

FORM 10-Q  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

/X/ Quarterly Report Under Section 13 or 15(d)  
of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 1996

/ / Transition Report Pursuant to Section 13 or 15(d)  
of the Securities Exchange Act of 1934

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

Commission file Number 0-16109

ADVANCED POLYMER SYSTEMS, INC.  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

94-2875566  
(IRS Employer  
Identification No.)

3696 Haven Avenue, Redwood City, CA 94063  
(Address of principal executive offices)

(415) 366-2626  
(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  
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At April 30, 1996 the number of outstanding shares of the Company's common stock, par value \$.01, was 17,839,922.

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ADVANCED POLYMER SYSTEMS, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(UNAUDITED)

March 31, 1996    December 31, 1995

	-----	-----
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 5,547,418	\$ 5,172,809
Trade accounts receivable, net	4,137,488	2,436,815
Inventory	6,575,638	7,858,584
Prepaid expenses and other	898,022	1,001,672
	-----	-----
Total current assets	17,158,566	16,469,880
Property and equipment, net	4,839,533	5,027,034
Deferred loan costs, net	815,362	832,324
Prepaid license fees	269,167	303,638
Intangible assets, including goodwill, net	1,475,618	345,557
Other assets	62,460	103,809
	-----	-----
	\$ 24,620,706	\$ 23,082,242
	=====	=====
<b>LIABILITIES &amp; SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,357,761	\$ 3,240,807
Accrued expenses	2,373,169	1,819,541
Accrued melanin purchase commitments	--	600,000
Accounts payable, Johnson & Johnson	3,731,445	4,229,637
Deferred revenues	750,000	750,000
Notes payable	500,000	--
Current portion - long-term debt	950,984	853,987
	-----	-----
Total current liabilities	9,663,359	11,493,972
Long-term debt	6,215,583	6,354,969
	-----	-----
Total liabilities	15,878,942	17,848,941
	-----	-----
Shareholders' equity:		
Common stock and common stock warrants	72,957,736	67,423,859
Unrealized gain on securities	6,231	12,348
Accumulated deficit	(64,222,203)	(62,202,906)
	-----	-----
Total shareholders' equity	8,741,764	5,233,301
	-----	-----
	\$ 24,620,706	\$ 23,082,242
	=====	=====

See accompanying notes.

ADVANCED POLYMER SYSTEMS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (UNAUDITED)

	3 Months Ended March 31, 1996 -----	3 Months Ended March 31, 1995 -----
Product revenues	\$ 5,103,472	\$ 4,286,219
Licensing revenues	50,000	855,000
	-----	-----
Total revenues	5,153,472	5,141,219
Cost of sales	3,304,806	3,023,046
Research & development	889,956	931,229
Selling & marketing	1,440,681	1,104,241
Advertising & promotion	596,887	273,163
General & administration	670,021	746,606
	-----	-----
Total expenses	6,902,351	6,078,285
	-----	-----
Operating loss	(1,748,879)	(937,066)
Interest income	38,956	97,984
Interest expense	(299,078)	(66,180)
Other expense	(10,296)	(4,343)
	-----	-----
Net loss	(\$ 2,019,297)	(\$ 909,605)
	=====	=====
Loss per common share	(\$ 0.12)	(\$ 0.06)
	=====	=====
Weighted average common shares outstanding	17,354,858	16,179,214
	=====	=====

See accompanying notes.

ADVANCED POLYMER SYSTEMS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 FOR THREE MONTHS ENDED MARCH 31, 1996 AND 1995  
 (UNAUDITED)

	March 31, 1996	March 31, 1995
	-----	-----
Cash flows from operating activities:		
Net loss	(\$2,019,297)	(\$ 909,605)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	418,627	288,022
Change in allowance for doubtful accounts	(1,308)	2,205
Accretion of marketable securities	--	(41,159)
Changes in operating assets and liabilities:		
Trade accounts receivable	(1,699,365)	(1,446,008)
Inventory	1,282,946	(1,977,778)
Prepaid expenses and other	103,650	34,467
Other assets	20,344	16,898
Current liabilities	(1,827,610)	3,669,417
	-----	-----
Net cash used in operating activities	(3,722,013)	(363,541)
	-----	-----
Cash flows from investing activities:		
Purchases of fixed assets	(61,225)	(192,429)
Purchase of marketable securities	(512,513)	(979,058)
Maturities and sales of marketable securities	506,396	1,476,845
	-----	-----
Net cash provided from (used in) investing activities	(67,342)	305,358
	-----	-----
Cash flows from financing activities:		
Proceeds from the exercise of common stock options	730,309	211,644
Proceeds from long-term debt and warrants	150,000	--
Proceeds from notes payable	500,000	--
Repayment of long-term debt	(192,389)	(31,300)
Proceeds from sale of common stock, net of costs	2,976,044	1,375,261
	-----	-----
Net cash provided from financing activities	4,163,964	1,555,605
	-----	-----
Net increase in cash and cash equivalents	374,609	1,497,422
Cash and cash equivalents, beginning of the period	5,172,809	2,741,994
	-----	-----
Cash and cash equivalents, end of the period	\$ 5,547,418	\$ 4,239,416
	=====	=====

Supplemental disclosure of non-cash financing transactions:

During the first quarter of 1996, the Company acquired all rights to the Polytrap technology from Dow Corning Corporation in exchange for shares of Common Stock valued at \$1,200,000.

During the first quarter of 1996, the Company paid Biosource for the 1995 purchase commitment totalling \$600,000 by issuing 94,000 shares of Common Stock.

See accompanying notes.

ADVANCED POLYMER SYSTEMS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
MARCH 31, 1996 AND 1995  
(UNAUDITED)

(1) BASIS OF PRESENTATION

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting of normal recurring adjustments) necessary to present fairly the financial position of Advanced Polymer Systems, Inc. and subsidiaries ("the Company") as of March 31, 1996 and the results of their operations and their cash flows for the three months ended March 31, 1996 and 1995.

These condensed consolidated statements should be read in conjunction with the Company's audited consolidated financial statements for the years ended December 31, 1995, 1994 and 1993.

The condensed consolidated financial statements include the financial statements of the Company and its subsidiaries, Premier, Inc. ("Premier"), Advanced Consumer Products, Inc., APS Analytical Standards, Inc., and APS Joint Venture Corporation. All significant intercompany balances and transactions have been eliminated in consolidation.

The business of Premier, the Company's marketing and distribution subsidiary, is highly seasonal in that it markets and distributes sunscreen products under an exclusive distribution agreement with Johnson & Johnson. In addition, effective September 1995, the Company licensed from Reckitt & Colman the exclusive U.S. rights to the Neet(R) line of depilatory products. Sales of the two sunscreen products and the depilatory product line are heavily weighted to the first two quarters of the calendar year, so the results of operations for the interim periods are not necessarily indicative of the results for the full year.

The Company considers all short-term investments which have original maturities of less than three months to be cash equivalents. Investments which have original maturities longer than three months are classified as marketable securities in the accompanying balance sheets.

Certain reclassifications have been made to the prior year financial statements to conform with the presentation in 1996.

## (2) COMMON SHARES OUTSTANDING AND PER SHARE INFORMATION

Common stock outstanding as of March 31, 1996 is as follows:

	Number of Shares -----
Common stock outstanding as of December 31, 1995	17,026,666
Options exercised after December 31, 1995	139,439
Shares issued to Lander Company	356,761
Shares issued in debt financing arrangements	10,675
Shares issued for acquisition of all rights to the Polytrap technology from Dow Corning	200,000
Shares issued to pay Biosource for the 1995 Melanin commitment	94,000
	-----
TOTAL SHARES	17,827,541 =====

Per share information is based on the weighted average number of shares of common stock outstanding, as adjusted during each of the periods. Stock options and warrants (common stock equivalents) are not included in the calculations as their inclusion would be anti-dilutive.

## (3) SALE OF COMMON STOCK

In the first quarter of 1996, the Company formed a collaborative agreement with the Lander Company under which the Company received \$2,976,000 in net proceeds from the sale of 356,761 shares of common stock. In addition, the Company will receive licensing fees, royalties on product sales and research and development funding in the future.

## (4) ACQUISITION OF ALL RIGHTS TO POLYTRAP TECHNOLOGY

In the first quarter of 1996, APS acquired all rights to the Polytrap technology from Dow Corning in exchange for 200,000 shares of APS Common Stock. APS recorded intangible assets totalling \$1,200,000 relating to this transaction. The intangible assets are being amortized on a straight line basis over a period of approximately 10 years, which is the remaining life of the main patent acquired.

## (5) NOTES PAYABLE

During the first quarter of 1996, the Company received advances from a supplier totalling \$500,000, with an interest rate equal to the Prime Rate. Interest and principal are due in October 1996.

## (6) SUBSEQUENT EVENT

In the second quarter of 1996, the Company entered into an agreement for the sale of up to \$5,000,000 of common stock and warrants, which can be initiated at the Company's sole discretion. In May 1996, the Company executed the sale of common stock and warrants totalling \$2,000,000.

## ITEM 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS  
(ALL DOLLAR AMOUNTS ROUNDED TO THE NEAREST THOUSAND)

## RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED MARCH 31, 1996 AND 1995

To the extent that this report discusses financial projections, information or expectations about our products or markets, or otherwise makes statements about future events, such statements are forward-looking and are subject to a number of risks and uncertainties that could cause actual results to differ materially from the statements made. These include, among others, uncertainty associated with timely approval and acceptance of new products, the costs associated with new product introductions, establishment of new corporate alliances, progress in research and development programs and other risks listed from time to time in the Company's Securities and Exchange Commission filings.

Revenues for the three month period ended March 31, 1996 totalled \$5,153,000 compared to \$5,141,000 in the corresponding period of the prior year. Product revenues increased by 19% to \$5,103,000 from \$4,286,000 while licensing revenues totalled \$50,000 compared to \$855,000 in the year-ago quarter.

The increase in product revenues was primarily attributable to sales of the Neet(R) depilatory which was licensed from Reckitt & Colman in the third quarter of 1995, and increased shipments of the Exact line of OTC acne medication products. Additionally, sales of the Everystep foot powder also increased due to a sampling program. These increases were partially offset by a decrease in orders from Scott Paper Co. due to that company's merger with Kimberly-Clark, and a reduction in sales of Take-Off makeup remover because the first quarter of 1995 included pipeline fill on the launch of the new Microsponge(R)-entrapped version.

Licensing fees decreased by \$805,000 because the first quarter of 1995 included a milestone payment of \$750,000 from Johnson & Johnson on the filing of the New Drug Application (NDA) on Microsponge-entrapped tretinoin.

Gross profit on product revenues for the first quarter of 35% increased by 6 percentage points due mainly to the increased percentage of higher margin consumer products, primarily Neet.

Research and development expense decreased by \$41,000 or 4% due to reduced spending on now-completed clinical studies, partially offset by increased expenses associated with patent applications. Selling and marketing expense increased by

\$336,000 or 30% due to higher variable costs associated with rising product sales volume and expanded activities in the ethical pharmaceutical and personal care markets. Advertising and promotion costs increased by \$324,000 or 119% due primarily to a sampling program for consumer products. General and administrative expense decreased by \$77,000 or 10% due primarily to general cost-containment measures.

Interest income decreased by \$59,000 or 60% due to lower interest rates on lower average cash balances. Interest expense increased by \$233,000 or 352% as a result of debt financings arranged in the second half of 1995 whereby the Company raised \$7.4 million.

The net loss for the quarter ended March 31, 1996 of \$2,019,000 represented an increase of \$1,110,000 over the quarter ended March 31, 1995.

#### CAPITAL RESOURCES AND LIQUIDITY

Total assets as of March 31, 1996 were \$24,621,000 compared with \$23,082,000 at December 31, 1995, and working capital increased to \$7,495,000 from \$4,976,000. In the same period, cash and cash equivalents increased to \$5,547,000 from \$5,173,000. During the first quarter, Company operations used \$3,722,000 of cash. The Company invested approximately \$900,000 in product research and development and \$2,000,000 in selling, marketing and promoting new products.

The Company has financed its operations, including product research and development, from amounts raised in debt and equity financings, the sale of consumer products, Microsponge delivery systems and analytical standard products; payments received under licensing agreements; and interest earned on short-term investments.

In the first quarter of 1996, the Company formed a collaborative agreement with the Lander Company under which the Company received \$2,976,000 in net proceeds from the sale of stock, and will receive licensing fees, royalties on product sales and research and development funding in the future. In addition, the Company received \$730,000 in proceeds from the exercise of common stock options during the quarter.

In prior years, cash was expended with regard to Phase III clinical tests of tretinoin entrapped in a Microsponge delivery system for the treatment of acne, and of APS' melanin-Microsponge sun protectant product, together with related research and development costs, all of which decreased substantially in 1995 following the filing of the respective NDAs. Additionally, the Company is contractually obligated to purchase minimum annual quantities of melanin. Failure to purchase the minimum quantities results in a mandatory annual payment of \$600,000 to its melanin supplier under "take or pay" provisions. The minimum financial commitments not yet expensed by the Company under the current agreements are \$600,000 per annum for each of the years in the two year period ending December 31, 1998, in aggregate \$1,200,000.

In the second quarter of 1996, the Company entered into an agreement for the sale of up to \$5,000,000 of common stock and warrants, which can be initiated at the Company's sole discretion. This, together with the Company's existing cash and cash equivalents, collections of trade accounts receivable, interest income and other revenue producing activities including milestone payments, are expected to be sufficient to meet the Company's near-term cash requirements assuming no changes to existing business plans.

PART II.

Item 1. Legal Proceedings

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits: 10-V - Investment Agreement between Registrant  
and the Lander Company

27 Financial Data Schedules

(b) Reports on Form 8-K: None

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.

ADVANCED POLYMER SYSTEMS, INC.

Date: May 14, 1996

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By: /s/ John J. Meakem, Jr.

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John J. Meakem, Jr.  
Chairman, President and  
Chief Executive Officer

Date: May 14, 1996

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By: /s/ Michael O'Connell

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Michael O'Connell  
Chief Financial Officer

EXHIBIT INDEX

Form 10-Q

ADVANCED POLYMER SYSTEMS, INC.

10-V -Investment Agreement between Registrant and the Lander Company  
27 -Financial Data Schedules.

## INVESTMENT AGREEMENT

AGREEMENT effective the 26th day of March, 1996, by and between ADVANCED POLYMER SYSTEMS, INC. ("APS") and LHC CORPORATION ("PURCHASER").

## R E C I T A L S

A. APS and PURCHASER are entering into a License and Supply Agreement (the "License Agreement") with respect to certain of the proprietary technologies of APS.

B. In connection with the License Agreement, APS desires to sell to PURCHASER, and PURCHASER desires to buy from APS, shares of APS Common Stock (the "Shares").

IT IS THEREFORE, AGREED as follows:

## 1. PURCHASE AND SALE OF SHARES.

## 1.1 Definitions.

(a) "Common Stock" means the Common Stock, \$.01 par value, of APS.

(b) "Share" means one of the shares of Common Stock being purchased hereunder.

(c) "Act" means the Securities Act of 1933, as amended.

(d) "Material Adverse Event" shall mean an occurrence having a consequence that is materially adverse as to the business, properties, prospects or financial condition of APS.

(e) "Subsidiary" constitutes any corporation more than 50% (by virtue of voting rights) of whose stock in the aggregate is owned directly or indirectly by APS and any partnership in which APS, directly or indirectly, owns more than 50% in interest or participation.

1.2 Sale and Issuance of Shares. Subject to the terms and conditions hereof, APS shall sell to PURCHASER and PURCHASER shall buy from APS at the Closing (as defined below) for a total consideration of \$3,000,000, that number of Shares which is equal to \$3,000,000 divided by the average closing price of APS Common Stock on the Nasdaq National Market for the 20 trading days ending on the day immediately preceding the Closing (as hereinafter defined).

## 1.3 Closing.

(a) Closing Date. The closing of the purchase and sale of the Shares (the "Closing") shall take place on March 25, 1996, or such other date as APS and PURCHASER may agree.

(b) Time and Place. The Closing shall take place at the offices of Heller, Ehrman, White & McAuliffe, 525 University Avenue, Suite 1100, Palo Alto, California, on the designated date at 10:00 a.m., or at such other place and time as APS and PURCHASER may agree.

1.4 Deliveries at the Closing. At the Closing, APS shall deliver to PURCHASER certificates for the Shares, in such denominations and registered in such name or names as PURCHASER may designate by notice to APS against delivery to APS of the purchase price for such Shares in immediately available funds.

2. REPRESENTATIONS AND WARRANTIES OF APS. APS hereby represents and warrants to the PURCHASER that:

## 2.1 Corporate Organization and Authority. APS:

(a) is a corporation duly incorporated and in good standing in the State of Delaware, and is authorized to exercise its corporate powers in that state;

(b) has full corporate power and authority to own and operate its properties and assets and to carry on its business as conducted; and

(c) has been duly qualified and is in good standing to do business as a foreign corporation in the states of California and Louisiana, which are the only jurisdictions in which the conduct of its business requires such qualification.

## 2.2 Capitalization. The authorized capital of APS consists of:

(a) Preferred Stock. 2,500,000 shares of Preferred Stock, \$.01 par value, none of which are issued or outstanding.

(b) Common Stock. 50,000,000 shares of Common Stock, of which 17,096,708 shares are validly issued (including, without limitation, issued in compliance with applicable federal and state securities laws) and outstanding, fully-paid and non-assessable as of January 31, 1996.

(c) Other Securities. As of January 31, 1996, APS has available for issuance 3,024,850 shares of Common Stock under APS's Stock Option Plans and outstanding warrants to purchase up to 1,628,211 shares of Common Stock. There are no other rights, warrants, options, conversion privileges,

subscriptions or other rights or agreements, either directly or indirectly, to purchase or otherwise acquire or issue any equity securities of APS.

2.3 Corporate Power. APS has and will have at Closing all requisite legal and corporate power to execute and deliver this Agreement and to sell and issue the Shares.

2.4 Subsidiaries. Except for Premier Inc. and APS Analytical Standards, Inc., each of which is wholly owned by APS, APS has no Subsidiaries.

2.5 Authorization. All corporate action on the part of APS necessary for the authorization, execution and delivery of this Agreement, the performance of APS's obligations hereunder, and for the authorization, sale, issuance and delivery of the Shares has been taken or will be taken prior to Closing. This Agreement, when executed and delivered, shall constitute a legally binding valid obligation of APS enforceable in accordance with its terms, subject to laws of general application relating to bankruptcy, insolvency and the relief of debtors and rules of law governing specific performance, injunctive relief or other equitable remedies and subject to limitations of public policy as they may effect the enforceability of the indemnification and contribution provisions of Section 6.6.

2.6 Validity of Shares. The Shares, when issued, sold and delivered in accordance with the terms and for the consideration expressed in this Agreement, shall be duly and validly issued (including, without limitation, in compliance with applicable federal and state securities laws), fully-paid and non-assessable.

2.7 Financial Statements. The audited financial statements of APS and the related notes (the "Audited Financial Statements") included in APS's Annual Report on Form 10-K for the fiscal year ended December 31, 1994 (the "1994 10-K") and the unaudited financial statements and the related notes (the "Unaudited Financial Statements") included in APS's Quarterly Reports on Form 10-Q for the fiscal quarters ended March 31, June 30 and September 30, 1995 (the "1995 10-Q's") are complete and correct in all material respects, present fairly the financial position and results of operations of APS at the dates and for the periods to which they relate, are in accordance with the books and records of APS, and have been prepared in accordance with generally accepted accounting principles consistently applied (to the extent required for interim reports with respect to the Unaudited Financial Statements).

2.8 Changes in Condition. Except as disclosed in the 1995 10-Q's, there has not been since December 31, 1994, any change in the business, properties, prospects or financial condition of APS which would constitute a Material Adverse Event.

## 2.9 Patents and Other Proprietary Rights.

(a) To the best knowledge of APS: (i) APS has sufficient rights to use all patents, patent applications, inventions, trademarks, service marks, trade names and copyrights, all licenses with respect to the foregoing, and all trade secrets, information, proprietary rights and processes necessary to the proper conduct of its business; and (ii) such business does not conflict with or constitute an infringement of the rights of others;

(b) APS has not received any communications alleging that APS has violated or, by conducting its business as proposed, would violate any of the patents, patent applications, inventions, trademarks, service marks, trade names, copyrights or trade secrets, information, proprietary rights or processes of any other person or entity; and

(c) APS has obtained from all key employees and consultants to APS agreements with respect to the confidentiality and non-disclosure of proprietary information of APS.

2.10 Compliance With Other Agreements. APS is not in violation of any term or provision of its Certificate of Incorporation or By-laws, or any material term or provision of any indebtedness, mortgage, indenture, contract, agreement, judgment or, to APS's knowledge, any decree, order, statute, rule or regulation applicable to APS, in each case, or in the aggregate, the violation of which would constitute a Material Adverse Event. The execution, delivery and performance of this Agreement and the issuances of the Shares by APS will not result in any violation of, be in conflict with, or constitute a default under, with or without the passage of time or the giving of notice, any provision of APS's Certificate of Incorporation or By-laws, any material contract, obligation or commitment to which APS is a party or by which it is bound, or any provision of any judgment, decree or order to which APS is a party or by which it is bound.

2.11 Governmental Consents. No consent, approval, order or authorization of, or registration, qualification, designation, declaration or filing with, any federal, state, local or provincial governmental authority on the part of APS is required in connection with the consummation of the transactions contemplated by this Agreement, except for possible filings pursuant to Section 25102 (f) of the California Corporate Securities Law of 1968, as amended, and the rules thereunder, other applicable blue sky filings and Regulation D promulgated under the Act, which filings will be effected if necessary within 15 days of the Closing.

2.12 Private Offering. Assuming the accuracy of the representations and warranties of PURCHASER contained in Section 3 hereof, the offer, issue and sale of the Shares are and will be

exempt from the registration and prospectus delivery requirements of the Act, and have been registered or qualified (or are exempt from registration and qualification) under the registration, permit or qualification requirement of all applicable state securities laws.

2.13 Full Disclosure. The representations and warranties of APS contained in this Agreement and the information included in the 1994 10-K and the 1995 10-Q's, when read together, do not contain any untrue statements of a material fact or omit any material fact necessary to make the statements contained therein or herein in view of the circumstances under which they were made not misleading; provided, however, that no representation or warranty is made by APS that any financial or market projections, product development schedules or forecasts will, in fact, be achieved; provided, further, that with respect to such projections, schedules and forecasts, APS represents that such projections, schedules and forecasts were prepared in good faith.

3. REPRESENTATIONS AND WARRANTIES OF PURCHASER. PURCHASER represents and warrants to APS as follows:

3.1 Investment Intent. This Agreement is made with PURCHASER in reliance upon PURCHASER's representation to APS that the Shares to be received by PURCHASER will be acquired for investment for PURCHASER's own account, not as a nominee or agent, and not with a view to the sale or distribution of any part thereof, and that PURCHASER has no present intention of selling, granting any participation in, or otherwise distributing the same. PURCHASER further represents that PURCHASER has no contract, undertaking, agreement or arrangement with any person to sell, transfer or grant participation to such person or to any third person, with respect to any of the Shares.

3.2 Shares Not Registered. PURCHASER understands and acknowledges that the Shares will not be registered under the Act on the grounds that the offering and sale of securities contemplated by this Agreement are exempt from registration under the Act, and that APS's reliance upon such exemption is predicated upon PURCHASER's representations set forth in this Agreement.

3.3 Rule 144. PURCHASER covenants that in no event will PURCHASER dispose of any of the Shares (other than pursuant to Rule 144 promulgated by the Securities and Exchange Commission ("Commission") under the Act ("Rule 144") or pursuant to a registration statement filed with the Commission pursuant to the Act) unless and until:

(a) PURCHASER shall have notified APS of the proposed disposition and shall have furnished APS with a statement of the circumstances surrounding the proposed disposition; and

(b) if requested by APS, PURCHASER shall have furnished APS with an opinion of PURCHASER's counsel reasonably satisfactory in form and substance to APS and APS's counsel to the effect that: (i) such disposition will not require registration under the Act; and (ii) appropriate action necessary for compliance with the Act and any applicable state, local or foreign law has been taken. The restrictions on transfer imposed by this Section 3 shall cease and terminate as to the Shares when: (1) such securities shall have been effectively registered under the Act and sold by the holder thereof in accordance with such registration; or (2) an opinion of the kind described in the preceding sentence states that all future transfers of such securities by the holder thereof would be exempt from registration under the Act. Each certificate evidencing the Shares shall bear an appropriate restrictive legend as set forth in Section 3.6 below, except that such certificate shall not bear such legend if the transfer was made in compliance with Rule 144 or pursuant to a registration statement or, if the opinion of counsel referred to above is to the further effect that such legend is not required in order to establish compliance with any provisions of the Act.

3.4 No Short Sales. PURCHASER further covenants that, until the Registration Statement referred to in Section 6.2 hereof is declared effective, PURCHASER will not:

(a) sell any equity security of APS if PURCHASER does not own the security sold (or, if PURCHASER owns such security, PURCHASER shall deliver it against such sale within 20 days thereafter); or

(b) engage in any other transaction which involves the "selling short", as that term is generally understood in the securities industry, of any equity security of APS.

3.5 Accredited Investor. PURCHASER is an "Accredited Investor" as that term is defined in Regulation D promulgated under the Act, and has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of PURCHASER's prospective investment in the Shares: (a) PURCHASER has received all the information it has requested from APS and considers necessary or appropriate for deciding whether to purchase the Shares; (b) PURCHASER has the ability to bear the economic risks of PURCHASER's prospective investment; and (c) PURCHASER is able, without materially impairing its financial condition, to hold the Shares for an indefinite period of time and to suffer complete loss on its investment.

3.6 Legends.

(a) All certificates for the Shares shall bear the following legend:

"The securities represented hereby have not been registered under the Securities Act of 1933, as amended ("Act"). Such securities may not be transferred unless a Registration Statement under the Act is in effect as to such transfer or in the opinion of counsel for the issuer, an exemption from registration is then available."

(b) The certificates evidencing the Shares shall also bear any legend required by the Commissioner of Corporations of the State of California or required pursuant to any state, local or foreign law governing such securities.

3.7 Reports under Securities Exchange Act of 1934. With a view to making available to the PURCHASER the benefits of Rule 144 and any other rule or regulation of the Commission that may at any time permit the PURCHASER to sell securities of APS to the public without registration, APS agrees to:

(a) make and keep public information available, as those terms are defined in Rule 144;

(b) file with the Commission in a timely manner all reports and other documents required of APS under the Act and the Securities Exchange Act of 1934 (the "1934 Act"); and

(c) furnish to the PURCHASER, so long as the PURCHASER owns any Shares forthwith upon request: (i) a written statement by APS that it has complied with the reporting requirements of Rule 144, the Act and the 1934 Act; (ii) a copy of the most recent annual or quarterly report of APS and such other reports and document so filed by APS; and (iii) such other information as may be reasonably requested in availing the PURCHASER of any rule or regulation of the Commission which permits the selling of any such securities without registration.

4. CONDITIONS OF PURCHASER'S OBLIGATIONS AT CLOSING. The obligations of PURCHASER under Section 1 of this Agreement are subject to the fulfillment at or before the Closing of each of the following conditions, any of which may be waived in writing by PURCHASER:

4.1 Representations and Warranties. The representations and warranties of APS contained in Section 2 shall be true in all material respects on and as of the Closing with the same effect as if made on and as of the Closing.

4.2 Covenants. APS shall have performed or fulfilled all agreements, obligations and conditions contained herein required to be performed or fulfilled by APS before the Closing.

4.3 Proceedings Satisfactory. All corporate and legal proceedings taken by APS in connection with the transactions contemplated by this Agreement and all documents and papers

relating to such transactions shall be satisfactory to PURCHASER, in the reasonable exercise of its judgment.

4.4 Qualifications. All authorizations, approvals or permits, if any, of any governmental authority or regulatory body that are required in connection with the lawful sale and issuance of the Shares pursuant to this Agreement shall have been duly obtained and shall be effective on and as of the Closing.

4.5 Nasdaq Listing. APS shall have filed an application to list the Shares for quotation on the Nasdaq National Market System.

4.6 Compliance Certificate. APS shall have delivered to PURCHASER a certificate dated as of the Closing, signed by APS' President, certifying that the conditions set forth in Sections 4.1, 4.2, 4.4 and 4.5 have been satisfied.

5. CONDITIONS OF APS'S OBLIGATIONS AT CLOSING. The obligations of APS under Section 1 of this Agreement are subject to the fulfillment at or before the Closing of each of the following conditions, any of which may be waived in writing by APS:

5.1 Representations and Warranties. The representations and warranties of PURCHASER contained in Section 3 shall be true on and as of the Closing with the same effect as though said representations and warranties had been made on and as of each the Closing.

5.2 Performance of Obligations. PURCHASER shall have performed and complied with all agreements and conditions herein required to be performed or complied with by it on or before the Closing.

5.3 Qualifications. All authorizations, approvals or permits, if any, of any governmental authority or regulatory body that are required in connection with the lawful sale and issuance of the Shares pursuant to this Agreement shall have been duly obtained and shall be effective on and as of the Closing.

6. REGISTRATION RIGHTS; LISTING.

6.1 Certain Definitions. As used in this Section 6, the following terms shall have the following respective meanings:

(a) "Commission" shall mean the Securities and Exchange Commission or any other federal agency at the time administering the Securities Act.

(b) "Convertible Securities" shall mean securities of APS convertible into or exchangeable for Registrable Securities.

(c) "Holder" shall mean any holder of outstanding Registrable Securities which have not been sold to the public, but only if such holder is PURCHASER or an assignee or transferee of Registration rights as permitted by Section 6.7.

(d) The terms "Register", "Registered" and "Registration" refer to a registration effected by preparing and filing a registration statement in compliance with the Securities Act ("Registration Statement"), and the declaration or ordering of the effectiveness of such Registration Statement.

(e) "Registrable Securities" shall mean the Shares purchased by or issued to PURCHASER at the Closing, including any Common Stock issued with respect to the Shares pursuant to stock splits, stock dividends and similar distributions, so long as such Shares have not been sold to the public in a public distribution or a public securities transaction or sold in a single transaction exempt from the registration and prospectus delivery requirements of the Securities Act such that all transfer restrictions and restrictive legends with respect to such Shares shall have been removed in connection with such sale.

(f) "Registration Expenses" shall mean all expenses incurred by APS in complying with this Section 6, including, without limitation, all federal and state registration, qualification and filing fees, printing expenses, fees and disbursements of counsel for APS, blue sky fees and expenses, and the expense of any special audits incident to or required by any such Registration.

(g) "Securities Act" shall mean the Securities Act of 1933, as amended, or any similar federal statute, and the rules and regulations of the Commission thereunder, all as the same shall be in effect at the time.

(h) "Selling Expenses" shall mean all underwriting discounts and selling commissions applicable to the sale of Registrable Securities pursuant to this Agreement.

## 6.2 Registration.

6.2.1 Registration. Subject to the terms of this Agreement, APS shall use its best efforts to effect Registration of the Registrable Securities by filing a Registration Statement with the Commission within 30 days after the Closing. APS shall use its best efforts to effect such Registrations on Form S-3 (or any successor to Form S-3) so long as APS is eligible to register securities on Form S-3 for an offering of Registrable Securities by the PURCHASER or any Holder; if APS is not so eligible, it shall use its best efforts to effect such Registrations on Form S-1. As of the date hereof, APS is eligible to register securities on Form S-3.

6.2.2 Registration of Other Securities. The Registration Statement filed under this Section 6 may include securities of APS other than Registrable Securities; provided, however, that neither PURCHASER or any Holder shall be required to utilize an underwriter in connection with the sale of their Registrable Securities.

6.2.3 Blue Sky. In connection with the Registration pursuant to Section 6, APS will exercise its best efforts to Register and qualify the securities covered by the Registration Statement under such other securities or Blue Sky laws of such jurisdictions (not to exceed twenty) as shall be reasonably appropriate for the distribution of such securities; provided, however, that:

(a) APS shall not be required to qualify to do business or to file a general consent to service of process in any such states or jurisdictions, unless APS is already subject to service in such jurisdiction; and

(b) notwithstanding anything in this Agreement to the contrary, in the event any jurisdiction in which the securities shall be qualified imposes a non-waivable requirement that expenses incurred in connection with the qualification of the securities be borne by selling shareholders, such expenses shall be payable pro rata by selling shareholders.

6.3 Expenses of Registration. All Registration Expenses (but not Selling Expenses) incurred in connection with the Registration pursuant to Section 6 shall be borne by APS.

6.4 Registration Procedures. Subject to the other provisions of this Agreement, APS shall, as expeditiously as reasonably possible:

(a) Prepare and file with the Commission a Registration Statement with respect to such securities within 30 days from the date of the Closing and use its diligent best efforts to cause such Registration Statement to become effective as promptly as possible thereafter and to remain effective for a period equal to the shorter of: (i) two years from the date of the Closing; or (ii) until the distribution described in the Registration Statement has been completed.

(b) Prepare and file with the Commission such amendments and supplements to such Registration Statement and the prospectus used in connection with such Registration Statement as may be necessary to comply with the provisions of the Securities Act with respect to the disposition of all securities covered by such Registration Statement.

(c) Furnish to the Holders participating in such Registration and the underwriters, if any, of the securities being Registered, such reasonable number of copies of the

Registration Statement, preliminary prospectus and final prospectus as they may request in order to facilitate the public offering of such securities.

6.5 Information Furnished by Holder. It shall be a condition precedent of APS's obligations under this Agreement that each Holder of Registrable Securities included in any Registration furnish to APS such information regarding such Holder and the distribution proposed by such Holder as APS may reasonably request.

6.6 Indemnification.

6.6.1 Company's Indemnification of Holder. To the extent permitted by law, APS will indemnify each Holder, each of the officers, directors, employees and constituent partners, and each person controlling such Holder, with respect to which Registration, qualification or compliance of Registrable Securities has been effected pursuant to this Agreement, from and against all claims, losses, damages or liabilities (or actions in respect thereof) to the extent such claims, losses, damages or liabilities arise out of or are based upon any untrue statement (or alleged untrue statement) of a material fact contained in any prospectus or other document (including any related Registration Statement) incident to any such Registration, qualification or compliance, or are based on any omission (or alleged omission) to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, or any violation by APS of any rule or regulation promulgated under the Securities Act applicable to APS and relating to action or inaction required of APS in connection with any such Registration, qualification or compliance; and APS will reimburse each such Holder, each such underwriter and each person who controls any such Holder or underwriter, for any legal and any other expenses reasonably incurred in connection with defending any such claim, loss, damage, liability or action; provided, however, that the indemnity contained in this Section 6.6.1 shall not apply to amounts paid in settlement of any such claim, loss, damage, liability or action if settlement is effected without the consent of APS (which consent shall not unreasonably be withheld) and; provided, further, that APS will not be liable in any such case to the extent that any such claim, loss, damage, liability or expense arises out of or is based upon any untrue statement or omission based upon written information furnished to APS by such Holder or controlling person and stated expressly to be for use in connection with the offering of securities of APS.

6.6.2 Holder's Indemnification of Company. To the extent permitted by law, each Holder will, if Registrable Securities held by such Holder are included in the securities as to which such Registration, qualification or compliance is being effected pursuant to this Agreement, indemnify APS, each of its directors, officers and employees, each person who controls APS within the meaning of the Securities Act, each other such Holder,

and each of its officers, directors, employees and constituent partners, and each person controlling such other Holder, from and against all claims, losses, damages and liabilities (or actions in respect thereof) arising out of or based upon any untrue statement (or alleged untrue statement) of a material fact contained in any such Registration Statement, prospectus, offering circular or other document, or any omission (or alleged omission) to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, or any violation by such Holder of any rule or regulation promulgated under the Securities Act applicable to such Holder and relating to action or inaction required of such Holder in connection with any such Registration, qualification or compliance; and will reimburse APS, such Holder, such directors, officers, employees, partners, persons or control persons for any legal and any other expenses reasonably incurred in connection with defending any such claim, loss, damage, liability or action, in each case to the extent, but only to the extent, that such untrue statement (or alleged untrue statement) or omission (or alleged omission) is made in such Registration Statement, prospectus, offering circular or other document in reliance upon and in conformity with written information furnished to APS by such Holder and specifically approved in writing by such Holder for use in connection with the offering of securities of APS; provided, however, that the indemnity contained in this Section 6.6.2 shall not apply with respect to a Holder to amounts paid in settlement of any claim, loss, damage, liability or action if settlement is effected without the consent of such Holder (which consent shall not be unreasonably delayed or withheld).

6.6.3 Indemnification Procedure. Promptly after receipt by an indemnified party under this Section 6.6 of notice of the commencement of any action, such indemnified party will, if a claim in respect thereof is to be made against an indemnifying party under this Section 6.6, notify the indemnifying party in writing of the commencement thereof and generally summarize such action. The indemnifying party shall have the right to participate in and to assume the defense of such claim; provided, however, that the indemnifying party shall be entitled to select counsel for the defense of such claim with the approval of any parties entitled to indemnification, which approval shall not be unreasonably withheld; provided, further, that if either party reasonably determines that there may be a conflict between the position of APS and a Holder in conducting the defense of such action, suit or proceeding by reason of recognized claims for indemnity under this Section 6.6, then counsel for such party shall be entitled to conduct the defense to the extent reasonably determined by such counsel to be necessary to protect the interest of such party. The failure to notify an indemnifying party promptly of the commencement of any such action, if prejudicial to the ability of the indemnifying party to defend such action, shall relieve such indemnifying party, to the extent so prejudiced, of any liability to the indemnified party under this Section 6.6, but the omission so to

notify the indemnifying party will not relieve such party of any liability that such party may have to any indemnified party otherwise other than under this Section 6.6.

6.7 Transfer of Rights. The right to cause APS to Register securities granted by APS to PURCHASER under this Agreement may be assigned by any Holder to a transferee or assignee of any Registrable Securities not sold to the public acquiring at least 50,000 shares of such Holder's Registrable Securities (equitably adjusted for any stock splits, subdivisions, stock dividends, changes, combinations or the like); provided, however, that:

(a) APS must receive written notice prior to the time of said transfer, stating the name and address of said transferee or assignee and identifying the securities with respect to which such information and Registration rights are being assigned; and

(b) the transferee or assignee of such rights must not be a person deemed by the Board of Directors of APS, in its best judgment, to be a competitor or potential competitor of APS. Notwithstanding the limitations set forth in the foregoing sentence respecting the minimum number of shares which must be transferred and permitted transferees and assignees: (i) any Holder which is a partnership may transfer such Holder's Registration rights to such Holder's constituent partners without restriction as to the number or percentage of shares acquired by any such constituent partner; and (ii) Section 6.7(b) shall not prohibit the transfer or assignment of such rights to an affiliate of the PURCHASER.

6.8 Nasdaq Listing. Prior to Closing, APS shall file an application to list the Shares for quotation on the Nasdaq National Market System.

6.9 Limits on Resale. Notwithstanding the foregoing, in consideration of the Registration and listing, PURCHASER on its own behalf and that of its successors and assigns, agrees not to sell any of the Shares until the Registration Statement is declared effective, and after the Registration Statement has been declared effective with respect to the Shares, PURCHASER and its successors and assigns may sell in the public market in any calendar quarter no more than 25% of the Shares.

## 7. MISCELLANEOUS.

7.1 Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the State of California applicable to contracts entered into and wholly to be performed within the State of California by California residents.

7.2 Successors and Assigns. Subject to the exceptions specifically set forth in this Agreement, the terms and

conditions of this Agreement shall inure to the benefit of and be binding upon the respective executors, administrators, heirs, successors and assigns of the parties.

7.3 Entire Agreement. This Agreement and any Exhibits and Schedule hereto constitute the entire contract between APS and the PURCHASER relative to the subject matter hereof. Any previous agreement between APS and the PURCHASER with respect to the subject matter hereof is superseded by this Agreement.

7.4 Severability. Any invalidity, illegality or limitation of the enforceability with respect to PURCHASER of any one or more of the provisions of this Agreement, or any part thereof, whether arising by reason of the law of PURCHASER's domicile or otherwise, shall in no way affect or impair the validity, legality or enforceability of this Agreement with respect to other investors. In case any provision of this Agreement shall be invalid, illegal or unenforceable, it shall to the extent practicable, be modified so as to make it valid, legal and enforceable and to retain as nearly as practicable the intent of the parties, and the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby.

7.5 Amendment of Agreement. Any provision of this Agreement may be amended only by a written instrument signed by APS and by PURCHASER.

7.6 Notices. Any notice required or permitted hereunder shall be given in writing and shall be conclusively deemed effectively given upon personal delivery, or five days after deposit in the United States mail, by registered or certified mail, postage prepaid, addressed:

(a) if to APS, Advanced Polymer Systems, Inc., 3696 Haven Avenue, Redwood City, California 94063, ATTENTION: President; and

(b) if to PURCHASER, LHC Corporation, ATTENTION: President.

7.7 Headings. The headings of the sections of this Agreement are for convenience and shall not by themselves determine the interpretation of this Agreement.

7.8 Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

IN WITNESS WHEREOF, the parties have executed this Agreement.

ADVANCED POLYMER SYSTEMS, INC.

By: John J. Meakem, Jr.

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Title: Chairman, CEO and President

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LEC CORPORATION

By: Francis Ziegler

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Title: Chairman

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