months ended June 30, 2005 and 2004. The condensed consolidated balance sheet as of December 31, 2004 has been derived from audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. These financial statements and notes should be read in conjunction with the Company's audited financial statements and notes thereto, included in the Company's annual report on Form 10-K filed with the Securities and Exchange Commission.

The results of operations for the interim periods presented are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year.

Inventories

Inventories are stated at the lower of cost or market, with cost determined on a first-in, first-out basis.

Inventories consisted of the following (in thousands):

	June 30, 2005	December 31, 2004
	(unaudited)	
Raw materials	\$ 148	\$ 175
Work in process	490	452
Finished goods	1,273	1,302

Total inventories	\$ 1,911	\$ 1,929
-------------------	----------	----------

Stock-Based Compensation

The Company accounts for stock-based employee compensation arrangements in accordance with the provisions and related interpretations of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and has elected to follow the “disclosure only” alternative prescribed by Financial Accounting Standards Board’s Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS 123). Under APB 25, stock-based compensation is based on the difference, if any, on the date of grant, between the fair value of the Company’s stock and the exercise price. Unearned compensation is amortized using the graded vesting method and expensed over the vesting period of the respective options.

Table of Contents

At June 30, 2005, the Company had five stock-based employee compensation plans. The Company accounts for those plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net loss when all options granted under those plans have an exercise price at least equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation (in thousands, except per share amounts).

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Net loss—as reported	\$(3,648)	\$(7,433)	\$ (9,075)	\$(13,423)
Add: Stock-based employee compensation expense included in reported net loss	336	5	338	(15)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(819)	(789)	(1,807)	(1,250)
Pro forma net loss	<u>\$(4,131)</u>	<u>\$(8,217)</u>	<u>\$(10,544)</u>	<u>\$(14,688)</u>
Net loss per share:				
Basic and diluted—as reported	<u>\$ (0.07)</u>	<u>\$ (0.14)</u>	<u>\$ (0.17)</u>	<u>\$ (0.26)</u>
Basic and diluted—pro forma	<u>\$ (0.08)</u>	<u>\$ (0.16)</u>	<u>\$ (0.20)</u>	<u>\$ (0.29)</u>

The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS 123 and Emerging Issues Task Force 96-18, *Accounting for Equity Instruments that are Issued to other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. The fair value of equity instruments granted to non-employees is periodically remeasured as the underlying options vest.

Revenue Recognition

Revenue from the sale of products is recognized at the time the product is shipped and title transfers to customers, provided no continuing obligation exists and the collectibility of the amounts owed is reasonably assured.

Upfront payment received upon execution of collaborative agreements are recorded as deferred revenue and recognized as collaborative research and development revenue on a systematic basis (based on a straight-line basis or upon the timing and level of work performed) over the period that the related research and development services are performed as defined in the respective agreements. Research and development revenue related to services performed under the collaborative arrangements with the Company's corporate partners is recognized as the related research and development services are performed. These research payments received under each respective agreement are not refundable and are generally based on reimbursement of qualified expenses, as defined in the agreements. Research and development expenses under the collaborative research and development agreements generally approximate or exceed the revenue recognized under such agreements over the term of the respective agreements. Milestone and royalties payments, if any, will be recognized as earned in accordance with the terms of the respective agreements. Deferred revenue may result when we do not expend the required level of effort during a specific period in comparison to funds received under the respective agreement.

Revenue on cost-plus-fee contracts, such as under contracts to perform research and development for others, is recognized only to the extent of reimbursable costs incurred plus estimated fees thereon. In all cases, revenue is recognized only after a signed agreement is in place. For contracts that have a ceiling price or contract value, losses

on contracts are recognized in the period in which the losses become known and estimable.

Comprehensive Loss

The Company's comprehensive losses include unrealized gains and losses on the Company's available-for-sale securities. For the three months ended June 30, 2005 and 2004, the Company's total comprehensive losses were \$3.5 million and \$7.8 million, respectively, compared to its net losses of \$3.6 million and \$7.4 million, respectively. For the six months ended June 30, 2005 and 2004, the Company's total comprehensive losses were \$9.1 million and \$13.7 million, respectively, compared to its net losses of \$9.1 million and \$13.4 million, respectively.

Table of Contents

Net Loss Per Share

Basic net loss per share is calculated by dividing net loss by the weighted-average number of common shares outstanding, less the weighted average number of common shares subject to repurchase, during the period. Diluted net loss per share would include the impact of options and warrants to purchase common stock (using the treasury stock method) and convertible notes, if dilutive. There is no difference between basic and diluted net loss per share as the Company incurred a net loss in each period presented and inclusion of common stock equivalents would have been antidilutive for all the periods presented. The following table presents the calculations of basic and diluted net loss per share (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Net loss	\$ (3,648)	\$ (7,433)	\$ (9,075)	\$ (13,423)
Basic and diluted weighted-average shares:				
Weighted-average shares of common stock outstanding	52,047	51,398	51,967	51,289
Less: weighted-average shares subject to repurchase	—	(2)	—	(29)
Weighted-average shares used in computing basic and diluted net loss per share	52,047	51,396	51,967	51,260
Basic and diluted net loss per share	\$ (0.07)	\$ (0.14)	\$ (0.17)	\$ (0.26)

The computation of diluted net loss per share for the three months ended June 30, 2005 excludes the impact of options to purchase 8.2 million weighted average shares of common stock, warrants to purchase 770 shares of common stock and 19.0 million shares of common stock issuable upon conversion of the subordinated notes at June 30, 2005, as such impact would be antidilutive. The computation of diluted net loss per share for the six months ended June 30, 2005 excludes the impact of options to purchase 8.4 million weighted average shares of common stock, warrants to purchase 770 shares of common stock and 19.0 million shares of common stock issuable upon conversion of the subordinated notes, as such impact would be antidilutive.

The computation of diluted net loss per share for the three months ended June 30, 2004 excludes the impact of options to purchase 7.4 million weighted average shares of common stock, warrants to purchase 1.0 million shares of common stock, and 19.0 million shares of common stock issuable upon conversion of the subordinated notes, as such impact would be antidilutive. The computation of diluted net loss per share for the six months ended June 30, 2004 excludes the impact of options to purchase 7.0 million weighted average shares of common stock, warrants to purchase 1.0 million shares of common stock and 19.0 million shares of common stock issuable upon conversion of the subordinated notes, as such impact would be antidilutive.

Recent Accounting Pronouncements

In December 2004, the FASB issued Statement No. 123 (revised 2004, or SFAS 123R), "Share-Based Payment," which was originally effective for annual or interim periods beginning after June 15, 2005. SFAS 123R supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and will require companies to recognize compensation expense, using a fair-value based method, for costs related to share-based payments including stock options and stock issued under our employee stock purchase plans. In April 2005, the SEC issued a press release that revised the required date of adoption under SFAS 123R. We will be required to adopt SFAS 123R no later than the fiscal year that begins after June 15, 2005. Our adoption will be applied on a modified prospective basis and measured compensation expense will be recognized commencing on January 1, 2006. We are currently evaluating option valuation methodologies and assumptions in light of SFAS 123R. These methodologies and assumptions may be different than those currently employed by the company in applying SFAS 123, outlined above in "Stock-Based

Compensation”section of this note. We expect that our adoption of SFAS 123R will have a material adverse impact on our consolidated results of operations.

In March 2005, the SEC issued SAB No. 107 regarding the interaction between SFAS 123R which was revised in December 2004, and certain SEC rules and regulations and provides the SEC’s staff views regarding the valuation of share-based payment arrangements for public companies. We are evaluating the impact this guidance will have on our consolidated results of operations and financial position.

Table of Contents

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3". SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle, and applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. This statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. We do not expect that adoption of this statement will have a material impact on our consolidated results of operations.

Note 2. Agreement with Endo Pharmaceuticals

On March 10, 2005, the Company entered into a license agreement with Endo Pharmaceuticals Inc. (Endo) under which the Company granted to Endo the exclusive right to develop and commercialize the Company's proprietary sufentanil transdermal patch product candidate (TRANSDUR-Sufentanil) in the U.S. and Canada. Under the terms of the agreement, Endo will assume all remaining development and regulatory filing responsibility in the U.S. and Canada, including the funding thereof. The Company will perform all formulation development for Endo unless the Company defaults on such obligations and the Company will be reimbursed for its fully allocated cost in performance of such work. Endo will also be responsible and pay for the manufacture, marketing, sales and distribution of TRANSDUR-Sufentanil in the U.S. and Canada.

Pursuant to the agreement, Endo was obligated to pay an upfront, nonrefundable fee of \$10 million. In April 2005, Endo paid the Company the \$10 million upfront fee, and will pay to the Company additional payments of up to approximately \$35 million in the aggregate based upon achievement of predetermined regulatory and commercial milestones. In addition, Endo reimburses the Company for all qualified research and development expenses incurred for TRANSDUR-Sufentanil. Endo will also pay the Company product royalties based on the net sales of TRANSDUR-Sufentanil under the agreement. The Company has the right to co-promote TRANSDUR-Sufentanil under terms specified in the agreement. The agreement also contains terms and conditions customary for this type of arrangement, including representations, warranties and indemnities. The agreement shall continue in effect until terminated. The agreement provides each party with specified termination rights, including the right of each party to terminate the agreement upon material breach of the agreement by the other party. In addition, Endo shall have the right to terminate the agreement at any time without cause subject to a specified notice period and due to adverse product events, legal impediment or the issuance of a final, non-appealable court order enjoining Endo from selling TRANSDUR-Sufentanil in the U.S. and Canada as a result of an action for patent infringement by a third party, provided that in the latter instance, the Company will be required to pay Endo a termination fee ranging from \$5 million to \$10 million, depending on the date of termination.

The \$10 million up-front fee is recognized as revenue ratably over the term of the Company's continuing involvement with Endo with respect to TRANSDUR-Sufentanil. The term of the continuing involvement has been estimated based on the currently anticipated Product Development Plan. Research and development expenses associated with the Company's TRANSDUR-Sufentanil product candidate from March 10, 2005 to June 30, 2005 reimbursable by Endo under the license agreement were recognized as collaborative research and development revenue in the six months ended June 30, 2005.

[Table of Contents](#)

Note 3. Goodwill and Intangible Assets

Intangible assets consist of the following (in thousands):

	June 30, 2005		
	Gross Intangibles	Accumulated Amortization	Net Intangibles
Developed technology	\$ 3,600	\$ (2,976)	\$ 624
Patents	466	(352)	114
Other intangibles	3,260	(2,860)	400
Total	\$ 7,326	\$ (6,188)	\$ 1,138

	December 31, 2004		
	Gross Intangibles	Accumulated Amortization	Net Intangibles
Developed technology	\$ 3,600	\$ (2,647)	\$ 953
Patents	466	(319)	147
Other intangibles	3,260	(2,615)	645
Total	\$ 7,326	\$ (5,581)	\$ 1,745

Intangible assets subject to amortization at June 30, 2005 totaled \$1.1 million, net of amortization. The Company expects to amortize the amounts as follows: \$602,000 in the six months ending December 31, 2005, \$424,000 in the year of 2006, \$31,000 in each of the years 2007, 2008 and 2009, and \$19,000 in the year 2010. Should intangible assets become impaired, the Company will write them down to their estimated fair value.

Goodwill totaled \$6.4 million at June 30, 2005 and December 31, 2004. In 2004, goodwill was evaluated and no indicators of impairment were noted. Should goodwill become impaired, we may be required to record an impairment charge to write the goodwill down to its estimated fair value.

Note 4. Subsequent Event

In July 2005, the Company entered into a privately negotiated agreement with a holder of its 6.25% Convertible Subordinated Notes, due June 2008, to exchange up to \$5.0 million in principal amount of convertible notes for 317,4603 shares of common stock per \$1,000 principal amount as originally defined in the indenture, plus additional shares to compensate the note holder for the early exchange. As of August 3, 2005, the Company exchanged approximately \$1.0 million in principal amount of its 6.25% convertible notes for approximately 365,000 shares of the Company's common stock pursuant to this agreement.

[Table of Contents](#)

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis of Financial Condition and Results of Operations for the three and six months ended June 30, 2005 and 2004 should be read in conjunction with our annual report on Form 10-K filed with the Securities and Exchange Commission and "Factors that May Affect Future Results" section included elsewhere in this Form 10-Q. This Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. When used in this report or elsewhere by management from time to time, the words "believe," "anticipate," "intend," "plan," "estimate," "expect," and similar expressions are forward-looking statements. Such forward-looking statements are based on current expectations. Any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties. Actual events or results may differ materially from those discussed in the forward-looking statements as a result of various factors. For a more detailed discussion of such forward-looking statements and the potential risks and uncertainties that may impact upon their accuracy, see the "Factors that May Affect Future Results" and "Overview" sections of this Management's Discussion and Analysis of Financial Condition and Results of Operations. These forward-looking statements reflect our view only as of the date of this report. Except as required by law, we undertake no obligations to update any forward looking statements. You should also carefully consider the factors set forth in other reports or documents that we file from time to time with the Securities and Exchange Commission.

Overview

We are an emerging specialty pharmaceuticals systems company focused on the development of pharmaceutical systems based on the following proprietary drug delivery technology platforms: the SABER™ Delivery System (a patented and versatile depot injectable useful for protein and small molecule delivery), the TRANSDUR™ Delivery System (a proprietary transdermal technology), the ORADUR™ sustained release oral gel-cap technology (an oral sustained release technology with several potential abuse deterrent properties), the DURIN™ Biodegradable Implant (a biodegradable drug-loaded implant), the DUROS® System, (an osmotic implant technology licensed to us for specified fields from ALZA Corporation, a Johnson & Johnson Company) and the MICRODUR™ Biodegradable Microparticulates (a microspheres injectable system). *

Our pharmaceutical systems combine engineering innovations and delivery technology from the drug delivery and medical device industries with our proprietary pharmaceutical and biotechnology drug formulations. By integrating these technologies, we are able to control the rate and duration of drug administration as well as target the delivery of the drug to its intended site of action, allowing our pharmaceutical systems to meet the special challenges associated with treating chronic diseases or conditions. Our pharmaceutical systems can enable new drug therapies or optimize existing therapies based on a broad range of compounds, including small molecule pharmaceuticals as well as biotechnology molecules such as proteins, peptides and genes.

We focus on the treatment of chronic diseases and the development of pharmaceutical product candidates incorporating pharmaceutical or biotechnology agents. We may also choose to develop product candidates for acute indications, such as our SABER-based post-operative pain product candidate, to the extent it makes strategic sense to do so. In addition to developing our own proprietary products, we also partner with pharmaceutical companies to develop and commercialize proprietary and enhanced pharmaceutical products based on our technologies. We have five disclosed on-going development programs of which three are in collaboration with pharmaceutical partners. The following are our most advanced product candidates in development:

SABER-Bupivacaine

Our post-operative pain relief depot product candidate (SABER-Bupivacaine) is a sustained release injectable using our SABER™ delivery system to deliver bupivacaine. SABER is a patented controlled drug delivery technology that can be formulated for systemic or local administration of drugs via the parenteral (i.e., injectable) or oral route. This product candidate is designed to be administered around a surgical site after surgery for post-operative pain relief and is intended to provide local analgesia for 3 days or more, which we believe coincides with the time period of the greatest need for post surgical pain control in most patients. Bupivacaine, the active agent for the product candidate, is currently FDA-approved for use as a local anesthetic.

* NOTE: CHRONOGESIC[®], ALZET[®], SABER[™], TRANSDUR[™], LACTEL[®], DURIN[™] and MICRODUR[™] are trademarks of DURECT Corporation. Other trademarks referred to belong to their respective owners.

Table of Contents

We initiated the Phase II program for this product candidate in October 2004 for the treatment of pain in patients following repair of inguinal hernia. We are currently conducting a Phase II dose escalation trial in Australia designed for dose optimization of the product candidate. The trial includes three cohorts and will evaluate the following factors: safety, pharmacokinetics, time to first supplemental analgesic, total supplemental analgesic usage, pain intensity and pain relief.

We completed dosing of first cohort of the Phase II clinical trial in February 2005 and completed dosing of the second cohort of the trial in May 2005. Six patients were enrolled in cohort 1, and fifteen patients were enrolled in cohort 2. In June 2005, we announced positive preliminary results from the second cohort of the Phase II study and the initiation of dosing of the third cohort of the study. We anticipate that approximately 60 patients will be enrolled in cohort 3 of the study.

TRANSDUR-Sufentanil

Our transdermal sufentanil product candidate (TRANSDUR-Sufentanil) uses our proprietary TRANSDUR delivery system to deliver sufentanil, an opioid medication, to provide extended chronic pain relief for up to seven days, as compared to the three days of relief provided with currently available opiate patches. We anticipate that the small size of our sufentanil patch (potentially as small as 1/5th the size of currently marketed transdermal fentanyl patches for a therapeutically equivalent dose) may offer improved convenience and compliance for patients. We commenced the Phase II program for this product candidate in February 2005. In March 2005, we entered into an agreement with Endo Pharmaceuticals Inc. (Endo) granting Endo exclusive rights to develop, market and commercialize TRANSDUR-Sufentanil in the U.S. and Canada. In the second quarter of 2005, we continued to work with Endo to perform preclinical and clinical activities with respect to this product candidate.

ORADUR- Oxycodone (Remoxy™)

In December 2002, we entered into an agreement with Pain Therapeutics, Inc. (Pain Therapeutics) under which we granted Pain Therapeutics the exclusive, worldwide right to develop and commercialize selected long-acting oral opioid products using our ORADUR technology. ORADUR is our SABER-based oral gel cap technology. Products based on the ORADUR technology can take the form of an easy to swallow gelatin capsule that provides controlled release of active ingredients for a period of from 12 to 24 hours of drug delivery. Oral dosage forms based on the ORADUR technology may also have the added benefit of being less prone to abuse than other sustained release dosage forms on the market today. The first product candidate being developed under the collaboration is Remoxy, a novel long-acting oral formulation of the opioid oxycodone targeted to decrease the potential for oxycodone abuse. Pain Therapeutics began Phase III clinical studies for Remoxy in December 2004. In June 2005, Pain Therapeutics announced that it had completed the enrollment and initiation of dosing in its Phase III study with Remoxy.

DURIN-Leuprolide

In July 2002, we entered into a development and commercialization agreement with Voyager Pharmaceutical Corporation (Voyager) under which we granted Voyager the exclusive, worldwide right to develop and commercialize a product candidate using the DURIN implant system to deliver the peptide leuprolide to treat Alzheimer's disease based on Voyager's patented method of treatment. DURIN is our proprietary biodegradable polymeric implant drug delivery technology which can deliver a wide variety of drugs from several weeks to six months or more. Voyager completed enrollment of a Phase I pharmacokinetic trial in volunteers for this product candidate in January 2005.

CHRONOGESIC® (sufentanil) Pain Therapy System

The CHRONOGESIC (sufentanil) Pain Therapy System is an osmotic implant that is intended to continuously deliver sufentanil for an extended duration. This product candidate is intended to treat chronic pain, and is based on the DUROS System, a miniature osmotic pump capable of continuously delivering drugs for up to a year in duration. We have granted to Endo exclusive commercialization rights for the CHRONOGESIC product candidate in the U.S. and Canada. To date, we have completed a Phase I clinical trial, a Phase II clinical trial, a pharmacokinetic trial and a pilot Phase III clinical trial for the CHRONOGESIC product candidate. We are presently working to

redesign the delivery system to address a premature shutdown of the system prior to end of the intended drug delivery period that we have observed in a small fraction of units. We have stopped all clinical testing of the product candidate and will not resume clinical testing until the system design is completed.

We are also currently researching and developing additional pharmaceutical systems in a variety of therapeutic areas, including chronic pain, central nervous system disorders and cardiovascular disease based on our proprietary drug delivery platform technologies.

For the three months ended June 30, 2005, revenues from our collaborative agreements with Pain Therapeutics (Remoxy), Endo (TRANSDUR-Sufentanil) and Voyager (DURIN-Leuprolide) represented 13%, 36% and 27% of our total revenues. For the six months ended June 30, 2005, revenues from our collaborative agreements with Pain Therapeutics, Endo

Table of Contents

and Voyager represented 16%, 30% and 24% of our total revenues. At June 30, 2005, three customers accounted for 38%, 24% and 13% of our gross accounts receivable. At December 31, 2004, two customers accounted for 40% and 26% of our gross accounts receivable.

Product Revenues

We currently generate product revenue from the sale of two product lines:

- ALZET osmotic pumps for animal research use; and
- LACTEL biodegradable polymers which are used by our customers as raw materials in their pharmaceutical and medical products. This product line was sold through our wholly-owned subsidiary API until it was merged with and into us as of December 31, 2004.

Because we consider our core business to be developing and commercializing pharmaceutical systems, we do not intend to significantly increase our investments in or efforts to sell or market any of our existing product lines. However, we expect that we will continue to make efforts to increase our revenue related to collaborative research and development by entering into additional research and development agreements with third-party partners to develop product candidates based on our drug delivery technologies.

Since our inception in 1998, we have had a history of operating losses. At June 30, 2005, we had an accumulated deficit of \$173.0 million. Our net loss for the six months ended June 30, 2005 was \$9.1 million. Our losses were \$27.6 million, \$22.7 million and \$37.2 million for the twelve months ended December 31, 2004, 2003 and 2002, respectively. These losses have resulted primarily from costs incurred to research and develop our product candidates and to a lesser extent, from selling, general and administrative costs associated with our operations and product sales. We expect our research and development expenses to increase modestly in the near future as we expect to continue to expand our animal studies, clinical trials and other research and development activities. We expect selling, general and administrative expenses to remain at comparable level in the near future as we strive to conserve cash and leverage our existing infrastructure to support our current business activities and to comply with corporate governance requirements. We also expect to incur additional non-cash expenses relating to amortization of intangible assets and stock-based compensation. We do not anticipate revenues from our pharmaceutical systems, should they be approved, for at least several years. Therefore, we expect to incur continuing losses and negative cash flow from operations for the foreseeable future.

Critical Accounting Policies and Estimates

General

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The most significant estimates and assumptions relate to revenue recognition, the recoverability of our long-lived assets, including goodwill and other intangible assets, accrued liabilities and contract research liabilities. Actual amounts could differ significantly from these estimates.

Table of Contents

Revenue Recognition

Revenue from the sale of products is recognized at the time the product is shipped and title transfers to customers, provided no continuing obligation exists and the collectibility of the amounts owed is reasonably assured. Incorrect assumptions at the time of sale about our customers' ability to pay could result in an overstatement of revenue.

Upfront payment received upon execution of collaborative agreements are recorded as deferred revenue and recognized as collaborative research and development revenue on a systematic basis (based on a straight-line basis or upon the timing and level of work performed) over the period that the related research and development services are performed as defined in the respective agreements. Research and development revenue related to services performed under the collaborative arrangements with the Company's corporate partners is recognized as the related research and development services are performed. These research payments received under each respective agreement are not refundable and are generally based on reimbursement of qualified expenses, as defined in the agreements. Research and development expenses under the collaborative research and development agreements generally approximate or exceed the revenue recognized under such agreements over the term of the respective agreements. Milestone and royalties payments, if any, will be recognized as earned in accordance with the terms of the respective agreements. Deferred revenue may result when we do not expend the required level of effort during a specific period in comparison to funds received under the respective agreement.

Revenue on cost-plus-fee contracts, such as other contract research and development revenue, is recognized only to the extent of reimbursable costs incurred plus estimated fees thereon. In all cases, revenue is recognized only after a signed agreement is in place. For contracts that have a ceiling price or contract value, losses on contracts are recognized in the period in which the losses become known and estimable. Incorrect estimates as to percentage of completion or losses expected to be incurred could result in greater or lesser revenues or losses being recorded.

Intangible Assets and Goodwill

We record intangible assets when we acquire other companies. The cost of an acquisition is allocated to the assets acquired and liabilities assumed, including intangible assets, with the remaining amount being classified as goodwill. Certain intangible assets such as completed or core technology are amortized over time, while acquired in-process research and development is recorded as a one-time charge on the acquisition date. Acquired in-process research and development represents the value of research projects in process at the time of acquisition which have not yet reached technological feasibility, and which have no alternative future use. The determination of the amount of acquired in-process research and development involves several estimates and judgments, including the percentage of completion of the in-process technology and assumptions about future cash flows to be derived from the technology and discount rates. Different assumptions employed in determining the value of in-process research and development could result in a greater or lesser amount being recorded.

Table of Contents

As of January 1, 2002, goodwill is not amortized to expense but rather periodically assessed for impairment. The allocation of the cost of an acquisition to intangible assets and goodwill therefore has a significant impact on our future operating results. The allocation process requires the extensive use of estimates and assumptions, including estimates of future cash flows expected to be generated by the acquired assets. We are also required to estimate the useful lives of those intangible assets subject to amortization, which determines the amount of amortization that will be recorded in a given future period and how quickly the total balance will be amortized. We periodically review the estimated remaining useful lives of our intangible assets. A reduction in our estimate of remaining useful lives, if any, could result in increased amortization expense in future periods.

We assess the impairment of identifiable intangible assets, long-lived assets and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
- significant negative industry or economic trends;
- significant decline in our stock price for a sustained period; and
- our market capitalization relative to net book value.

When we determine that the carrying value of intangibles, long-lived assets and goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. The amount of any impairment charge is significantly impacted by and highly dependent upon assumptions as to future cash flows and the appropriate discount rate. Management believes that the discount rate used in this analysis is reasonable in light of currently available information. The use of different assumptions or discount rates could result in a materially different impairment charge.

In 2002, Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS 142) became effective. As a result, we ceased amortizing approximately \$4.7 million of goodwill and assembled workforce. In lieu of amortization, we perform a review for impairment at least annually. No impairment of goodwill has been recorded through June 30, 2005. However, there can be no assurance that at the time other periodic reviews are completed, a material impairment charge will not be recorded.

Accrued Liabilities and Contract Research Liabilities

We incur significant costs associated with third-party consultants and organizations for clinical trials, animal toxicological studies, engineering, validation, testing and other research and development-related services. We are required to estimate periodically the cost of services rendered but unbilled based on management's estimates of project status. If these good faith estimates are inaccurate, actual expenses incurred could materially differ from our estimates.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by accounting principles generally accepted in the United States, with no need for management's judgment in their application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result. See our audited consolidated financial statements and notes thereto in Item 8 of our Form 10-K which contain accounting policies and other disclosures required by generally accepted accounting principles.

Results of Operations

Three and six months ended June 30, 2005 and 2004

Revenues Net revenues were \$8.8 million and \$14.2 million in the three and six months ended June 30, 2005

revenues. Net revenues were \$8.8 million and \$14.2 million in the three and six months ended June 30, 2005, respectively, compared to \$3.1 million and \$6.5 million for the corresponding periods in 2004. The increases in total revenues were primarily attributable to higher collaborative research and development revenue recognized from our agreements with strategic partners.

Table of Contents

Product revenue

A portion of our revenues is derived from our product sales, which include our ALZET mini pump product line, and to a lesser extent our biodegradable polymer products. Net product revenues were \$1.9 million and \$3.6 million in the three and six months ended June 30, 2005, respectively, compared to \$1.8 million and \$3.1 million for the corresponding periods in 2004. The increases were primarily due to higher product revenue from our ALZET mini pump product line resulted from a greater number of units sold in the three and six months ended June 30, 2005. Polymer sales remained comparable in both periods.

Collaborative research and development and other revenue

We also recognize revenues from collaborative research and development activities and service contracts. We recorded \$6.9 million and \$10.5 million of collaborative research and development revenue for the three and six months ended June 30, 2005, respectively, compared to \$1.2 million and \$3.0 million for the corresponding periods in 2004. Collaborative research and development revenue represents reimbursement of qualified expenses related to the collaborative agreements with various third parties to research, develop and commercialize potential products using our drug delivery technologies. The increase in collaborative research and development revenue in the three and six months ended June 30, 2005 was primarily attributable to our significantly increased development activities for TRANSDUR-Sufentanil (collaboration with Endo), DURIN-Leuprolide (collaboration with Voyager) and Remoxy (collaboration with Pain Therapeutics) compared with the same periods in 2004.

In March 2005, we signed a license agreement with Endo in which we granted to Endo the exclusive right to develop and commercialize our TRANSDUR-Sufentanil product candidate in the U.S. and Canada. Under the terms of the agreement, Endo will assume all remaining development and regulatory filing responsibility in the U.S. and Canada, including the funding thereof. We will perform all formulation development for Endo unless we default on such obligations, and we will be reimbursed for our fully allocated cost for performing such work. Endo will also be responsible and pay for the manufacture, marketing, sales and distribution of TRANSDUR-Sufentanil in the U.S. and Canada. We expect our collaborative research and development revenue to increase in the future years as we continue to increase our effort to develop partnered products with various strategic partners.

Other revenue from service contracts was \$21,000 and \$63,000 for the three and six months ended June 30, 2005 and \$94,000 and \$294,000 for the same periods in 2004. The service contract revenues were related to certain polymer related service contracts we signed with various customers through API, our former subsidiary. The decrease was primarily due to completion of certain service contracts in the three and six months ended June 30, 2005. We do not expect to increase our effort to generate significant revenue from our service contracts related to polymer business in the future.

In the future, we do not intend to significantly increase our investments in or efforts to sell or market any of our existing product lines. However, we will continue to make efforts to increase our revenue related to collaborative research and development by entering into additional research and development agreements with third parties to develop products based on our drug delivery technologies.

Cost of revenues. Cost of revenues were \$689,000 and \$1.4 million for the three and six months ended June 30, 2005, respectively, from \$867,000 and \$1.4 million for the corresponding periods in 2004. Cost of revenues includes cost of product revenue from our ALZET mini pump product line and our biodegradable polymer products and, to a lesser extent, cost of certain polymer related service contracts through API, our former subsidiary. The decrease in the cost of revenues were primarily due to higher manufacturing efficiencies achieved from our existing commercial product lines in the three months ended June 30, 2005. Cost of revenues remained comparable for the six months ended June 30, 2005 and 2004.

Cost of revenues associated with product revenue were \$677,000 and \$1.3 million for the three and six months ended June 30, 2005, respectively, compared with \$797,000 and \$1.2 million for the corresponding periods in 2004. The decrease in the cost of revenues were primarily due to higher manufacturing efficiencies achieved from our existing commercial product lines in the three months ended June 30, 2005. The increase in cost of product revenue for the six months ended June 30, 2005 was primarily the result of higher product revenue of our ALZET mini pump

product line compared with the same period in 2004.

Cost of service revenues were \$12,000 and \$55,000 for the three and six months ended June 30, 2005, respectively, compared with \$69,000 and \$258,000 for the same periods of 2004 due to a decline in our service contract revenue related to our polymer business. As of June 30, 2005 and 2004, we had 20 manufacturing employees. We expect cost of revenues to remain comparable in the future, as we do not expect product revenues to increase significantly in the future.

Research and Development. Research and development expenses were \$7.6 million and \$14.2 million for the three and six months ended June 30, 2005, respectively, compared with \$6.0 million and \$11.4 million for the corresponding periods in 2004. The increases in the three and six months ended June 30, 2005 was primarily attributable to the higher employee costs and higher development expenses for SABER-Bupivacaine, TRANSDUR-Sufentanil, Remoxy and DURIN-Leuprolide, partially offset by lower development expenses for CHRONOGESIC, compared with the same periods in 2004.

Table of Contents

In the three and six months ended June 30, 2005, we continued with Phase II clinical trials and animal toxicological studies for SABER-Bupivacaine. In addition, we incurred higher expenses for formulation development, clinical and non-clinical studies for TRANSDUR-Sufentanil in the three and six months ended June 30, 2005 compared with the same periods in 2004 as we commenced a Phase II clinical program and conducted animal studies for this product candidate in the first six months of 2005. We also incurred higher research and development expenses for Remoxy and DURIN-Leuprolide in the three and six months ended June 30, 2005 compared with the same periods in 2004. As of June 30, 2005, we had 82 research and development employees compared with 63 as of the corresponding date in 2004. We expect research and development expenses to increase in the near future as we continue product development efforts for our internal and partnered product candidates.

Selling, General and Administrative. Selling, general and administrative expenses were \$2.8 million and \$5.3 million for the three and six months ended June 30, 2005, respectively, compared with \$2.3 million and \$4.6 million for the corresponding periods in 2004. The increase was primarily due to higher employee related costs, severance expenses and external costs to comply with the Sarbanes-Oxley Act. As of June 30, 2005, we had 30 selling, general and administrative personnel compared with 33 as of the corresponding date in 2004. We expect selling, general and administrative expenses to remain at comparable level in the near future as we strive to conserve cash and leverage our existing infrastructure to support our current business activities and to comply with corporate governance requirements.

Amortization of intangible assets. Amortization of intangible assets was \$303,000 and \$606,000 for the three and six months ended June 30, 2005, respectively, compared with \$308,000 and \$643,000 for the corresponding periods in 2004, respectively. The amortization of intangible assets decreased slightly in the three and six months ended June 30, 2005 as certain intangible assets were fully amortized in the quarter ended June 30, 2004. We continue to amortize the existing intangible assets at a constant rate over their estimated useful lives. In 2004, goodwill was evaluated for impairment in accordance with SFAS 142. Based on our evaluation, no indicators of impairment were noted. Should goodwill become impaired in the future, we may be required to record an impairment charge to write the goodwill down to its estimated fair value.

The net amount of other intangible assets at June 30, 2005 was \$1.1 million, which will be amortized as follows: \$602,000 for the six months ending December 31, 2005, \$424,000 for the year ending December 31, 2006, \$31,000 in each of the years ending December 31, 2007, 2008 and 2009, and \$19,000 for the year ending December 31, 2010. We periodically evaluate acquired intangible assets for impairment or obsolescence. Should the intangible assets become impaired or obsolete, we will write them down to their estimated fair value.

Stock-Based Compensation. For the three and six months ended June 30, 2005, we recorded \$343,000 and \$393,000 of stock-based compensation including expenses related to modifications of certain employee stock options, compared with \$135,000 and \$170,000 recorded for the corresponding periods in 2004. Of these amounts, employee stock-based compensation related to the following: cost of revenues of none for both the three and six months ended June 30, 2005, and (\$2,000) and \$1,000 for the corresponding periods in 2004; research and development expenses of none and \$1,000 for the three and six months ended June 30, 2005, compared with \$2,000 and (\$26,000) for the corresponding periods in 2004; and selling, general and administrative expenses of \$336,000 and \$338,000 in the three and six months ended June 30, 2005, compared with \$5,000 and \$10,000 for the corresponding periods in 2004.

Non-employee stock compensation related to research and development expenses were none and \$45,000 for the three and six months ended June 30, 2005, compared with \$124,000 and \$179,000 for the corresponding periods in 2004. Non-employee stock compensation related to selling, general and administrative expenses was \$7,000 and \$9,000 for the three and six months ended June 30, 2005, compared with \$6,000 and \$6,000 in the corresponding periods in 2004. Expenses for non-employee stock options are recorded over the vesting period of the options, with the amount determined by the Black-Scholes option valuation method and remeasured over the vesting term.

Other Income (Expense). Interest and other income was \$407,000 and \$892,000 for the three and six months ended June 30, 2005, respectively, from \$289,000 and \$593,000 for the corresponding periods in 2004. The increase

in interest and other income was primarily the result of higher yields on our cash and investment balances during the three and six months ended June 30, 2005. The increase during the six months ended June 30, 2005 was also due to the receipt of approximately \$150,000 settlement from our former collaboration partner in the first quarter of 2005. Interest expense was \$1.1 million and \$2.2 million for both the three and six months ended June 30, 2005 and 2004. The interest expenses were primarily due to the interest accrued on the \$60.0 million convertible notes we issued in June and July of 2003.

[Table of Contents](#)

Liquidity and Capital Resources

Since our inception in 1998, we have funded our operations primarily through convertible preferred stock financings of \$53.2 million, our initial public offering of \$84.0 million and the issuance of \$60.0 million principal amount of convertible notes. We had cash, cash equivalents and investments totaling \$60.5 million at June 30, 2005 compared to \$61.8 million at December 31, 2004. These numbers include \$2.4 million and \$2.8 million of interest-bearing marketable securities classified as restricted investments on our balance sheets as of June 30, 2005 and December 31, 2004, respectively. The decrease in cash, cash equivalents and investments during the six months ended June 30, 2005 was primarily the result of ongoing operating expenses, partially offset by payments received from collaborative partners and customers.

Working capital was \$51.4 million and \$42.1 million at June 30, 2005 and December 31, 2004, respectively. The increase was primarily attributable to the \$10.0 million of upfront payment received from Endo in connection with the license agreement signed in March 2005, offset by our operating expenditures in the six months ended June 30, 2005.

We used \$444,000 of cash for operations for the six months ended June 30, 2005 compared to \$11.0 million for the corresponding period in 2004. The cash used for operations was primarily to fund operations as well as our working capital requirements. The decrease in cash used for operations was primarily attributable to the \$10.0 million of upfront payment received from Endo for the six months ended June 30, 2005.

We received \$10.3 million of cash from investing activities for the six months ended June 30, 2005 compared to \$3.0 million of cash used for the corresponding period in 2004. The increase in cash provided by investing activities was primarily due to a net increase in proceeds from maturities of available for sale securities, net of investment purchases, partially offset by an increase in purchases of plant and equipment during the six months ended June 30, 2005.

We received \$370,000 of cash from financing activities for the six months ended June 30, 2005 compared to \$451,000 for the corresponding period in 2004. The slight decrease in cash received from financing activities was primarily due to lower proceeds from exercises of stock options and notes receivable from stockholders during the six months ended June 30, 2005.

In June and July 2003, we completed a private placement of an aggregate of \$60.0 million in convertible subordinated notes. The notes bear interest at a fixed rate of 6.25% per annum and are due on June 15, 2008. The notes are convertible at the option of the note holders into our common stock at a conversion rate of 317.4603 shares per \$1,000 principal amount of notes, subject to adjustment in certain circumstances. Interest on the notes is payable semi-annually in arrears in June and December. We received net proceeds of approximately \$56.7 million after deducting underwriting fees of \$3.0 million and related expenses of \$300,000. The convertible subordinated notes are unsecured obligation of ours and are subordinate to any secured debt we currently have or any future senior debt we may have. The proceeds from the convertible notes will be used to fund the research, development, manufacture and commercialization of existing and future products and for general corporate purpose, including working capital and capital expenditures.

On July 21, 2005, we entered into a privately negotiated agreement with a holder of our 6.25% Convertible Subordinated Notes, due June 2008, to exchange up to \$5.0 million in principal amount of convertible notes for 317.4603 shares of common stock per \$1,000 principal amount as originally defined in the indenture, plus additional shares to compensate the note holder for early exchange. As of August 3, 2005, we exchanged approximately \$1.0 million in principal amount of our 6.25% convertible notes for approximately 365,000 shares of our common stock pursuant to this agreement. We may enter into similar transactions from time to time with holders of its convertible notes if we are able to do so on acceptable terms and depending on capital market conditions.

In conjunction with the acquisition of Southern BioSystems, Inc. (SBS) in April 2001, we assumed Alabama State Industrial Development Bonds (SBS Bonds) with remaining principal payments of \$1.7 million and a current interest rate of 6.35% increasing each year up to 7.20% at maturity on November 1, 2009. As part of the acquisition agreement, we were required to guarantee and collateralize these bonds with a letter of credit of approximately

\$2.4 million that we secured with investments deposited with a financial institution in July 2001. Interest payments are due semi-annually and principal payments are due annually. Principal payments increase in annual increments from \$150,000 to \$240,000 over the term of the bonds until the principal is fully amortized in 2009. We have the option to call the SBS Bonds at any time. On December 31, 2002, SBS was merged into DURECT, and the SBS bonds were assigned to DURECT with the terms unchanged. At June 30, 2005, the remaining principal payments of the bonds were \$1.1 million.

Table of Contents

We anticipate that cash used in operating and investing activities will stay at current level or slightly decrease in the near future as we continue to research, develop and manufacture our products through internal efforts and partnering activities, and service our debt obligations. In aggregate, we are required to make future payments pursuant to our existing contractual obligations at June 30, 2005 as follows (in thousands):

Contractual Obligations	2005	2006	2007	2008	2009	Total
Convertible subordinated notes (1)	\$1,875	\$3,750	\$3,750	\$61,875	\$ —	\$71,250
Long-term debt (1)	228	263	258	258	258	1,265
Term loan (1)	144	24	—	—	—	168
APT acquisition consideration payable (2)	250	500	—	—	—	750
Capital lease	6	11	11	10	6	44
Operating lease obligations	1,400	1,950	1,353	1,331	270	6,304
Total contractual cash obligations	\$3,903	\$6,498	\$5,372	\$63,474	\$534	\$79,781

Note (1): Includes principal and interest payments

Note (2): To be paid by our common stock or cash at our election

We also anticipate incurring capital expenditures of at least \$2 million over the next 12 months to purchase research and development and other capital equipment. The amount and timing of these capital expenditures will depend on, among other things, the timing of clinical trials for our products and our collaborative research and development activities.

We believe that our existing cash, cash equivalents and investments will be sufficient to finance our planned operations and capital expenditures through at least the next 12 months. We may consume available resources more rapidly than currently anticipated, resulting in the need for additional funding. Additionally, we do not expect to generate revenues from our pharmaceutical systems currently under development for at least the next several years. Accordingly, we may be required to raise additional capital through a variety of sources, including:

- the public equity market;
- private equity financing;
- collaborative arrangements; and
- public or private debt.

There can be no assurance that additional capital will be available on favorable terms, if at all. If adequate funds are not available, we may be required to significantly reduce or refocus our operations or to obtain funds through arrangements that may require us to relinquish rights to certain of our products, technologies or potential markets, any of which could have a material adverse effect on our business, financial condition and results of operations. To the extent that additional capital is raised through the sale of equity or convertible debt securities, the issuance of such securities would result in ownership dilution to our existing stockholders.

Our cash and investments policy emphasizes liquidity and preservation of principal over other portfolio considerations. We select investments that maximize interest income to the extent possible given these two constraints. We satisfy liquidity requirements by investing excess cash in securities with different maturities to match projected cash needs and limit concentration of credit risk by diversifying our investments among a variety of high credit-quality issuers.

Recent Accounting Pronouncements

In December 2004, the FASB issued Statement No. 123 (revised 2004, or SFAS 123R), "Share-Based Payment," which was originally effective for annual or interim periods beginning after June 15, 2005. SFAS 123R supersedes APB

Opinion No. 25, "Accounting for Stock Issued to Employees," and will require companies to recognize compensation expense, using a fair-value based method, for costs related to share-based payments including stock options and stock issued under our employee stock purchase plans. In April 2005, the SEC issued a press release that revised the required date of adoption under SFAS 123R. We will be required to adopt SFAS 123R no later than the fiscal year that begins after June 15, 2005. Our adoption will be applied on a modified prospective basis and measured compensation expense will be recognized commencing on January 1, 2006. We expect that our adoption of SFAS 123R will have a material adverse impact on our consolidated results of operations.

Table of Contents

In March 2005, the SEC issued SAB No. 107 regarding the interaction between SFAS 123R which was revised in December 2004, and certain SEC rules and regulations and provides the SEC's staff views regarding the valuation of share-based payment arrangements for public companies. We are evaluating the impact this guidance will have on our consolidated results of operations and financial position.

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3". SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle, and applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. This statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. We do not expect that adoption of this statement will have a material impact on our consolidated results of operations.

Table of Contents

Factors that May Affect Future Results

In addition to the other information in this Form 10-Q, a number of factors may affect our business and prospects. These factors include but are not limited to the following, which you should consider carefully in evaluating our business and prospects.

We have not completed development of any of our pharmaceutical systems, and we cannot be certain that our pharmaceutical systems will be able to be commercialized

To be profitable, we or our collaborative partners must successfully research, develop, obtain regulatory approval for, manufacture, introduce, market and distribute our pharmaceutical systems under development. For each pharmaceutical system that we or our third-party collaborators intend to commercialize, we must successfully meet a number of critical developmental milestones for each disease or medical condition targeted, including:

- selecting and developing drug delivery platform technology to deliver the proper dose of drug over the desired period of time;
- determining the appropriate drug dosage for use in the pharmaceutical system;
- developing drug compound formulations that will be tolerated, safe and effective and that will be compatible with the system;
- demonstrating the drug formulation will be stable for commercially reasonable time periods;
- selecting and developing catheter or other targeting technology, if appropriate, to deliver the drug to a specific location within the body; and
- demonstrating through clinical trials that the drug and system combination is safe and effective in patients for the intended indication.

The time frame necessary to achieve these developmental milestones for any individual product candidate is long and uncertain, and we may not successfully complete these milestones for any of our product candidates in development. We have not yet selected the drug dosages nor finalized the formulation or the system design of any pharmaceutical systems, including our SABER Bupivacaine and TRANSDUR-Sufentanil product candidates, Remoxy, our DURIN-Leuprolide product candidate and our CHRONOGESIC product candidate, and we have limited experience in developing such products. We may not be able to finalize the design or formulation of any of our product candidates. In addition, we may select components, solvents, excipients or other ingredients to include in our pharmaceutical systems that have not been previously approved for use in pharmaceutical products, which may require us to perform additional studies and may delay clinical testing and regulatory approval of our pharmaceutical systems. Even after we complete the design of the product candidate, the product candidate must still complete required clinical trials and additional safety testing in animals before approval for commercialization. See "We must conduct and satisfactorily complete required laboratory performance and safety testing, animal studies and clinical trials for our pharmaceutical systems before we can sell them." We are continuing testing and development of our product candidates and may explore possible design or formulation changes to address issues of safety, manufacturing efficiency and performance. We may not be able to complete development of any product candidates that will be safe and effective and that will have a commercially reasonable treatment and storage period. If we are unable to complete development of our SABER-based post-operative pain depot product candidate, our TRANSDUR-Sufentanil patch, Remoxy, our DURIN-based Alzheimer's disease product candidate, CHRONOGESIC or other product candidates, we will not be able to earn revenue from them, which would materially harm our business.

We or our collaborative partners must conduct and satisfactorily complete required laboratory performance and safety testing, animal studies and clinical trials for our pharmaceutical systems before they can be sold

Before we or our collaborative partners can obtain government approval to sell any of our pharmaceutical systems, we or they, as applicable, must demonstrate through laboratory performance studies and safety testing, preclinical (animal) studies and clinical (human) trials that each system is safe and effective for human use for each

targeted disease. The clinical development status of our most advanced programs is as follows:

- SABER-Bupivacaine—Phase I trial completed and Phase II trial initiated. Dosing of first and second cohorts of Phase II trial completed as of May 2005. Dosing of the third cohort of Phase II trial initiated as of June 2005.
- TRANSDUR-Sufentanil Patch—Dosing of Phase I trial completed and first trial of Phase II program initiated as of February 2005.
- ORADUR-Oxycodone (Remoxy)—Phase I trial completed and Phase III program initiated by Pain Therapeutics. In June 2005, Pain Therapeutics announced that it has completed the enrollment and initiation of dosing in its Phase III study with Remoxy.

Table of Contents

- DURIN-Leuprolide for Alzheimer's disease—Phase I trial initiated by Voyager. Enrollment completed in Phase I trial as of January 2005.
- CHRONOGESIC—Phase I, Phase II and Pilot Phase III completed. Redesigning the system to address premature shutdown problem and will resume clinical trials when system design is completed.

We are currently in the preclinical or research stages with respect to all our other product candidates under development. We plan to continue extensive and costly tests, clinical trials and safety studies in animals to assess the safety and effectiveness of our product candidates. These studies include laboratory performance studies and safety testing, clinical trials and animal toxicological studies necessary to support regulatory approval of product candidates in the United States and other countries of the world. These studies are costly, complex and last for long durations, and may not yield the data required for regulatory approval. We may not be permitted to begin or continue our planned clinical trials for our potential product candidates. If our trials are permitted, our potential product candidates may not prove to be safe or produce their intended effects. In addition, we may be required by regulatory agencies to conduct additional animal or human studies regarding the safety and efficacy of our product candidates which we have not planned or anticipated that could delay commercialization of such product candidates and harm our business and financial conditions.

The length of our clinical trials will depend upon, among other factors, the rate of trial site and patient enrollment and the number of patients required to be enrolled in such studies. We or our third-party collaborators may fail to obtain adequate levels of patient enrollment in our clinical trials. Delays in planned patient enrollment may result in increased costs, delays or termination of clinical trials, which could have a material adverse effect on us. In addition, even if we or our third-party collaborators enroll the number of patients we expect in the time frame we expect, such clinical trials may not provide the data necessary to support regulatory approval for the product candidates for which they were conducted. Additionally, we or our third-party collaborators may fail to effectively oversee and monitor these clinical trials, which would result in increased costs or delays of our clinical trials. Even if these clinical trials are completed, we or our third-party collaborators may fail to complete and submit a new drug application as scheduled. The Food and Drug Administration may not clear any such application in a timely manner or may deny the application entirely.

Data already obtained from preclinical studies and clinical trials of our pharmaceutical systems do not necessarily predict the results that will be obtained from later preclinical studies and clinical trials. Moreover, preclinical and clinical data such as ours is susceptible to varying interpretations, which could delay, limit or prevent regulatory approval. A number of companies in the pharmaceutical industry have suffered significant setbacks in advanced clinical trials, even after promising results in earlier trials. The failure to adequately demonstrate the safety and effectiveness of a product candidate under development could delay or prevent regulatory clearance of the potential product candidate, resulting in delays to the commercialization of our product candidates, and could materially harm our business. Clinical trials may not demonstrate the sufficient levels of safety and efficacy necessary to obtain the requisite regulatory approvals for our product candidates, and thus our product candidates may not be approved for marketing.

We and our third-party collaborators may not be able to manufacture sufficient quantities of our products and components to support the clinical and commercial requirements of our collaborators and ourselves at an acceptable cost, and we have limited manufacturing experience

We or our third-party collaborators to whom we have assigned such responsibility must manufacture our product candidates and components in clinical and commercial quantities, either directly or through third parties, in compliance with regulatory requirements and at an acceptable cost. The manufacture processes associated with our pharmaceutical systems are complex. We and our third-party collaborators, where relevant, have not yet completed development of the manufacturing process for any product candidates or components including our SABER Bupivacaine and TRANSDUR-Sufentanil patch product candidate, Remoxy, our DURIN-based Alzheimer's disease product candidate and our CHRONOGESIC product candidate. If we and our third-party collaborators, where relevant, fail to timely complete the development of the manufacturing process for our product candidates, we and our third-party collaborators, where relevant, will not be able to timely produce product for clinical trials

and commercialization of our product candidates. In the future, we will continue to consider ways to optimize our manufacturing process and to explore possible changes to improve product performance and quality, increase efficiencies and lower costs. We have also committed to manufacture and supply product or components under a number of our collaborative agreements with third-party companies. We have limited experience manufacturing pharmaceutical products, and we may not be able to timely accomplish these tasks. If we and our third-party collaborators, where relevant, fail to develop manufacturing processes to permit us to manufacture a product candidate or component at an acceptable cost, then we and our third-party partners may not be able to commercialize that product candidate or we may be in breach of our supply obligations to our third-party partners.

Our manufacturing facility in Cupertino is a functional multi-discipline site that we have used to manufacture research and clinical supplies of several of our pharmaceutical system product candidates under good manufacturing practices (GMP), including SABER-Bupivacaine, TRANSDUR-Sufentanil, Remoxy and CHRONOGESIC. We have recently made significant site improvements and equipment installations to upgrade and expand our manufacturing capabilities. In the future, we intend to develop additional manufacturing capabilities for our pharmaceutical systems and components to meet our demands and

Table of Contents

those of our third-party collaborators by contracting with third-party manufacturers and by construction of additional manufacturing space at our current facilities in Cupertino, CA and Pelham, AL. We have limited experience building and validating manufacturing facilities, and we may not be able to timely accomplish these tasks.

In order to manufacture clinical and commercial supplies of our pharmaceutical systems or components for our third-party collaborators or ourselves, we must attain and maintain compliance with applicable federal, state and foreign regulatory standards relating to manufacture of pharmaceutical products which are rigorous, complex and subject to varying interpretations. Furthermore, our facilities will be subject to government audits to determine compliance with good manufacturing practices regulations, and we may be unable to pass inspection with the applicable regulatory agencies or may be asked to undertake corrective measures which may be costly and cause delay.

If we and our third-party collaborators, where relevant, are unable to manufacture product or components in a timely manner or at an acceptable cost, quality or performance level, and attain and maintain compliance with applicable regulations, the clinical trials and the commercial sale of our pharmaceutical systems and those of our third-party partners could be delayed. Additionally, we may need to alter our facility design or manufacturing processes, install additional equipment or do additional construction or testing in order to meet regulatory requirements, optimize the production process, increase efficiencies or production capacity or for other reasons, which may result in additional cost to us or delay production of product needed for the clinical trials and commercial launch of our product candidates and those of our third-party collaborators. We and our third-party collaborators, where relevant, may also need or choose to subcontract with third-party contractors to perform manufacturing steps of our pharmaceutical systems or supply required components for our pharmaceutical systems in which case we will be subject to the schedule, expertise and performance of third parties as well as incur significant additional costs. See “We rely heavily on third parties to support development, clinical testing and manufacturing of our product candidates” and “Key Components of our pharmaceutical systems are provided by limited numbers of suppliers, and supply shortages or loss of these suppliers could result in interruptions in supply or increased costs.” Under our development and commercialization agreement with ALZA, we cannot subcontract the manufacture of subassemblies of the DUROS system components of our DUROS-based pharmaceutical system product candidates to third parties which have not been approved by ALZA. If we cannot manufacture product or components in time to meet the clinical or commercial requirements of our partners or ourselves or at an acceptable cost, our operating results will be harmed.

Failure to obtain product approvals or comply with ongoing governmental regulations could delay or limit introduction of our product candidates and result in failure to achieve anticipated revenues

The manufacture and marketing of our product candidates and our research and development activities are subject to extensive regulation for safety, efficacy and quality by numerous government authorities in the United States and abroad. We or our third-party collaborators must obtain clearance or approval from applicable regulatory authorities before we or they, as applicable, can market or sell our product candidates in the United States or abroad. Clinical trials, manufacturing and marketing of products are subject to the rigorous testing and approval process of the FDA and equivalent foreign regulatory authorities.

The Federal Food, Drug and Cosmetic Act and other federal, state and foreign statutes and regulations govern and influence the testing, manufacture, labeling, advertising, distribution and promotion of drugs and medical devices. These laws and regulations are complex and subject to change. Furthermore, these laws and regulations may be subject to varying interpretations, and we may not be able to predict how an applicable regulatory body or agency may choose to interpret or apply any law or regulation. As a result, clinical trials and regulatory approval can take a number of years to accomplish and require the expenditure of substantial resources. We or our third-party collaborators, as applicable, may encounter delays or rejections based upon administrative action or interpretations of current rules and regulations. We or our third-party collaborators, as applicable, may not be able to timely reach agreement with the FDA on our clinical trial protocols or on the required data we or they must collect to continue with our clinical trials or eventually commercialize our product candidates.

We or our third-party collaborators, as applicable, may also encounter delays or rejections based upon additional government regulation from future legislation, administrative action or changes in FDA policy during the period of product development, clinical trials and FDA regulatory review. We or our third-party collaborators, as applicable, may encounter similar delays in foreign countries. Sales of our product candidates outside the United States are subject to foreign regulatory standards that vary from country to country. The time required to obtain approvals from foreign countries may be shorter or longer than that required for FDA approval, and requirements for foreign licensing may differ from FDA requirements. We or our third-party collaborators, as applicable, may be unable to obtain requisite approvals from the FDA and foreign regulatory authorities, and even if obtained, such approvals may not be on a timely basis, or they may not cover the clinical uses that we specify. If we or our third-party collaborators, as applicable, fail to obtain timely clearance or approval for our product candidates, we or they will not be able to market and sell our product candidates, which will limit our ability to generate revenue.

Table of Contents

Marketing or promoting a drug is subject to very strict controls. Furthermore, clearance or approval may entail ongoing requirements for post-marketing studies. The manufacture and marketing of drugs are subject to continuing FDA and foreign regulatory review and requirements that we update our regulatory filings. Later discovery of previously unknown problems with a product, manufacturer or facility, or our failure to update regulatory files, may result in restrictions, including withdrawal of the product from the market. Any of the following events, if they were to occur, could delay or preclude us from further developing, marketing or realizing full commercial use of our product candidates, which in turn would materially harm our business, financial condition and results of operations:

- failure to obtain or maintain requisite governmental approvals;
- failure to obtain approvals for clinically intended uses of our product candidates under development; or
- identification of serious and unanticipated adverse side effects in our product candidates under development.

Manufacturers of drugs also must comply with the applicable FDA good manufacturing practice regulations, which include production design controls, testing, quality control and quality assurance requirements as well as the corresponding maintenance of records and documentation. Compliance with current good manufacturing practices regulations is difficult and costly. Manufacturing facilities are subject to ongoing periodic inspection by the FDA and corresponding state agencies, including unannounced inspections, and must be licensed before they can be used for the commercial manufacture of our product candidates. We and/or our present or future suppliers and distributors may be unable to comply with the applicable good manufacturing practice regulations and other FDA regulatory requirements. We have not been subject to a good manufacturing regulation inspection by the FDA relating to our pharmaceutical systems. If we do not achieve compliance for the product candidates we manufacture, the FDA may refuse or withdraw marketing clearance or require product recall, which may cause interruptions or delays in the manufacture and sale of our product candidates.

Our near-term revenues depend on collaborations agreements with other companies. These agreements subject us to obligations which must be fulfilled and require us to manage complex relationships with third parties. If we are unable to meet our obligations or manage our relationships with our collaborators under these agreements or enter into additional collaboration agreements or if our existing collaborations are terminated, our revenues may decrease

Our near-term revenues are based to a significant extent on collaborative arrangements with third parties, pursuant to which we receive payments based on our performance of research and development activities and the attainment of milestones set forth in the agreements. We may not be able to fulfill our obligations or attain milestones set forth in any specific agreement, which could cause our revenues to fluctuate or be less than anticipated and may expose us to liability for contractual breach. In addition, these agreements may require us to devote significant time and resources to communicating with and managing our relationship with such collaborators and resolving possible issues of contractual interpretation which may detract from time our management would otherwise devote to our managing our operations. In general, our collaboration agreements, including our agreements with Endo with respect to CHRONOGESIC and TRANSDUR-Sufentanil, Pain Therapeutics with respect to Remoxy and Voyager with respect to DURIN-Leuprolide, may be terminated by the other party at will or upon specified conditions including, for example, if we fail to satisfy specified performance milestones or if we breach the terms of the agreement.

Our agreement with Endo for the development and commercialization of our CHRONOGESIC product candidate in the United States and Canada can be terminated by Endo starting in January 2006 in the event we have not commenced a specified clinical trial for the CHRONOGESIC product candidate by January 1, 2006, provided that Endo provides us written notice of termination prior to January 31, 2006.

If any of our collaborative agreements are terminated, our revenues will be reduced and our product candidates related to those agreements may not be commercialized.

We do not have or have limited control over the development, sales and distribution for our product candidates which are the subject of third-party collaborative or license agreements

We have yet to establish any marketing, sales or distribution capabilities for our pharmaceutical system product candidates, and therefore are dependent on third-party companies to market, sell and distribute such product candidates. We have entered into agreements with Endo related to the promotion and distribution of our CHRONOGESIC and TRANSDUR-Sufentanil product candidates in the United States and Canada once such products are approved for commercialization. In addition, we have entered into agreements with Pain Therapeutics and Voyager under which we granted such third parties the right to develop, apply for regulatory approval for, market, promote or distribute Remoxy and DURIN-Leuprolide, respectively, subject to payments to us in the form of product royalties and other payments. We have limited or no control over the expertise or resources that any collaborator may devote to the development, marketing or sale of these product candidates, or the timing of their activities. Any of our present or future collaborators may not perform their obligations as expected. These collaborators may breach or terminate their agreement with us or otherwise fail to conduct their collaborative activities successfully and in a timely manner. Further, our collaborators may elect not to develop or commercialize products

Table of Contents

arising out of our collaborative arrangements or not devote sufficient resources to the development, manufacture, marketing or sale of these products. If any of these events occur, we may not be able to develop our technologies or recognize revenue from the commercialization of our product candidates based on such collaborations. In addition, these third parties may have similar or competitive products to the ones which are the subject of their collaborations with us, or relationships with our competitors, which may reduce their interest in developing or selling our product candidates.

We and our third-party collaborators compete with many other companies that currently have extensive and well-funded marketing and sales operations. Our marketing and sales efforts and those of our third-party collaborators may be unable to compete successfully against these other companies. We and our third-party collaborators, if relevant, may be unable to establish a sufficient sales and marketing organization on a timely basis, if at all. We and our third-party collaborators, if relevant, may be unable to engage qualified distributors. Even if engaged, these distributors may:

- fail to satisfy financial or contractual obligations to us;
- fail to adequately market our products;
- cease operations with little or no notice to us;
- offer, design, manufacture or promote competing product lines;
- fail to maintain adequate inventory and thereby restrict use of our products; or
- build up inventory in excess of demand thereby limiting future purchases of our products resulting in significant quarter-to-quarter variability in our sales.

The failure of us or our third-party collaborators to effectively develop, gain regulatory approval for sell and market our products will hurt our business and financial results.

We rely heavily on third parties to support development, clinical testing and manufacturing of our product candidates

We rely on third-party contract research organizations, service providers and suppliers to provide critical services to support development, clinical testing, and manufacturing of our pharmaceutical systems. For example, we currently depend on third-party vendors to manage and monitor our clinical trials and to perform critical manufacturing steps for our pharmaceutical systems. In the past, we relied on a third-party contract manufacturer to perform the final manufacturing steps of our CHRONOGESIC product candidate, and we anticipate that in the near future that we will need or choose to rely on a third-party manufacturer to manufacture or perform manufacturing steps relating to our pharmaceutical systems or components. See “We may not be able to manufacture sufficient quantities of our product candidates to support our clinical and commercial requirements at an acceptable cost, and we have limited manufacturing experience.” We anticipate that we will continue to rely on these and other third-party contractors to support development, clinical testing, and manufacturing of our pharmaceutical systems. Failure of these contractors to provide the required services in a timely manner or on reasonable commercial terms could materially delay the development and approval of our product candidates, increase our expenses and materially harm our business, financial condition and results of operations.

Key components of our pharmaceutical systems are provided by limited numbers of suppliers, and supply shortages or loss of these suppliers could result in interruptions in supply or increased costs

Certain components and drug substances used in our pharmaceutical systems (including the SABER post-operative pain depot, the TRANSDUR-Sufentanil patch, Remoxy, the DURIN-Leuprolide and the CHRONOGESIC product candidates) are currently purchased from a single or a limited number of outside sources. The reliance on a sole or limited number of suppliers could result in:

- delays associated with redesigning a product candidate due to a failure to obtain a single source component;

- an inability to obtain an adequate supply of required components; and
- reduced control over pricing, quality and time delivery.

We have a supply agreement with Mallinckrodt, Inc. for our sufentanil requirements, the initial term of which expires on September 30, 2009. Other than this agreement, we do not have long-term agreements with any of our suppliers, and therefore the supply of a particular component could be terminated at any time without penalty to the supplier. In addition, we may not be able to procure required components or drugs from third-party suppliers at a quantity, quality and cost acceptable to us. Any interruption in the supply of single source components could cause us to seek alternative sources of supply or manufacture these components internally. If the supply of any components for our pharmaceutical systems is interrupted, components from alternative suppliers may not be available in sufficient volumes or at acceptable quality levels within required timeframes, if at all, to meet our needs. This could delay our ability to complete clinical trials and obtain approval for commercialization and marketing of our product candidates, causing us to lose sales, incur additional costs and delay new product introductions and could harm our reputation.

Table of Contents

If we do not generate sufficient cash flow through increased revenues or raising additional capital, then we may not be able to meet our substantial debt obligations

As of June 30, 2005, we had approximately \$60.0 million in long-term convertible subordinated notes which mature in June 2008, \$31,000 in non-current lease obligations, \$875,000 in non-current bonds payable and \$631,000 in other long-term liabilities. Our substantial indebtedness, which totals \$61.5 million, has and will continue to impact us by:

- making it more difficult to obtain additional financing; and
- constraining our ability to react quickly in an unfavorable economic climate.

Currently we are not generating positive cash flow. Adverse occurrences related to our product development efforts will adversely impact our ability to meet our obligations to repay the principal amounts on our convertible subordinated notes when due in June 2008. In addition, if the market price of our common stock on the due date of our notes is below \$3.15 per share, the approximate equity conversion price of the notes, it will be highly unlikely that the holders of a large percentage of our outstanding convertible subordinated notes will convert such securities to equity in accordance with their existing terms. If we are unable to satisfy our debt service requirements, substantial liquidity problems could result. As of June 30, 2005 we had cash and investments valued at approximately \$60.5 million. We expect to use substantially all of these assets to fund our on-going operations over the next few years. We may not generate sufficient cash from operations to repay our convertible subordinated notes or satisfy any other of these obligations when they become due and may have to raise additional financing from the sale of equity or debt securities or otherwise restructure our obligations in order to do so. There can be no assurance that any such financing or restructuring will be available to us on commercially acceptable terms, if at all. If we are unable to restructure our obligations, we may be forced to seek protection under applicable bankruptcy laws. Any restructure or bankruptcy could materially impair the value of our common stock.

We may not have sufficient funds to redeem our outstanding convertible subordinated notes if required to do so, and the redemption rights in our outstanding convertible subordinated notes could discourage a potential acquirer

If we engage in any transaction or event in connection with which all or substantially all of our common stock is exchanged for, converted into, acquired for or constitutes solely the right to receive consideration which is not all or substantially all common stock listed on a United States national securities exchange or approved for quotation on the NASDAQ National Market or any similar United States system of automated dissemination of quotations of securities prices, or, if for any reason, our common stock is no longer listed for trading on a United States national securities exchange nor approved for trading on the NASDAQ National Market (a "fundamental change"), we may be required to redeem all or part of the \$60 million in outstanding principal, plus any accrued but unpaid interest on our outstanding convertible promissory notes. We may not have enough funds to pay the redemption price for all tendered notes. In addition, any credit agreement or other agreements relating to our indebtedness may contain provisions prohibiting redemption of the notes under certain circumstances, or expressly prohibit our redemption of the notes upon a designated event or may provide that a designated event constitutes an event of default under that agreement. Our failure to redeem tendered notes would constitute an event of default under the indenture, which might also constitute a default under the terms of our other indebtedness. Any such default could cause us to seek to restructure our indebtedness or seek protection under applicable bankruptcy laws, either of which could materially impair the value of our common stock.

This redemption feature upon fundamental change could also discourage a potential acquirer. However, this redemption feature is not the result of management's knowledge of any specific effort to obtain control of us by means of a merger, tender offer or solicitation, or part of a plan by management to adopt a series of anti-takeover provisions. The term "fundamental change" is limited to specified transactions and may not include other events that might adversely affect our financial condition or business operations.

We have a history of operating losses, expect to continue to have losses in the future and may never achieve or

maintain profitability

We have incurred significant operating losses since our inception in 1998 and, as of June 30, 2005, had an accumulated deficit of approximately \$173.0 million. We expect to continue to incur significant operating losses over the next several years as we continue to incur costs for research and development, clinical trials and manufacturing. Our ability to achieve profitability depends upon our ability, alone or with others, to successfully complete the development of our proposed product candidates, obtain the required regulatory clearances and manufacture and market our proposed product candidates. Development of pharmaceutical systems is costly and requires significant investment. In addition, we may choose to license either additional drug delivery platform technology or rights to particular drugs or other appropriate technology for use in our pharmaceutical systems. The license fees for these technologies or rights would increase the costs of our pharmaceutical systems.

Table of Contents

To date, we have not generated significant revenue from the commercial sale of our products and do not expect to receive significant revenue in the near future. Our current product revenues are from the sale of the ALZET product we acquired in April 2000 from ALZA and the sale of biodegradable polymers. We do not expect these product revenues to increase significantly in future periods. We do not anticipate commercialization and marketing of our product candidates in development in the near future, and therefore do not expect to generate sufficient revenues to cover expenses or achieve profitability in the near future.

We may have difficulty raising needed capital in the future

Our business currently does not generate sufficient revenues to meet our capital requirements and we do not expect that it will do so in the near future. We have expended and will continue to expend substantial funds to complete the research, development and clinical testing of our product candidates. We will require additional funds for these purposes, to establish additional clinical- and commercial-scale manufacturing arrangements and facilities and to provide for the marketing and distribution of our product candidates. Additional funds may not be available on acceptable terms, if at all. If adequate funds are unavailable from operations or additional sources of financing, we may have to delay, reduce the scope of or eliminate one or more of our research or development programs which would materially harm our business, financial condition and results of operations.

We believe that our cash, cash equivalents and investments, will be adequate to satisfy our capital needs for at least the next 12 months. However, our actual capital requirements will depend on many factors, including:

- continued progress and cost of our research and development programs;
- success in entering into collaboration agreements and meeting milestones under such agreements;
- progress with preclinical studies and clinical trials;
- the time and costs involved in obtaining regulatory clearance;
- costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims;
- costs of developing sales, marketing and distribution channels and our ability to sell our product candidates;
- costs involved in establishing manufacturing capabilities for clinical and commercial quantities of our product candidates;
- competing technological and market developments;
- market acceptance of our product candidates; and
- costs for recruiting and retaining employees and consultants.

We may consume available resources more rapidly than currently anticipated, resulting in the need for additional funding. We may seek to raise any necessary additional funds through equity or debt financings, convertible debt financings, collaborative arrangements with corporate partners or other sources, which may be dilutive to existing stockholders and may cause the price of our common stock to decline. In addition, in the event that additional funds are obtained through arrangements with collaborators or other sources, we may have to relinquish rights to some of our technologies, product candidates or products that we would otherwise seek to develop or commercialize ourselves. If adequate funds are not available, we may be required to significantly reduce or refocus our product development efforts, resulting in loss of sales, increased costs, and reduced revenues.

Investors may experience substantial dilution of their investment

In the past, we have issued and have assumed, pursuant to the SBS acquisition, options and warrants to acquire common stock. To the extent these outstanding options are ultimately exercised, there will be dilution to investors. In addition, conversion of some or all of the \$60.0 million aggregate principal amount of convertible

subordinated notes that we issued in June and July 2003 will dilute the ownership interests of investors. Investors may experience further dilution of their investment if we raise capital through the sale of additional equity securities or convertible debt securities. See "Liquidity and Capital Resources". Any sales in the public market of the common stock issuable upon such conversion could adversely affect prevailing market prices for our common stock.

We may choose to purchase a portion of our convertible subordinated notes in exchange for shares of our common stock in the open market. These transactions could dilute existing stockholders and increase the volatility of our stock.

To the extent we are able to do so on terms favorable to us, we may choose to purchase a portion of our outstanding 6.25% Convertible Subordinated Notes due June 2008 from time to time in privately negotiated transactions under Section

Table of Contents

3(a)(9) of the Securities Act of 1933. On July 21, 2005, we entered into an agreement for such a transaction for notes with an aggregate principal amount of up to \$5.0 million. The issuance of shares of our common stock in such transactions will dilute our existing investors. To the extent such shares are resold, such transactions may increase the volatility of our stock.

Our stock price may fluctuate, and your investment in our stock could decline in value

The average daily trading volume of our common stock for the three months ending June 30, 2005, was 224,659 shares. The limited trading volume of our stock may contribute to its volatility, and an active trading market in our stock might not continue. In accordance with our Common Stock Purchase Agreement with Endo, we filed a registration statement on Form S-3 with the SEC on August 29, 2003 to register 1,533,742 shares of our common stock issued to Endo and 485,122 shares issued to former APT shareholders for resale. The registration statement was declared effective by the SEC on September 26, 2003. Pursuant to a Purchase Agreement with Morgan Stanley & Co., Incorporated, we filed a registration statement with the SEC on Form S-3 to register an aggregate of \$60.0 million in convertible subordinated notes for resale on August 29, 2003. The registration statement was declared effective by the SEC on November 3, 2003. The convertible subordinated notes are convertible into shares of our common stock at a conversion rate of 317.4603 shares per \$1,000 principal amount of notes, subject to adjustment and will bear interest at a rate of 6.25% per annum. So long as these registration statements are effective, shares covered thereunder are tradeable without limitation. If substantial amounts of our common stock were to be sold in the public market, the market price of our common stock could fall. In addition, the existence of our convertible subordinated notes may encourage short selling by market participants. The market price of our common stock may fluctuate significantly in response to factors which are beyond our control. The stock market in general has recently experienced extreme price and volume fluctuations. In addition, the market prices of securities of technology and pharmaceutical companies have also been extremely volatile, and have experienced fluctuations that often have been unrelated or disproportionate to the operating performance of these companies. These broad market fluctuations could result in extreme fluctuations in the price of our common stock, which could cause a decline in the value of our investors' stock.

We could be exposed to significant product liability claims which could be time consuming and costly to defend, divert management attention and adversely impact our ability to obtain and maintain insurance coverage

The testing, manufacture, marketing and sale of our product candidates involve an inherent risk that product liability claims will be asserted against us. Although we are insured against such risks up to an annual aggregate limit in connection with clinical trials and commercial sales of our product candidates, our present product liability insurance may be inadequate and may not fully cover the costs of any claim or any ultimate damages we might be required to pay. Product liability claims or other claims related to our product candidates, regardless of their outcome, could require us to spend significant time and money in litigation or to pay significant damages. Any successful product liability claim may prevent us from obtaining adequate product liability insurance in the future on commercially desirable or reasonable terms. In addition, product liability coverage may cease to be available in sufficient amounts or at an acceptable cost. An inability to obtain sufficient insurance coverage at an acceptable cost or otherwise to protect against potential product liability claims could prevent or inhibit the commercialization of our pharmaceutical systems. A product liability claim could also significantly harm our reputation and delay market acceptance of our product candidates.

Table of Contents

We may be required to obtain rights to certain drugs

Some of the pharmaceutical systems that we are currently developing require the use of proprietary drugs to which we do not have commercial rights. For example, our research collaboration with the University of Maastricht has demonstrated that the use of a proprietary angiogenic factor in a pharmaceutical system can lead to elevated local concentration of the angiogenic factor in the pericardial sac of the heart, resulting in physical changes, including the growth of new blood vessels. We do not currently have a license to develop or commercialize a product candidate containing such proprietary angiogenic factor.

To complete the development and commercialization of pharmaceutical systems containing drugs to which we do not have commercial rights, we will be required to obtain rights to those drugs. We may not be able to do this at an acceptable cost, if at all. If we are not able to obtain required rights to commercialize certain drugs, we may not be able to complete the development of pharmaceutical systems which require use of those drugs. This could result in the cessation of certain development projects and the potential write-off of certain assets.

Technologies and businesses which we have acquired may be difficult to integrate, disrupt our business, dilute stockholder value or divert management attention. We may also acquire additional businesses or technologies in the future, which could have these same effects

We may acquire technologies, products or businesses to broaden the scope of our existing and planned product lines and technologies. For example, in October 1999, we acquired substantially all of the assets of IntraEAR, Inc.; in April 2000 we acquired the ALZET product and related assets from ALZA; in April 2001, we completed the acquisition of SBS and in August 2003, we acquired APT. These and our future acquisitions expose us to:

- increased costs associated with the acquisition and operation of the new businesses or technologies and the management of geographically dispersed operations;
- the risks associated with the assimilation of new technologies, operations, sites and personnel;
- the diversion of resources from our existing business and technologies;
- the inability to generate revenues to offset associated acquisition costs;
- the requirement to maintain uniform standards, controls, and procedures; and
- the impairment of relationships with employees and customers as a result of any integration of new management personnel.

Table of Contents

Acquisitions may also result in the issuance of dilutive equity securities, the incurrence or assumption of debt or additional expenses associated with the amortization of acquired intangible assets or potential businesses. Past acquisitions, such as our acquisitions of IntraEAR, ALZET, SBS and APT, as well future acquisitions, may not generate any additional revenue or provide any benefit to our business.

Our limited operating history makes evaluating our stock difficult

Investors can only evaluate our business based on a limited operating history. We were incorporated in February 1998 and have engaged primarily in research and development, licensing technology, raising capital and recruiting scientific and management personnel. This short history may not be adequate to enable investors to fully assess our ability to successfully develop our product candidates, achieve market acceptance of our product candidates and respond to competition. Furthermore, we anticipate that our quarterly and annual results of operations will fluctuate for the foreseeable future. We believe that period-to-period comparisons of our operating results should not be relied upon as predictive of future performance. Our prospects must be considered in light of the risks, expenses and difficulties encountered by companies at an early stage of development, particularly companies in new and rapidly evolving markets such as pharmaceuticals, drug delivery and biotechnology. To address these risks, we must, among other things, obtain regulatory approval for and commercialize our product candidates, which may not occur. We may not be successful in addressing these risks and difficulties. We may require additional funds to complete the development of our product candidates and to fund operating losses to be incurred in the next several years.

Acceptance of our product candidates in the marketplace is uncertain, and failure to achieve market acceptance will delay our ability to generate or grow revenues

Our future financial performance will depend upon the successful introduction and customer acceptance of our future products, including our SABER post-operative pain depot, TRANSDUR-Sufentanil patch, Remoxy, DURIN-Leuprolide and CHRONOGESIC product candidates. Even if approved for marketing, our product candidates may not achieve market acceptance. The degree of market acceptance will depend upon a number of factors, including:

- the receipt of regulatory clearance of marketing claims for the uses that we are developing;
- the establishment and demonstration in the medical community of the safety and clinical efficacy of our products and their potential advantages over existing therapeutic products, including oral medication, transdermal drug delivery products such as drug patches, or external or implantable drug delivery products; and
- pricing and reimbursement policies of government and third-party payors such as insurance companies, health maintenance organizations and other health plan administrators.

Physicians, patients, payors or the medical community in general may be unwilling to accept, utilize or recommend any of our products. If we are unable to obtain regulatory approval, commercialize and market our future products when planned and achieve market acceptance, we will not achieve anticipated revenues.

If users of our products are unable to obtain adequate reimbursement from third-party payors, or if new restrictive legislation is adopted, market acceptance of our products may be limited and we may not achieve anticipated revenues

The continuing efforts of government and insurance companies, health maintenance organizations and other payors of healthcare costs to contain or reduce costs of health care may affect our future revenues and profitability, and the future revenues and profitability of our potential customers, suppliers and collaborative partners and the availability of capital. For example, in certain foreign markets, pricing or profitability of prescription pharmaceuticals is subject to government control. In the United States, recent federal and state government initiatives have been directed at lowering the total cost of health care, and the U.S. Congress and state legislatures will likely continue to focus on health care reform, the cost of prescription pharmaceuticals and on the reform of the Medicare and Medicaid systems. While we cannot predict whether any such legislative or regulatory proposals will be adopted, the announcement or adoption of such proposals could materially harm our business,

financial condition and results of operations.

The successful commercialization of our product candidates will depend in part on the extent to which appropriate reimbursement levels for the cost of our product candidates and related treatment are obtained by governmental authorities, private health insurers and other organizations, such as HMOs. Third-party payors are increasingly limiting payments or reimbursement for medical products and services. Also, the trend toward managed health care in the United States and the concurrent growth of organizations such as HMOs, which could control or significantly influence the purchase of health care services and products, as well as legislative proposals to reform health care or reduce government insurance programs, may limit reimbursement or payment for our products. The cost containment measures that health care payors and providers are instituting and the effect of any health care reform could materially harm our ability to operate profitably.

Table of Contents

We may be sued by third parties which claim that our product candidates infringe on their intellectual property rights, particularly because there is substantial uncertainty about the validity and breadth of medical patents

We may be exposed to future litigation by third parties based on claims that our product candidates or activities infringe the intellectual property rights of others or that we have misappropriated the trade secrets of others. This risk is exacerbated by the fact that the validity and breadth of claims covered in medical technology patents and the breadth and scope of trade secret protection involve complex legal and factual questions for which important legal principles are unresolved. Any litigation or claims against us, whether or not valid, could result in substantial costs, could place a significant strain on our financial resources and could harm our reputation. In addition, intellectual property litigation or claims could force us to do one or more of the following, any of which could harm our business or financial results:

- cease selling, incorporating or using any of our product candidates that incorporate the challenged intellectual property, which would adversely affect our revenue;
- obtain a license from the holder of the infringed intellectual property right, which license may be costly or may not be available on reasonable terms, if at all; or
- redesign our product candidates, which would be costly and time-consuming.

If we are unable to adequately protect or enforce our intellectual property rights or secure rights to third-party patents, we may lose valuable assets, experience reduced market share or incur costly litigation to protect our rights

Our success will depend in part on our ability to obtain patents, maintain trade secret protection and operate without infringing the proprietary rights of others. As of June 30, 2005, we held 25 issued U.S. patents and 14 issued foreign patents. In addition, we have 42 pending U.S. patent applications and have filed 50 patent applications under the Patent Cooperation Treaty, from which 105 national phase applications are currently pending in Europe, Australia, Japan, Canada, Mexico, New Zealand, Brazil, Israel, India, Hong Kong and China. Our patents expire at various dates starting in the year 2012. Under our agreement with ALZA, we must assign to ALZA any intellectual property rights relating to the DUROS system and its manufacture and any combination of the DUROS system with other components, active agents, features or processes. In addition, ALZA retains the right to enforce and defend against infringement actions relating to the DUROS system, and if ALZA exercises these rights, it will be entitled to the proceeds of these infringement actions.

The patent positions of pharmaceutical companies, including ours, are uncertain and involve complex legal and factual questions. In addition, the coverage claimed in a patent application can be significantly reduced before the patent is issued. Consequently, our patent applications or those of ALZA that are licensed to us may not issue into patents, and any issued patents may not provide protection against competitive technologies or may be held invalid if challenged or circumvented. Our competitors may also independently develop products similar to ours or design around or otherwise circumvent patents issued to us or licensed by us. In addition, the laws of some foreign countries may not protect our proprietary rights to the same extent as U.S. law.

We also rely upon trade secrets, technical know-how and continuing technological innovation to develop and maintain our competitive position. We require our employees, consultants, advisors and collaborators to execute appropriate confidentiality and assignment-of-inventions agreements with us. These agreements typically provide that all materials and confidential information developed or made known to the individual during the course of the individual's relationship with us is to be kept confidential and not disclosed to third parties except in specific circumstances, and that all inventions arising out of the individual's relationship with us shall be our exclusive property. These agreements may be breached, and in some instances, we may not have an appropriate remedy available for breach of the agreements. Furthermore, our competitors may independently develop substantially equivalent proprietary information and techniques, reverse engineer our information and techniques, or otherwise gain access to our proprietary technology.

We may be unable to meaningfully protect our rights in trade secrets, technical know-how and other non-

patented technology. We may have to resort to litigation to protect our intellectual property rights, or to determine their scope, validity or enforceability. Enforcing or defending our proprietary rights is expensive, could cause diversion of our resources and may not prove successful. Any failure to enforce or protect our rights could cause us to lose the ability to exclude others from using our technology to develop or sell competing products.

If we or our third-party collaborators are unable to train physicians to use our pharmaceutical systems to treat patients' diseases or medical conditions, we may incur delays in market acceptance of our products

Broad use of our pharmaceutical systems will require extensive training of numerous physicians on the proper and safe use of our products. The time required to begin and complete training of physicians could delay introduction of our products and adversely affect market acceptance of our products. We or third parties selling our products may be unable to rapidly train physicians in numbers sufficient to generate adequate demand for our pharmaceutical systems. Any delay in training would materially delay the demand for our systems and harm our business and financial results. In addition, we may expend significant funds towards such training before any orders are placed for our products, which would increase our expenses and harm our financial results.

Table of Contents

Some of our product candidates contain controlled substances, the making, use, sale, importation and distribution of which are subject to regulation by state, federal and foreign law enforcement and other regulatory agencies

Some of our product candidates currently under development contain, and our products in the future may contain, controlled substances which are subject to state, federal and foreign laws and regulations regarding their manufacture, use, sale, importation and distribution. Our TRANSDUR-Sufentanil patch, Remoxy and CHRONOGESIC product candidates and other product candidates we have under development contain opioids which are classified as Schedule II controlled substances under the regulations of the U.S. Drug Enforcement Agency. For our product candidates containing controlled substances, we and our suppliers, manufacturers, contractors, customers and distributors are required to obtain and maintain applicable registrations from state, federal and foreign law enforcement and regulatory agencies and comply with state, federal and foreign laws and regulations regarding the manufacture, use, sale, importation and distribution of controlled substances. These regulations are extensive and include regulations governing manufacturing, labeling, packaging, testing, dispensing, production and procurement quotas, record keeping, reporting, handling, shipment and disposal. Failure to obtain and maintain required registrations or comply with any applicable regulations could delay or preclude us from developing and commercializing our product candidates containing controlled substances and subject us to enforcement action. In addition, because of their restrictive nature, these regulations could limit our commercialization of our product candidates containing controlled substances.

Write-offs related to the impairment of long-lived assets and other non-cash charges, as well as future deferred compensation expenses may adversely impact or delay our profitability

We may incur significant non-cash charges related to impairment write-downs of our long-lived assets, including goodwill and other intangible assets. In 2002, Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS 142) became effective and as a result, we ceased to amortize approximately \$4.7 million of goodwill and assembled workforce on January 1, 2002.

However, we will continue to incur non-cash charges related to amortization of other intangible assets. We are required to perform periodic impairment reviews of our goodwill at least annually. To the extent these reviews conclude that the expected future cash flows generated from our business activities are not sufficient to recover the cost of our long-lived assets, we will be required to measure and record an impairment charge to write down these assets to their realizable values. We completed our last review during the fourth quarter of 2004 and determined that goodwill was not impaired as of December 31, 2004. However, there can be no assurance that upon completion of subsequent reviews a material impairment charge will not be recorded. If future periodic reviews determine that our assets are impaired and a write down is required, it will adversely impact or delay our profitability.

To date, we have recorded deferred compensation expenses related to stock options grants, including stock options assumed in our acquisition of SBS, which will be amortized through 2006. In addition, deferred compensation expense related to option awards to non-employees will be calculated during the vesting period of the option based on the then-current price of our common stock, which could result in significant charges that adversely impact or delay our profitability. Furthermore, we have issued to ALZA common stock and a warrant to purchase common stock with an aggregate value of approximately \$13.5 million, which will be amortized over time based on sales of our DUROS-based products and which will also adversely impact or delay our profitability.

We depend upon key personnel who may terminate their employment with us at any time, and we need to hire additional qualified personnel

Our success will depend to a significant degree upon the continued services of key management, technical and scientific personnel, including Felix Theeuwes, our Chairman and Chief Scientific Officer and James E. Brown, our President and Chief Executive Officer. Although we have obtained key man life insurance policies for each of Messrs. Theeuwes and Brown in the amount of \$1.0 million, this insurance may not adequately compensate us for the loss of their services. In addition, our success will depend on our ability to attract and retain other highly skilled

personnel. Competition for qualified personnel is intense, and the process of hiring and integrating such qualified personnel is often lengthy. We may be unable to recruit such personnel on a timely basis, if at all. Our management and other employees may voluntarily terminate their employment with us at any time. The loss of the services of key personnel, or the inability to attract and retain additional qualified personnel, could result in delays to product development or approval, loss of sales and diversion of management resources.

We may not successfully manage our growth

Our success will depend on the timely expansion of our operations and the effective management of growth, which will place a significant strain on our management and on our administrative, operational and financial resources. To manage such growth, we must expand our facilities, augment our operational, financial and management systems and hire, train and supervise additional qualified personnel. If we were unable to manage growth effectively our business would be harmed.

Table of Contents

The market for our product candidates is new, rapidly changing and competitive, and new products or technologies developed by others could impair our ability to grow our business and remain competitive

The pharmaceutical industry is subject to rapid and substantial technological change. Developments by others may render our product candidates under development or technologies noncompetitive or obsolete, or we may be unable to keep pace with technological developments or other market factors. Technological competition in the industry from pharmaceutical and biotechnology companies, universities, governmental entities and others diversifying into the field is intense and is expected to increase. Many of these entities have significantly greater research and development capabilities than we do, as well as substantially more marketing, manufacturing, financial and managerial resources. These entities represent significant competition for us. Acquisitions of, or investments in, competing pharmaceutical or biotechnology companies by large corporations could increase such competitors' financial, marketing, manufacturing and other resources.

We are engaged in the development of novel therapeutic technologies. Our resources are limited and we may experience technical challenges inherent in such novel technologies. Competitors have developed or are in the process of developing technologies that are, or in the future may be, the basis for competitive products. Some of these products may have an entirely different approach or means of accomplishing similar therapeutic effects than our product candidates. Our competitors may develop products that are safer, more effective or less costly than our product candidates and, therefore, present a serious competitive threat to our product offerings.

The widespread acceptance of therapies that are alternatives to ours may limit market acceptance of our product candidates even if commercialized. Chronic and post-operative pain are currently being treated by oral medication, transdermal drug delivery systems, such as drug patches, and implantable drug delivery devices which will be competitive with our product candidates. These treatments are widely accepted in the medical community and have a long history of use. The established use of these competitive products may limit the potential for our product candidates to receive widespread acceptance if commercialized.

Our business involves environmental risks and risks related to handling regulated substances

In connection with our research and development activities and our manufacture of materials and product candidates, we are subject to federal, state and local laws, rules, regulations and policies governing the use, generation, manufacture, storage, air emission, effluent discharge, handling and disposal of certain materials, biological specimens and wastes. Although we believe that we have complied with the applicable laws, regulations and policies in all material respects and have not been required to correct any material noncompliance, we may be required to incur significant costs to comply with environmental and health and safety regulations in the future. Our research and development involves the use, generation and disposal of hazardous materials, including but not limited to certain hazardous chemicals, solvents, agents and biohazardous materials. The extent of our use, generation and disposal of such substances has increased substantially since we started manufacturing and selling biodegradable polymers. Although we believe that our safety procedures for storing, handling and disposing of such materials comply with the standards prescribed by state and federal regulations, we cannot completely eliminate the risk of accidental contamination or injury from these materials. We currently contract with third parties to dispose of these substances generated by us, and we rely on these third parties to properly dispose of these substances in compliance with applicable laws and regulations. If these third parties do not properly dispose of these substances in compliance with applicable laws and regulations, we may be subject to legal action by governmental agencies or private parties for improper disposal of these substances. The costs of defending such actions and the potential liability resulting from such actions are often very large. In the event we are subject to such legal action or we otherwise fail to comply with applicable laws and regulations governing the use, generation and disposal of hazardous materials and chemicals, we could be held liable for any damages that result, and any such liability could exceed our resources.

Our agreement with ALZA limits our fields of operation for our DUROS-based pharmaceutical systems and gives ALZA a first right to negotiate to distribute selected products for us

Our agreement with ALZA gives us exclusive rights to develop, commercialize and manufacture products using

ALZA's DUROS technology to deliver by catheter:

- drugs to the central nervous system to treat select nervous system disorders;
- drugs to the middle and inner ear;
- drugs to the pericardial sac of the heart; and
- select drugs into vascular grafts.

Table of Contents

We also have the right to use the DUROS technology to deliver systemically and by catheter:

- sufentanil to treat chronic pain; and
- select cancer antigens.

We may not develop, manufacture or commercialize DUROS-based pharmaceutical systems outside of these specific fields without ALZA's prior approval. In addition, if we develop or commercialize any drug delivery technology for use in a manner similar to the DUROS technology in a field covered in our license agreement with ALZA, then we may lose our exclusive rights to use the DUROS technology in such field as well as the right to develop new product candidates using DUROS technology in such field. In order to maintain commercialization rights for our products on a worldwide basis, we must diligently develop our product candidates, procure required regulatory approvals and commercialize the product candidates in selected major market countries. If we fail to meet commercialization diligence requirements, we may lose rights for products in some or all countries, including the United States. These rights would revert to ALZA, which could then develop DUROS-based pharmaceutical products in such countries itself or license others to do so. In addition, in the event that our rights terminate with respect to any product or country, or this agreement terminates or expires in its entirety (except for termination by us due to a breach by ALZA), ALZA will have the exclusive right to use all of our data, rights and information relating to the products developed under the agreement as necessary for ALZA to commercialize these products, subject to the payment of a royalty to us based on the net sales of the products by ALZA.

Our agreement with ALZA gives us the right to perform development work and manufacture the DUROS pump component of our DUROS-based pharmaceutical systems. In the event of a change in our corporate control, including an acquisition of us, our right to manufacture and perform development work on the DUROS pump would terminate and ALZA would have the right to manufacture and develop DUROS systems for us so long as ALZA can meet our specification and supply requirements following such change in control.

Under the ALZA agreement, we must pay ALZA royalties on sales of DUROS-based pharmaceutical systems we commercialize and a percentage of any up-front license fees, milestone or special fees, payments or other consideration we receive, excluding research and development funding. In addition, commencing upon the commercial sale of a product developed under the agreement, we are obligated to make minimum product payments to ALZA on a quarterly basis based on our good faith projections of our net product sales of the product. These minimum payments will be fully credited against the product royalty payments we must pay to ALZA.

ALZA may obtain from us, for its own behalf or on behalf of one of its affiliates, the exclusive right to develop and commercialize a product in a field of use exclusively licensed to us, provided that such product does not incorporate a drug in the same drug class and is not intended for the same therapeutic indication as a product which is then being developed or commercialized by us or for which we have made commitments to a third-party. In the event that ALZA or an affiliate commercializes such a product, ALZA or its affiliate will pay us a royalty on sales of such product at a specified rate.

ALZA also has an exclusive option to distribute any DUROS-based pharmaceutical system we develop to deliver non-proprietary cancer antigens worldwide. The terms of any distribution arrangement have not been set and are to be negotiated in good faith between ALZA and us. ALZA's option to acquire distribution rights limits our ability to negotiate with other distributors for these products and may result in lower payments to us than if these rights were subject to competitive negotiations. We must allow ALZA an opportunity to negotiate in good faith for commercialization rights to our products developed under the agreement prior to granting these rights to a third-party. These rights do not apply to products that are subject to ALZA's option or products for which we have obtained funding or access to a proprietary drug from a third-party to whom we have granted commercialization rights prior to the commencement of human clinical trials.

ALZA has the right to terminate the agreement in the event that we breach a material obligation under the agreement and do not cure the breach in a timely manner. In addition, ALZA has the right to terminate the agreement if at any time prior to July 2006, we solicit for employment or hire, without ALZA's consent, a person who is or within the previous 180 days has been an employee of ALZA in the DUROS technology group.

We do not control ALZA's ability to develop and commercialize DUROS technology outside of fields licensed to us, and problems encountered by ALZA could result in negative publicity, loss of sales and delays in market acceptance of our DUROS-based pharmaceutical systems

ALZA retains complete rights to the DUROS technology for fields outside the specific fields licensed to us. Accordingly, ALZA may develop and commercialize DUROS-based products or license others to do so, so long as there is no conflict with the rights granted to us. ALZA received FDA approval to market its first DUROS-based product, VIADUR (leuprolide acetate implants) for the palliative treatment of advanced prostate cancer in March 2000. If ALZA or its commercialization partner, Bayer, fails to commercialize this product successfully, or encounters problems associated with this product, negative publicity could be created about all DUROS-based products, which could result in harm to our reputation and cause reduced sales of our DUROS-based product candidates. In addition, if any third party that may be licensed by ALZA fails to develop and commercialize DUROS-based products successfully, the success of all DUROS-based systems could be impeded, including ours, resulting in delay or loss of revenue or damage to our reputation, any one of which could harm our business.

Table of Contents

Our corporate headquarters, manufacturing facilities and personnel are located in a geographical area that is seismically active

Our corporate headquarters, manufacturing facilities and personnel are located in a geographical area that is known to be seismically active and prone to earthquakes. Should such a natural disaster occur, our ability to conduct our business could be severely restricted, and our business and assets, including the results of our research and development efforts, could be destroyed.

We have broad discretion over the use of our cash and investments, and their investment may not yield a favorable return

Our management has broad discretion over how our cash and investments are used and may invest in ways with which our stockholders may not agree and that do not yield favorable returns.

Executive officers, directors and entities affiliated with them have substantial control over us, which could delay or prevent a change in our corporate control favored by our other stockholders

Our directors, executive officers and principal stockholders, together with their affiliates have substantial control over us. The interests of these stockholders may differ from the interests of other stockholders. As a result, these stockholders, if acting together, would have the ability to exercise control over all corporate actions requiring stockholder approval irrespective of how our other stockholders may vote, including:

- the election of directors;
- the amendment of charter documents;
- the approval of certain mergers and other significant corporate transactions, including a sale of substantially all of our assets; or
- the defeat of any non-negotiated takeover attempt that might otherwise benefit the public stockholders.

Our certificate of incorporation, our bylaws, Delaware law and our stockholder rights plan contain provisions that could discourage another company from acquiring us

Provisions of Delaware law, our certificate of incorporation, bylaws and stockholder rights plan may discourage, delay or prevent a merger or acquisition that stockholders may consider favorable, including transactions in which you might otherwise receive a premium for your shares. These provisions include:

- authorizing the issuance of “blank check” preferred stock without any need for action by stockholders;
- providing for a dividend on our common stock, commonly referred to as a “poison pill”, which can be triggered after a person or group acquires 17.5% or more of common stock;
- providing for a classified board of directors with staggered terms;
- requiring supermajority stockholder voting to effect certain amendments to our certificate of incorporation and bylaws;
- eliminating the ability of stockholders to call special meetings of stockholders;
- prohibiting stockholder action by written consent; and
- establishing advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted on by stockholders at stockholder meetings.

Legislative actions, potential new accounting pronouncements and higher insurance costs are likely to impact our future financial position or results of operations

Future changes in financial accounting standards, including proposed changes in accounting for employee stock-based awards, may cause adverse, unexpected fluctuations in the timing of the recognition of revenues or

expenses and may affect our financial position or results of operations. New pronouncements and varying interpretations of pronouncements have occurred with frequency and may occur in the future and we may make changes in our accounting policies in the future. Compliance with changing regulation of corporate governance and public disclosure may result in additional expenses. Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations, PCAOB pronouncements and Nasdaq National Market rules, are creating

Table of Contents

uncertainty for companies such as ours and insurance, accounting and auditing costs are increasing as a result of this uncertainty and other factors. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we intend to invest all reasonably necessary resources to comply with evolving standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities.

In December 2004, the FASB issued Statement No. 123 (revised 2004, or SFAS 123R), "Share-Based Payment," which was originally effective for annual or interim periods beginning after June 15, 2005. SFAS 123R supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and will require companies to recognize compensation expense, using a fair-value based method, for costs related to share-based payments including stock options and stock issued under our employee stock purchase plans. In April 2005, the SEC issued a press release that revised the required date of adoption under SFAS 123R. We will be required to adopt SFAS 123R no later than the fiscal year that begins after June 15, 2005. Our adoption will be applied on a modified prospective basis and measured compensation expense will be recognized commencing on January 1, 2006. We expect that our adoption of SFAS 123R will have a material adverse impact on our consolidated results of operations.

In March 2005, the SEC issued SAB No. 107 regarding the interaction between SFAS 123R which was revised in December 2004, and certain SEC rules and regulations and provides the SEC's staff views regarding the valuation of share-based payment arrangements for public companies. We are evaluating the impact this guidance will have on our consolidated results of operations and financial position.

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3". SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle, and applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. This statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. We do not expect that adoption of this statement will have a material impact on our consolidated results of operations.

[Table of Contents](#)

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Sensitivity

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio and long-term debt obligations. Fixed rate securities and borrowings may have their fair market value adversely impacted due to fluctuations in interest rates, while floating rate securities may produce less income than expected if interest rates fall and floating rate borrowings may lead to additional interest expense if interest rates increase. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates.

Our primary investment objective is to preserve principal while at the same time maximizing yields without significantly increasing risk. Our portfolio includes money markets funds, commercial paper, medium-term notes, corporate notes, government securities, auction rate securities, corporate bonds and market auction preferreds. The diversity of our portfolio helps us to achieve our investment objective. As of June 30, 2005, approximately 84% of our investment portfolio is composed of investments with original maturities of one year or less and approximately 51% of our investment portfolio matures less than 90 days from the date of purchase. The following table presents the amounts of our cash equivalents and investments that may be subject to interest rate risk and the average interest rates as of June 30, 2005 by year of maturity (dollars in thousands):

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>Total</u>
Cash equivalents:					
Fixed rate	\$29,447	\$ —	\$ —	\$ —	\$29,447
Average fixed rate	3.20%	— %	— %	— %	3.20%
Variable rate	\$ 13	\$ —	\$ —	\$ —	\$ 13
Average variable rate	3.27%	— %	— %	— %	3.27%
Short-term investments:					
Fixed rate	\$ 9,765	\$ 9,153	\$ —	\$ —	\$18,918
Average fixed rate	2.02%	2.22%	— %	— %	2.11%
Long-term investments:					
Fixed rate	\$ —	\$ 5,910	\$2,017	\$ 999	\$ 8,926
Average fixed rate	— %	2.52%	3.35%	4.00%	2.87%
Restricted investments:					
Fixed rate	\$ 2,425	\$ —	\$ —	\$ —	\$ 2,425
Average fixed rate	0.88%	— %	— %	— %	0.88%
<hr/>					
Total investment securities	\$41,650	\$15,063	\$2,017	\$ 999	\$59,729
<hr/>					
Average rate	2.55%	2.35%	3.35%	4.00%	2.56%
<hr/>					

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures. The Company's principal executive and financial officers reviewed and evaluated the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this Form 10-Q. Based on that evaluation, the Company's principal executive and financial officers concluded that the Company's disclosure controls and procedures are effective in timely providing them with material information relating to the Company, as required to be disclosed in the reports the Company files under the Exchange Act.

Changes in Internal Control Over Financial Reporting. Mr. Thomas A. Schreck resigned as Chief Financial Officer of the Company effective April 30, 2005. However, there were no significant changes in the Company's internal control over financial reporting during the Company's most recently completed fiscal quarter that has materially

affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

[Table of Contents](#)

PART II—OTHER INFORMATION

ITEM 1. *Legal Proceedings*

We are not a party to any material legal proceedings.

ITEM 2. *Unregistered Sales of Equity Securities*

None

ITEM 3. *Defaults Upon Senior Securities*

None

ITEM 4. *Submission of Matters to a Vote of Security Holders*

On June 22, 2005, the Annual Meeting of Stockholders of DURECT Corporation was held at our offices in Cupertino, California.

An election of Class II directors was held with the following individuals being elected to our Board of Directors to serve until our annual meeting of stockholders for the year ending December 31, 2008:

David R. Hoffmann (42,344,702 votes for, 1,438,136 votes withheld)

Jon S. Saxe (37,099,909 votes for, 6,682,929 votes withheld)

Other matters voted upon and approved at the meeting and the number of affirmations, negative votes cast and abstentions with respect to each such matter were as follows:

- Amendment of the Company's 2000 Stock Plan (25,100,541 votes in favor, 7,468,289 votes opposed, 266,694 votes abstaining and 10,947,314 non-votes).
- Amendment of the Company's 2000 Directors' Stock Option Plan (24,131,084 votes in favor, 8,439,161 votes opposed, 265,279 votes abstaining and 10,947,314 non-votes).
- Ratification of the appointment of Ernst & Young LLP as our independent auditors for the fiscal year ending December 31, 2005 (43,729,307 votes in favor, 16,850 votes opposed, 36,681 votes abstaining and 0 non-votes).

ITEM 5. *Other Information*

None

Table of Contents

ITEM 6. Exhibits

(a) Exhibits:

10.42 Indenture of Lease between the Company and the Board of Trustees of the University of Alabama dated as of April 25, 2005.

31.1 Rule 13a-14(a) Section 302 Certification of James E. Brown.

31.2 Rule 13a-14(a) Section 302 Certification of Jian Li.

32.1 Certificate pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of James E. Brown.

32.2 Certificate pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of Jian Li.

[Table of Contents](#)

SIGNATURES

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

DURECT CORPORATION

By: /s/ JAMES E. BROWN

James E. Brown
Chief Executive Officer

Date: August 4, 2005

By: /s/ JIAN LI

Jian Li
Vice President, Finance and Corporate Controller
(Principal Financial and Accounting Officer)

Date: August 4, 2005