
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2009

OR

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

For the transition period from _____ to _____

Commission File Number 001-33221

A.P. PHARMA, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation)

123 Saginaw Drive
Redwood City CA
(Address of principal executive offices)

94-2875566
(I.R.S. Employer
Identification No.)

94063
(Zip Code)

(650) 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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Small reporting company

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

At July 31, 2009, the number of outstanding shares of the Company's common stock, par value \$.01, was 31,376,432.

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A.P. Pharma, Inc.
Condensed Balance Sheets
(in thousands)

	<u>June 30, 2009</u> <u>(unaudited)</u>	<u>December 31, 2008</u> <u>(Note 1)</u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 3,610	\$ 9,967
Marketable securities	194	571
Accounts receivable	11	32
Prepaid expenses and other current assets	165	246
Total current assets	<u>3,980</u>	<u>10,816</u>
Property and equipment, net	684	881
Other long-term assets	128	103
Total assets	<u>\$ 4,792</u>	<u>\$ 11,800</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 554	\$ 344
Accrued expenses	1,239	2,222
Accrued disposition costs	621	621
Total current liabilities	<u>2,414</u>	<u>3,187</u>
Deferred revenue	1,000	1,000
Other long-term liabilities	—	15
Total liabilities	<u>3,414</u>	<u>4,202</u>
Stockholders' equity:		
Common stock	139,337	138,692
Accumulated deficit	(137,953)	(131,051)
Accumulated other comprehensive loss	(6)	(43)
Total stockholders' equity	<u>1,378</u>	<u>7,598</u>
Total liabilities and stockholders' equity	<u>\$ 4,792</u>	<u>\$ 11,800</u>

See accompanying notes to condensed financial statements.

A.P. Pharma, Inc.
Condensed Statements of Operations (unaudited)
(in thousands, except per share amounts)

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2009</u>	<u>2008</u>	<u>2009</u>	<u>2008</u>
Contract revenue	\$ 14	\$ 152	\$ 22	\$ 284
Operating expenses:				
Research and development	2,908	5,538	4,958	11,678
General and administrative	1,066	863	1,993	1,943
Total operating expenses	<u>3,974</u>	<u>6,401</u>	<u>6,951</u>	<u>13,621</u>
Operating loss	(3,960)	(6,249)	(6,929)	(13,337)
Interest income, net	19	155	27	436
Other income, net,	—	4	1	7
Loss from continuing operations	(3,941)	(6,090)	(6,901)	(12,894)
Income (loss) from discontinued operations	—	(40)	—	(80)
Net loss	<u>\$ (3,941)</u>	<u>\$ (6,130)</u>	<u>\$ (6,901)</u>	<u>\$ (12,974)</u>
Basic and diluted net loss per share:				
Loss from continuing operations	<u>\$ (0.13)</u>	<u>\$ (0.20)</u>	<u>\$ (0.22)</u>	<u>\$ (0.42)</u>
Net loss	<u>\$ (0.13)</u>	<u>\$ (0.20)</u>	<u>\$ (0.22)</u>	<u>\$ (0.42)</u>
Shares used to compute basic and diluted net				
Loss per share	<u>31,016</u>	<u>30,800</u>	<u>30,943</u>	<u>30,786</u>

See accompanying notes to condensed financial statements.

A.P. Pharma, Inc.
Condensed Statements of Cash Flows (unaudited)
(in thousands)

	<u>Six Months Ended June 30,</u>	
	<u>2009</u>	<u>2008</u>
Cash flows from operating activities:		
Net loss	\$ (6,901)	\$ (12,974)
Adjustments to reconcile net loss to net cash used in operating activities:		
Loss from discontinued operations	—	80
Depreciation and amortization	182	204
Stock-based compensation expense	620	578
Loss on retirement of fixed asset	17	—
Changes in operating assets and liabilities:		
Accounts receivable	21	(20)
Prepaid expenses and other current assets	81	93
Other long-term assets	(25)	(28)
Accounts payable	211	(152)
Accrued expenses	(999)	(1,067)
Net cash used in continuing operating activities	(6,793)	(13,286)
Net cash provided by discontinued operations	—	19
Net cash used in operating activities	(6,793)	(13,267)
Cash flows from investing activities:		
Purchases of property and equipment	(2)	(288)
Maturities of marketable securities	414	372
Net cash provided by investing activities	412	84
Cash flows from financing activities:		
Proceeds from the exercise of stock options	4	2
Proceeds from the issuance of shares under the Employee Stock Purchase Plan	23	27
Repurchase of restricted stock	(3)	—
Net cash provided by financing activities	24	29
Net decrease in cash and cash equivalents	(6,357)	(13,154)
Cash and cash equivalents, beginning of the period	9,967	33,510
Cash and cash equivalents, end of the period	<u>\$ 3,610</u>	<u>\$ 20,356</u>

See accompanying notes to condensed financial statements.

A.P. Pharma, Inc.
Notes to Condensed Financial Statements
June 30, 2009 and 2008 (unaudited)

(1) BUSINESS AND BASIS OF PRESENTATION

A.P. Pharma, Inc. (the “Company”, “we”, “our”, or “us”) is a specialty pharmaceutical company focused on developing pharmaceutical products using our proprietary Biochronomer polymer-based drug delivery technology. Our primary focus is on our lead product candidate, APF530, which during 2008 completed a pivotal Phase III clinical trial for the prevention of chemotherapy-induced nausea and vomiting (“CINV”). In May 2009 we submitted our new drug application (“NDA”) for approval of APF530 to the U.S. Food and Drug Administration (“FDA”). The NDA was accepted for review by the FDA in July 2009 and based on the Prescription Drug User Fee Act (PDUFA), the FDA has issued an action date of March 18, 2010.

Our core Biochronomer technology, on which APF530 and our other products are based, consists of bioerodible polymers designed to release drugs over a defined period of time. We have completed over 100 *in vivo* and *in vitro* studies demonstrating that our Biochronomer technology is potentially applicable to a range of therapeutic areas, including prevention of nausea and vomiting, pain management, control of inflammation and treatment of ophthalmic diseases. We have also completed comprehensive animal and human toxicology studies that have established that our Biochronomer polymers are safe and well tolerated. Furthermore, our Biochronomer technology can be designed to deliver drugs over periods varying from days to several months.

In addition to our lead drug candidate, we have a pipeline of other product candidates that use our Biochronomer technology. Further development of our pipeline products has been temporarily deferred in order to focus corporate resources, both managerial and financial, on the APF530 NDA and negotiations of a commercialization partnership for this CINV prevention product.

The accompanying unaudited condensed financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. All adjustments (all of which are of a normal recurring nature) considered necessary for a fair presentation have been included. We have evaluated subsequent events through August 4, 2009, which is the date that these financial statements were issued. Operating results for the three and six months ended June 30, 2009 are not indicative of the results that may be expected for the year ending December 31, 2009 or for any other period. The condensed balance sheet as of December 31, 2008 has been derived from the audited financial statements as of that date but it does not include all of the information and notes required by U.S. GAAP. These condensed financial statements and the notes thereto should be read in conjunction with the audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2008 filed with the Securities and Exchange Commission (the “SEC”) on March 30, 2009 (our “2008 10-K”).

Our financial statements for 2008 contain an explanatory paragraph in the auditors’ opinion regarding our ability to continue as a going concern. The accompanying financial statements have been prepared assuming we will continue as a going concern. We have incurred significant operating losses and negative cash flows from operations and have an accumulated deficit of \$138 million as of June 30, 2009.

At June 30, 2009, we had cash, cash equivalents and marketable securities of \$3.8 million and working capital of \$1.6 million which we believe will enable us to fund our operations into the fourth quarter of 2009, based on our expected spending levels and certain anticipated positive cash inflows.

We are seeking additional financing to continue our activities, which may include a collaborative arrangement, an equity offering or other alternatives. If we are unable to obtain sufficient financing, we may be required to further reduce, defer or discontinue our activities or may not be able to continue as a going concern.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. GAAP requires our management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ significantly from those estimates. On an on-going basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates are discussed in our 2008 10-K.

Recent Accounting Pronouncements

With the exception of those discussed below, and those adopted and discussed in Note 2, there have been no recent accounting pronouncements or changes in accounting pronouncements during the six months ended June 30, 2009, as compared to the recent accounting pronouncements described in our 2008 10-K, that are of significance, or potential significance to the Company.

On June 3, 2009, the Financial Accounting Standards Board (“FASB”) approved the “*FASB Accounting Standards Codification*”, or the Codification, as the single source of authoritative nongovernmental Generally Accepted Accounting Principles, or GAAP, in the United States. The Codification will be effective for interim and annual periods ending after September 15, 2009, which means the quarterly period beginning July 1, 2009 for AP Pharma, Inc. Upon the effective date, the Codification will be the single source of authoritative accounting principles to be applied by all nongovernmental U.S. entities. All other accounting literature not included in the Codification will be nonauthoritative. We do not expect the adoption of the Codification to have an impact on our financial position or results of operations.

In June 2009, the FASB issued the following new accounting standards:

- SFAS No. 166, “*Accounting for Transfers of Financial Assets*”, an amendment of FASB Statement No. 140, or SFAS 166;
- SFAS No. 167, “*Amendments to FASB Interpretation No. 46(R)*”, or SFAS 167; and
- SFAS No. 168, “*The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162*”, or SFAS 168

SFAS 166 prescribes the information that a reporting entity must provide in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor’s continuing involvement in transferred financial assets. Specifically, among other aspects, SFAS 166 amends Statement of Financial Standard No. 140, “*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*”, or SFAS 140, by removing the concept of a qualifying special-purpose entity from SFAS 140 and removes the exception from applying FASB Interpretation No. 46, “*Consolidation of Variable Interest Entities (revised December 2003) — an interpretation of ARB No. 51*”, or FIN 46(R) to variable interest entities that are qualifying special-purpose entities. It also modifies the financial-components approach used in SFAS 140. SFAS 166 is effective for the transfer of financial assets occurring on or after January 1, 2010. Historically, we have not had any material transfer of financial assets and believe the effect will generally be limited to future transactions.

SFAS 167 amends FIN 46(R) to require an enterprise to determine whether its variable interest or interests give it a controlling financial interest in a variable interest entity. The primary beneficiary of a variable interest entity is the enterprise that has both (1) the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance and (2) the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. SFAS 167 also amends FIN 46(R) to require ongoing reassessments of whether an enterprise is the primary beneficiary of a

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variable interest entity. SFAS 167 is effective for all variable interest entities and relationships with variable interest entities existing as of January 1, 2010. We do not expect the adoption of this standard to have a material impact on our financial position or results of operations.

SFAS 168 replaces SFAS No. 162, “*The Hierarchy of Generally Accepted Accounting Principles*”, to establish the *FASB Accounting Standards Codification* as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in preparation of financial statements in conformity with generally accepted accounting principles in the United States. SFAS 168 is effective for interim and annual periods ending after September 15, 2009. We do not expect the adoption of this standard to have a material impact on our financial position or results of operations.

(2) CASH EQUIVALENTS AND MARKETABLE SECURITIES

At June 30, 2009 and December 31, 2008, the amortized cost and estimated fair value of investments in debt securities and cash equivalents are set forth in the tables below:

<u>June 30, 2009</u> <u>(in thousands)</u>	<u>Amortized</u> <u>Cost</u>	<u>Gross</u> <u>Unrealized</u> <u>Gains</u>	<u>Gross</u> <u>Unrealized</u> <u>Losses</u>	<u>Estimated</u> <u>Fair Value</u>
Available-for-sale:				
Asset-backed securities (included in marketable securities)	\$ 200	\$ —	\$ (6)	\$ 194
Money market fund (included in cash and cash equivalents)	3,394	—	—	3,394
Total available-for-sale	<u>\$ 3,594</u>	<u>\$ —</u>	<u>\$ (6)</u>	<u>\$ 3,588</u>
<u>December 31, 2008</u> <u>(in thousands)</u>	<u>Amortized</u> <u>Cost</u>	<u>Gross</u> <u>Unrealized</u> <u>Gains</u>	<u>Gross</u> <u>Unrealized</u> <u>Losses</u>	<u>Estimated</u> <u>Fair Value</u>
Available-for-sale:				
Asset-backed securities (maturing within one year and included in marketable securities)	\$ 614	\$ —	\$ (43)	\$ 571
Money market fund (included in cash and cash equivalents)	9,882	—	—	9,882
Total available-for-sale	<u>\$ 10,496</u>	<u>\$ —</u>	<u>\$ (43)</u>	<u>\$ 10,453</u>

At June 30, 2009 and December 31, 2008 all available-for sale investments are expected to mature within one year.

We consider our investments in marketable securities as available-for-sale and, accordingly, we have recorded these investments at fair value. Our cash, cash equivalents and marketable securities as of June 30, 2009 and December 31, 2008 consist of approximately 95% of a money market fund containing U.S. Government-backed or collateralized overnight securities and the remainder in asset-backed securities with the underlying assets consisting of pools of residential mortgages. We assessed the decline in the fair value of the asset-backed securities of \$6,000 as of June 30, 2009 to be temporary, as we do not intend to sell the securities, believe we will not be required to sell the securities before recovering their cost and expect to recover the securities' entire amortized cost. There is significant judgment in the determination of when an other-than-temporary decline in value has occurred. We evaluate our investment securities for other-than-temporary declines based on quantitative and qualitative factors. There were no realized gains or losses for the three months ended June 30, 2009 or 2008.

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Fair Value Measurements

The tables that follow summarize the basis used to measure certain assets at fair value on a recurring basis in our balance sheet at June 30, 2009 and December 31, 2008 (in thousands).

The three tier value hierarchy utilized prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which require us to develop our own assumptions. The hierarchy requires us to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, we measure our available-for-sale securities at fair value.

	Basis of Fair Value Measurements			
	Balance at June 30, 2009	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 3,394	\$ 3,394	\$ —	\$ —
Asset-backed securities	194	—	194	—
Total	\$ 3,588	\$ 3,394	\$ 194	\$ —

	Basis of Fair Value Measurements			
	Balance at December 31, 2008	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 9,882	\$ 9,882	\$ —	\$ —
Asset-backed securities	571	—	571	—
Total	\$ 10,453	\$ 9,882	\$ 571	\$ —

The following methods and assumptions were used to determine the fair value of each class of assets recorded at fair value in the balance sheets:

Cash equivalents: Cash equivalents consist of highly rated money market funds with maturities of one year or less, and are purchased daily at par value with specified yield rates. Due to the high ratings and short-term nature of these funds, we consider all cash equivalents as Level 1 inputs.

Short-term available-for-sale investments at fair value: Fair values are based on quoted market prices, where available. These fair values are obtained from third party pricing services, which generally use Level 1 or Level 2 inputs for the determination of fair value in accordance with SFAS 157. Third party pricing services normally derive the security prices through recently reported trades for identical or similar securities making adjustments through the reporting date based upon available market observable information. For securities not actively traded, the third party pricing services may use quoted market prices of comparable instruments or discounted cash flow analyses, incorporating inputs that are currently observable in the markets for similar securities. Inputs that are often used in valuation methodologies include, but are not limited to, benchmark yields, reported trades, broker/dealer quotes, issuer spreads, benchmark securities, bids, offers and reference data. We utilize third party pricing services to obtain fair value and we generally obtain one price for each individual security. We review the fair value hierarchy classification. Changes in the observability of valuation inputs may result in a reclassification of levels for certain securities within the fair value hierarchy.

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Investment securities are exposed to various risks, such as interest rate, market and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is possible that changes in these risk factors in the near term could have an adverse impact on our results of operations or stockholders' equity.

The carrying amounts reflected in our balance sheets for cash, accounts receivable, accounts payable and accrued expenses approximate fair value because of the short-term nature of these items.

Effective January 1, 2009, we implemented Statement of Financial Standards No. 157, "*Fair Value Measurements*", or SFAS 157, for our non-financial assets and liabilities that are re-measured at fair value on a non-recurring basis. The adoption of SFAS 157 for our non-financial assets and liabilities that are re-measured at fair value on a non-recurring basis did not impact our financial position or results of operations; however, could have an impact in future periods.

Effective this quarter, we implemented FSP FAS 157-4, "*Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*", or FSP FAS 157-4. FSP FAS 157-4 provides additional guidelines for making fair value measurements more consistent with the principles presented in SFAS 157 and provides authoritative guidance in determining whether a market is active or inactive, and whether a transaction is distressed. This FSP is applicable to all assets and liabilities (i.e. financial and nonfinancial) and requires enhanced disclosures, including interim and annual disclosure of the input and valuation techniques (or changes in techniques) used to measure fair value and the defining of the major security types comprising debt and equity securities held based upon the nature and risk of the security. The adoption of this FSP did not have a material impact our financial position or results of operations.

Effective this quarter, we also implemented FSP FAS 107-1 and APB 28-1, "*Interim Disclosures about Fair Value of Financial Instruments*", or FSP FAS 107-1. FSP FAS 107-1 amended Statement of Financial Accounting Standards No. 107, "*Disclosures about Fair Value of Financial Instruments*", and APB Opinion No. 28, "*Interim Financial Reporting*", to require disclosures about the fair value of financial instruments in interim as well as in annual financial statements. The adoption of this FSP did not have a material impact our financial position or results of operations.

Impairments

We adopted the provisions of FSP FAS 115-2 on April 1, 2009. FSP No. FAS 115-2 and FAS 124-2, "*Recognition and Presentation of Other-than-Temporary Impairments*", or FSP FAS 115-2, amended the other-than-temporary impairment model for debt securities. The impairment model for equity securities was not affected.

Under this FSP, an other-than-temporary impairment must be recognized through earnings if an investor has the intent to sell the debt security or if it is more likely than not that the investor will be required to sell the debt security before recovery of its amortized cost basis. However, even if an investor does not expect to sell a debt security, it must evaluate expected cash flows to be received and determine if a credit loss has occurred. In the event of a credit loss, only the amount associated with the credit loss is recognized in income. The amount of loss relating to other factors is recorded in accumulated other comprehensive income. The FSP also requires additional disclosures regarding the calculation of credit losses and the factors considered in reaching a conclusion that an investment is not other-than-temporarily impaired. The adoption of the FSP did not have a material impact on our financial position or results of operations.

We conduct periodic reviews to identify and evaluate each investment that has an unrealized loss, in accordance with FSP FAS 115-1, "*The Meaning of Other-than-Temporary Impairment and its Application to Certain Investments*", or FSP FAS 115-1, and FSP FAS 115-2. An unrealized loss exists when the current fair value of an individual security is less than its amortized cost basis. Unrealized losses on available-for-sale securities that are determined to be temporary, and not related to credit loss, are recorded, net of tax, in accumulated other comprehensive income.

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For available-for-sale debt securities with unrealized losses, management performs an analysis to assess whether we intend to sell or whether we would more likely than not be required to sell the security before the expected recovery of the amortized cost basis. Where we intend to sell a security, or may be required to do so, the security's decline in fair value is deemed to be other-than-temporary and the full amount of the unrealized loss is recorded within earnings as an impairment loss.

Regardless of our intent to sell a security, we perform additional analysis on all securities with unrealized losses to evaluate losses associated with the creditworthiness of the security. Credit losses are identified where we do not expect to receive cash flows sufficient to recover the amortized cost basis of a security.

For equity securities, when assessing whether a decline in fair value below our cost basis is other-than-temporary, we consider the fair market value of the security, the duration of the security's decline, and the financial condition of the issuer. We then consider our intent and ability to hold the equity security for a period of time sufficient to recover our carrying value. Where we have determined that we lack the intent and ability to hold an equity security to its expected recovery, the security's decline in fair value is deemed to be other-than-temporary and is recorded within earnings as an impairment loss.

Prior to our adoption of FSP FAS 115-2 in the current quarter, we recognized impairments under the previously effective guidance contained within SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities".

No impairment losses were recognized through earnings related to available-for-sale securities during the three or six months ended June 30, 2009 or 2008.

For the three and six months ended June 30, 2009 and 2008, we recognized in other comprehensive income (loss), \$16,000, \$37,000, \$(3,000) and \$(16,000), respectively, in gains (charges) associated with the temporary impairment of available-for-sale securities primarily related to mortgage and asset-backed securities.

(3) NET LOSS PER SHARE INFORMATION

Basic and diluted net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding. Diluted net loss per share excludes the effect of potentially dilutive securities because they are anti-dilutive. Such potentially dilutive securities at June 30, 2009 include outstanding stock options for 3,248,600 common shares and unearned restricted stock awards for 140,000 common shares.

(4) STOCK-BASED COMPENSATION

The following table shows the stock-based compensation expense for all awards (in thousands except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Operating expenses:				
Research and development	\$ 66	\$ 220	\$ 129	\$ 285
General and administrative	338	63	491	293
Total stock-based compensation expense	\$ 404	\$ 283	\$ 620	\$ 578
Impact on basic and diluted net loss per common share	\$.01	\$.01	\$.02	\$.02

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The following table summarizes option activity for the six months ended June 30, 2009:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)
Outstanding at January 1, 2009	2,701,073	\$ 2.38	8.41
Granted	991,500	\$ 0.67	
Exercised	(5,386)	\$ 0.71	
Expired and Forfeited	(438,587)	\$ 1.97	
Outstanding at June 30, 2009	<u>3,248,600</u>	\$ 1.91	8.24

Employee Stock Purchase Plan. We adopted an Employee Stock Purchase Plan (the "Purchase Plan") in 1997. Qualified employees may elect to have a certain percentage of their salary withheld to purchase shares of our common stock under the Purchase Plan. The purchase price per share is equal to 85% of the fair market value of the stock on specified dates. Sales under the Purchase Plan in the six month periods ended June 30, 2009 and 2008 were 57,336 and 26,103 shares at an average price of \$0.42 and \$1.03, respectively. Shares available for future purchase under the Purchase Plan are 200,007 at June 30, 2009.

(5) COMPREHENSIVE LOSS

Comprehensive loss for the three and six months ended June 30, 2009 and 2008 consists of the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net loss	\$(3,941)	\$(6,130)	\$(6,901)	\$(12,974)
Unrealized (losses) gains on available-for-sale marketable securities	16	(4)	37	(16)
Comprehensive loss	<u>\$(3,925)</u>	<u>\$(6,134)</u>	<u>\$(6,864)</u>	<u>\$(12,990)</u>

(6) INCOME TAXES

There is no provision for income taxes for the three or six months ended June 30, 2009 or 2008 because we incurred net operating losses.

(7) STOCKHOLDERS' EQUITY

At our annual meeting in May 2009, our shareholders approved an amendment to our Amended and Restated Certificate of Incorporation to increase the total number of shares of common stock authorized for issuance from 50,000,000 to 100,000,000 shares. They also approved an amendment to increase by 200,000 the number of shares of common stock reserved for issuance under our Employee Stock Purchase Plan.

On December 18, 2006, we entered into a Preferred Shares Rights Agreement. As part of this agreement, preferred stock purchase rights ("the rights") were distributed to stockholders of record as of January 2, 2007 (and to each person who acquires our common stock after that date unless determined otherwise by the board of directors) at the rate of one right for each share of common stock held. The rights become exercisable only upon the acquisition, or the acquisition of the right to acquire, by a person or group of

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affiliated or associated persons, of 20% (amended to 30% or more with regard to Tang Capital Partners, LP and its affiliates) or more of the outstanding shares of our common stock. Once exercisable, each right entitles the holder to purchase, at a price of \$44.00, one one-thousandth of a share of Series A Participating Preferred Stock. For a limited period of time following the announcement of any such acquisition or offer, the rights are redeemable by us at a price of \$0.01 per right. If the rights are not redeemed or exchanged, each right will then entitle the holder to receive, upon exercise of such right, a number of shares of our common stock having a then current value equal to two times the purchase price of such right. Similarly, if the rights are not redeemed or exchanged and following the acquisition of 20% (amended to 30% or more with regard to Tang Capital Partners, LP and its affiliates) or more of the outstanding shares of our common stock by a person or group of affiliated or associated persons, (i) we consolidate with or merge into another entity, (ii) another entity consolidates with or merges into us or (iii) we sell or otherwise transfer 50% or more of its consolidated assets or earning power, each right will then entitle the holder to receive, upon exercise of such right, a number of shares of common stock of the acquiring company having a then current value equal to two times the purchase price. For a limited period of time after the exercisability of the rights, each right, at the discretion of the board of directors, may be exercised for such number of shares of common stock determined in accordance with the rights agreement. We have initially reserved 200,000 shares of preferred stock pursuant to the exercise of these rights. These rights expire on December 31, 2016.

(8) DISCONTINUED OPERATIONS

We completed the sale of certain assets of our Analytical Standards division as well as certain technology rights for our topical pharmaceutical and cosmeceutical product lines and other assets (“cosmeceutical and toiletry business”) in February 2003 and July 2000, respectively.

The Analytical Standards division and cosmeceutical and toiletry business are reported as discontinued operations for all periods presented in the accompanying Condensed Statements of Operations.

Loss from discontinued operations represents primarily the loss attributable to changes in estimates of our cosmeceutical and toiletry business that was sold to RP Scherer on July 25, 2000, as follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2009	2008	2009	2008
<u>Analytical Standards Division</u>				
Royalties earned in excess of minimum amount recorded	\$ —	\$ —	\$ —	\$ —
<u>Cosmeceutical and Toiletry Business</u>				
Change in estimates for gross profit guarantees	—	(40)	—	(80)
Total loss from discontinued operations	<u>\$ —</u>	<u>\$ (40)</u>	<u>\$ —</u>	<u>\$ (80)</u>

Basic and diluted loss per common share from discontinued operations was nil and less than \$0.01 per share for the three and six months ended June 30, 2009 and 2008, respectively.

The cash provided by discontinued operations of \$19,000 in 2008 relates primarily to royalties received from GFS Chemicals, Inc. (“GFS”), a privately held company based in Columbus, Ohio, from sales of Analytical Standards products.

On February 13, 2003, we completed the sale of our Analytical Standards division to GFS. In this transaction, we received \$2.1 million on closing and were entitled to receive royalties on sales of Analytical Standards products for a period of five years following the sale at rates ranging from 5% to 15%. As of March 31, 2008, all royalties due from GFS have been received.

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In conjunction with the terms of an agreement with RP Scherer, a subsidiary of Cardinal Health, pursuant to which we sold certain technology rights associated with our cosmeceutical and toiletry business, we guaranteed a minimum gross profit percentage on RP Scherer's combined sales of products to Ortho Neutrogena and Dermik ("Gross Profit Guaranty"). The guaranty period initially commenced on July 1, 2000 and was to end on the earlier of July 1, 2010 or the end of two consecutive guaranty periods where the combined gross profit on sales to Ortho and Dermik equals or exceeds the guaranteed gross profit (the "two period test"). The Gross Profit Guaranty expense totaled \$944,000 for the first seven guaranty years and in those years profits did not meet the two period test. Effective March 2007, in conjunction with a sale of assets by RP Scherer's successor company to an Amcol International subsidiary ("Amcol"), a new agreement was signed between us and Amcol to provide continuity of product supply to Ortho and Dermik. This new agreement potentially extends the Gross Profit Guaranty period an additional three years to July 1, 2013, unless it is terminated earlier with the two period test. Amcol has indicated that its costs differ from those it charged historically to the RP Scherer successor company to produce the products. We have not paid any Gross Profit Guaranty amount asserted by Amcol, and have requested documentation of their actual costs. As there is no minimum amount of Gross Profit Guaranty due, no accrual for the guaranty is estimable for future years. A liability of \$621,000 related to the amount due under Gross Profit Guarantees is included in accrued disposition costs as of June 30, 2009 and December 31, 2008.

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

Forward-looking Statements

This Form 10-Q contains "forward-looking statements" as defined by the Private Securities Reform Act of 1995. These forward-looking statements involve risks and uncertainties including uncertainties associated with capital resources and liquidity, timely development and regulatory approval of product candidates, establishment of new corporate alliances, progress in research and development programs, launch and acceptance of new products and other risks and uncertainties identified in the our filings with the Securities and Exchange Commission. We caution investors that forward-looking statements reflect our analysis only on their stated date. We do not intend to update them except as required by law.

Results of Operations for the Three and Six Months Ended June 30, 2009 and 2008

Contract revenue, which is derived from work performed under collaborative research and development arrangements, was \$14,000, \$152,000, \$22,000 and \$284,000 for the three months ended June 30, 2009 and 2008 and the six months ended June 30, 2009 and 2008, respectively. The amount of contract revenue varies from period to period depending on the level of activity requested of us by our collaborators. Therefore, we cannot predict the amount of contract revenue in future periods.

Our revenue has been derived principally from contract revenue. In January 2006, we completed the sale of our rights to royalties on sales of Retin-A Micro® and Carac® for up to \$30 million. We received proceeds of \$25 million upon the closing of the transaction and received a \$2.5 million milestone payment in June 2007. We may receive up to an additional \$2.5 million based on the satisfaction of certain predetermined milestones. As a result of this transaction, there were no royalties for the first half of 2009 or 2008. We will not record additional royalty revenue on sales of Retin-A Micro® and Carac® in future periods.

Research and development expense for the three months ended June 30, 2009 decreased by \$2.6 million from \$5.5 million for the three months ended June 30, 2008 to \$2.9 million. Research and development expense for the six months ended June 30, 2009 decreased by \$6.7 million from \$11.7 million to \$5.0 million. The decreases in research and development expenses for the three and six months ended June 30, 2009 as compared with comparable periods in 2008 are primarily due to decreased expenditures related to APF530, largely as a result of the completion of our Phase III trial for APF530. Research and development expenses for the three and six months ended June 30, 2009 include the FDA filing fee for our APF530 NDA of approximately \$1.25 million. Additionally, in late 2008 we placed our other product candidates "on hold" to focus our financial and managerial resources on APF 530. As a result, we had reductions in force in November 2008 and May 2009, resulting in lower payroll and related expenses. Changes in the rate of research and development expenses for the remaining quarters of 2009 will depend primarily on the availability of financial resources to continue our current research and development activities.

General and administrative expense increased for the three months ended June 30, 2009 by \$203,000 from \$863,000 for the three months ended June 30, 2008 to \$1,066,000 primarily as a result of stock-based compensation expense, salary and bonuses for our CEO and CFO hired in the third quarter of 2008 and first quarter of 2009, respectively. General and administrative expense was \$2.0 million for the six months ended June 30, 2009 as compared with \$1.9 million for the comparable period of 2008. Increases in payroll and related for the six months ended June 30, 2009 are largely offset by decreases in outside expenses as a result of cost containment measures or of performing tasks in-house. Changes in the rate of general and administrative expenses for the remaining quarters of 2009 will depend primarily on the achievement of corporate goals and stock-based compensation and/or retention efforts.

Net interest income decreased for the six months ended June 30, 2009 by \$409,000 to \$27,000 from \$436,000 for the six months ended June 30, 2008 primarily due to lower average balances of cash, cash equivalents and marketable securities, as a result of operating losses and lower interest rates. As a result of the current world-wide financial situation, we have invested most of our available cash equivalents in a money market fund containing U.S. Government-backed or collateralized overnight securities.

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Loss from discontinued operations represents the net income/loss from the cosmeceutical and toiletries business which was sold to RP Scherer Corporation in July 2000. Net loss from discontinued operations totaled \$0 and \$40,000 for the three months ended June 30, 2009 and 2008 and \$0 and \$80,000 for the six months ended June 30, 2009 and 2008, respectively.

Capital Resources and Liquidity

Cash, cash equivalents and marketable securities decreased by \$6.7 million to \$3.8 million at June 30, 2009 from \$10.5 million at December 31, 2008 due primarily to our net loss for the six months ended June 30, 2009.

Net cash used in continuing operating activities for the six months ended June 30, 2009 was \$6.8 million, compared to net cash used of \$13.3 million for the six months ended June 30, 2008. The decrease in net cash used by continuing operating activities in 2009 was mainly due to the decreased loss for the six months ended June 30, 2009, as compared to the same period in 2008.

Net cash provided by investing activities for the six months ended June 30, 2009 was \$412,000 compared to net cash provided of \$84,000 from investing activities for the six months ended June 30, 2008. The change in 2009 from 2008 in cash flows associated with investing activities was primarily due to lower purchases of property and equipment.

To date, we have financed our operations, including technology and product research and development, through the sale of common stock, royalties received on sales of Retin-A Micro® and Carac®, income from collaborative research and development fees, the proceeds received from the sales of our Analytical Standards division and our cosmeceutical and toiletry business, interest earned on short-term investments and the sale of our interest in the royalty income from Retin-A Micro® and Carac®.

At June 30, 2009, we had cash, cash equivalents and marketable securities of \$3.8 million and working capital of \$1.6 million, which we believe will enable us to fund our operations into the fourth quarter of 2009, based on our expected spending levels and certain anticipated positive cash inflows.

Our capital requirements going forward will depend on numerous factors including, among others: our ability to enter into licensing agreements and collaborative research and development arrangements; time required to gain regulatory approvals for our product candidates; progress of product candidates; investment in new research and development programs; resources that we devote to self-funded products; potential acquisitions of technology, product candidates or businesses; and the costs of defending or prosecuting any patent opposition or litigation necessary to protect our proprietary technology.

We are seeking additional financing to continue our activities, which may include a collaborative arrangement, an equity offering or other alternatives. If we are unable to obtain sufficient financing, we may be required to further reduce, defer or discontinue our activities or may not be able to continue as a going concern.

We may not be able to raise sufficient additional capital when we need it or to raise capital on favorable terms. The sale of additional equity or convertible debt securities in the future may be dilutive to our stockholders, and debt financing arrangements may require us to pledge certain assets and enter into covenants that could restrict certain business activities or our ability to incur further indebtedness and may contain other terms that are not favorable to us or our stockholders. If we are unable to obtain adequate funds on reasonable terms, we may be required to curtail operations significantly or to obtain funds by entering into financing, supply or collaboration agreements on unattractive terms.

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Below is a summary of fixed payments related to certain contractual obligations (in thousands). This table excludes amounts already recorded on our condensed balance sheet as current liabilities at June 30, 2009.

	<u>Total</u>	<u>Less than 1 year</u>	<u>2 to 3 years</u>	<u>4 to 5 Years</u>	<u>More than 5 years</u>
Other Operating Leases	<u>\$ 999</u>	<u>\$ 563</u>	<u>\$ 427</u>	<u>\$ 9</u>	<u>\$ —</u>

Off- Balance Sheet Arrangements

As of June 30, 2009 we did not have any off-balance sheet arrangements.

Item 3. Quantitative and Qualitative Disclosure about Market Risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments. We manage our interest rate risk by maintaining an investment portfolio primarily consisting of debt instruments of high credit quality and relatively short average maturities. Due to the financial crisis and our anticipated cash flow requirements, we have maintained 95% of our available cash, cash equivalents and marketable securities in cash and a money market fund containing U.S. Government-backed or collateralized overnight securities.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures: We carried out an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) and 15(d)-15(e) of the Securities and Exchange Act of 1934. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2009, the end of period covered by this report, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in internal controls: During the three months ended June 30, 2009, there have been no significant changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Not applicable.

Item 1A. Risk Factors

There have been no material changes to the risk factors set forth in the “Risk Factors” section of our 2008 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders

Our annual shareholders’ meeting was held on May 27, 2009, at which all of the following four proposals were approved.

Proposal I: Election of the following directors:

	<u>Votes For</u>	<u>Votes Withheld</u>
Paul Goddard	21,669,201	3,826,593
Ronald Prentki	24,990,360	505,434
Toby Rosenblatt	24,970,506	525,288
Kevin C. Tang	25,008,975	486,819
Gregory Turnbull	24,979,027	516,767
Robert Zerbe	24,987,887	507,907

Proposal II: To approve an amendment to the Company’s Amended and Restated Certificate of Incorporation to increase the total number of authorized shares of the Company’s common stock from 50,000,000 to 100,000,000.

<u>Votes For</u>	<u>Votes Against</u>	<u>Abstain</u>	<u>Non-Votes</u>
24,521,924	933,393	40,477	0

Proposal III: To approve an amendment to the Company’s 1997 Employee Stock Purchase Plan (“ESPP”) to increase by 200,000 the number of shares of common stock reserved for issuance under the Company’s ESPP.

<u>Votes For</u>	<u>Votes Against</u>	<u>Abstain</u>	<u>Non-Votes</u>
17,014,209	230,126	12,211	8,239,248

Proposal IV: To ratify the appointment of Odenberg, Ullakko, Muranishi & Co. LLP as the Company’s independent registered public accounting firm for the year ending December 31, 2009.

<u>Votes For</u>	<u>Votes Against</u>	<u>Abstain</u>	<u>Non-Votes</u>
24,502,763	79,819	913,212	0

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Item 5. Other Information

Not applicable.

Item 6. Exhibits –

Exhibit 3.1 Copy of Registrant’s Certificate of Incorporation, as amended as of July 29, 2009.

Exhibit 31.1 Certification of Chief Executive Officer pursuant to Rules 13A-15(f) Promulgated under the Securities Exchange Act of 1934 as amended.

Exhibit 31.2 Certification of Chief Financial Officer pursuant to Rules 13A-15(f) Promulgated under the Securities Exchange Act of 1934 as amended.

Exhibit 32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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.

Date: August 4, 2009

A.P. PHARMA, INC.

/s/ Ronald Prentki

Ronald Prentki
President and Chief Executive Officer

CERTIFICATE OF INCORPORATION
OF
DELAWARE ADVANCED POLYMER SYSTEMS, INC.

I. Name. The name of the Corporation is Delaware Advanced Polymer Systems, Inc.

II. Registered Office. The address of the registered office of the Corporation in the State of Delaware is 229 South State Street, in the City of Dover, County of Kent. The name of its registered agent at such address is United States Corporation Company.

III. Purposes. The purpose of the Corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of the State of Delaware.

IV. Capital Stock.

A. Authorized Capital. The Corporation is authorized to issue two classes of shares of stock to be designated, respectively, "preferred" and "common". The total number of shares which the Corporation is authorized to issue is twelve million five hundred thousand (12,500,000) and the aggregate amount of all shares that are to have a par value shall be \$125,000. The number of common shares authorized is ten million (10,000,000), each such share to have a par value of \$.01 ("Common Stock"), and the number of shares of preferred stock authorized is two million five hundred thousand (2,500,000), each such share to have a par value of \$.01.

B. Preferred Stock. The Corporation is authorized to issue four series of its preferred stock, which shall be known as (i) Series A Preferred Stock (the "Series A Preferred"), which shall consist of 364,200 shares, (ii) Series B Preferred Stock ("Series B Preferred"), which shall consist of 541,503 shares, (iii) Series C Preferred Stock ("Series C Preferred"), which shall consist of 226,802 shares and (iv) Series D Preferred Stock ("Series D Preferred"), which shall consist of 620,000 shares. Reference hereafter to "Preferred" shall mean the Series A Preferred, Series B Preferred, Series C Preferred and Series D Preferred, collectively.

The remaining authorized preferred stock may be issued from time to time in one or more series. The Board of Directors is expressly authorized at any time, and from time to time, to provide for the issuance of shares of preferred stock in one or more series, with such voting powers, full or limited, or without voting powers and with such designations, preferences

and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the resolution or resolutions providing for the issue thereof adopted by the Board of Directors, and as are not stated and expressed in this Certificate of Incorporation, or any amendment thereto, including (but without limiting the generality of the foregoing) the following:

(1) the distinctive serial designation of such series and the number of shares constituting a series;

(2) the dividend rate of such series, the conditions and dates upon which such dividends shall be payable, the preference or relation which such dividends shall bear to the dividends payable on any other class or classes or of any other series of capital stock, and whether such dividends shall be cumulative or noncumulative;

(3) whether the shares of such series shall be subject to redemption by the Corporation, and, if made subject to such redemption, the times, prices and other terms and conditions of such redemption;

(4) whether the shares are entitled to the benefit of a sinking or retirement fund to be applied to the purchase or redemption of shares of a series and, if so entitled, the amount of the fund and the manner of its application, including the price or prices at which the shares may be redeemed or purchased through the application of the fund;

(5) whether or not the shares of such series shall be convertible into or exchangeable for, shares of any other class or classes or of any other series of any class or classes of capital stock of the Corporation, and, if provision be made for conversion or exchange, the times, prices, rates, adjustments, and other terms and conditions of such conversion or exchange;

(6) the voting powers, full or limited, if any, of the shares of the series;

(7) the restrictions, if any, on the issue or reissue of any additional preferred stock;

(8) the rights of the holders of the shares of such series upon the dissolution of, or upon the distribution of assets of, the Corporation.

There is hereby expressly granted to the Board of Directors of the Corporation authority to increase or decrease the number of shares of any series subsequent to the issue of shares of that series, but not below the number of shares of that series then outstanding. In case the number of shares of any series shall be so decreased, the shares constituting such decrease shall resume the status which they had prior to the adoption of the resolution originally fixing the number of shares of such series.

C. Rights of Preferred. The rights, preferences, privileges and restrictions granted to or imposed upon the Preferred or the holders thereof are as follows:

1. Dividend Rights.

1.1. The holders of the Series A Preferred, Series B Preferred, Series C Preferred and Series D Preferred shall be entitled to receive dividends for each outstanding share, when and as declared by the Board of Directors out of any funds of this Corporation at the time legally available for the declaration of dividends, at the rate of \$.25 per annum, \$.25 per annum, \$.66 per annum and \$.87 per annum, respectively. Dividends on the Series B Preferred, Series C Preferred and Series D Preferred shall be in preference and priority to any payment of any dividend on Series A Preferred and Common Stock, and dividends on the Series A Preferred shall be in preference and priority to any payment of any dividend on Common Stock. The right to such dividends shall not be cumulative, and no right shall accrue to holders of Series A Preferred, Series B Preferred, Series C Preferred and Series D Preferred by reason of the fact that dividends on such shares are not declared or paid in any prior period. Dividends, if paid, or if declared and set apart for payment, on the Series B Preferred, Series C Preferred and Series D Preferred, must be paid, or declared and set apart for payment, on all outstanding Series B Preferred, Series C Preferred and Series D Preferred contemporaneously.

1.2. At any time after all dividends on the Preferred shall have been declared and paid or set apart for payment in accordance with the provisions of Section 1.1 above, if the Board of Directors shall elect to make further payments of dividends out of any funds legally available therefor, such dividends shall be paid as follows:

(i) such amount as the Board of Directors may declare as a dividend on the Common Stock, but not more than \$.25 per share per annum; and

(ii) such additional amount, if any, as the Board of Directors may declare as a dividend payable equally to all shareholders regardless of class based on the number of shares of Common Stock held and into which the Preferred is convertible on the date of dividend.

1.3. Dividends shall be paid by forwarding a check, postage prepaid, to the address of each holder (or, in the case of joint holders, to the address of any such holder) of Preferred as shown on the books of the Corporation, or to such other address as such holder specifies for such purpose by written notice to the Corporation. The forwarding of such check shall satisfy all obligations of the Corporation with respect to such dividends, unless such check is not paid upon timely presentation.

2. Liquidation Rights.

2.1. In the event of any liquidation, dissolution or winding up of the corporation, whether voluntary or not, the holders of Series B Preferred, Series C Preferred and Series D Preferred shall be entitled to receive an amount per share equal to \$6.00, \$6.60 and \$8.70, respectively (as adjusted for stock splits, combinations or similar events), plus all declared and unpaid dividends, if any, before any amount shall be paid to the holders of Series A Preferred and Common Stock, and the holders of Series A Preferred shall be entitled to receive an amount per share equal to \$2.50 per share (as adjusted for stock splits, combinations or similar events), plus all declared and unpaid dividends, if any, before any amount shall be paid to the holders of Common Stock. If, upon the occurrence of a liquidation, dissolution or winding up, the assets and surplus funds available for distribution to the holders of Series B Preferred, Series C Preferred and Series D Preferred shall be insufficient to permit the payment to such holders of the full liquidation preference, then the entire assets and surplus funds of the Corporation legally available for distribution shall be distributed ratably among the holders of Series B Preferred, Series C Preferred and Series D Preferred so that the per share amount distributed to each such series constitutes the same percentage of the full per share liquidation preference for such series as for the other series. If, upon the occurrence of a liquidation, dissolution or winding up, the assets and surplus funds available for distribution to the holders of Series A Preferred, after payment of the full liquidation preference to the holders of the Series B Preferred, Series C Preferred and Series D Preferred, shall be insufficient to permit the payment to such holders of the full liquidation preference, then the entire assets and surplus funds of the Corporation then legally available for distribution shall be distributed ratably among the holders of the Series A Preferred based on the number of shares held. If, upon the occurrence of a liquidation, dissolution or winding up, after the payment to the holders of Preferred of the full preferential amount specified for each series of Preferred, assets or surplus funds remain in the

Corporation, such remaining assets or surplus funds shall be distributed equally to all shareholders regardless of class based on the number of shares of Common Stock held and into which the Preferred is convertible on the date of liquidation.

2.2. For purposes of this Section 2, a liquidation, dissolution or winding up of the Corporation shall be deemed to be occasioned by, and to include, the Corporation's sale of all or substantially all of its assets but shall not be deemed to be occasioned by, or to include, the merger or consolidation of this Corporation with or into another entity.

2.3. The Corporation, in accordance with Section 160 of the General Corporation of the State of Delaware, may repurchase at cost (or such other price as may be agreed to by the Corporation's Board of Directors) shares of Common Stock issued to or held by officers, directors or employees of, or consultants to, the Corporation or its subsidiaries upon termination of their employment or services pursuant to agreements (whether now existing or hereafter entered into) providing for the right of such repurchase between the Corporation and such persons.

3. Redemption of Preferred.

3.1. This Corporation, at the option of the Board of Directors, may, at any time with respect to the Series A Preferred and the Series B Preferred and at any time after December 15, 1987 with respect to the Series C Preferred and Series D Preferred, redeem the whole or any part of the then outstanding shares of any such series of Preferred by paying \$2.75 per share in the case of the Series A Preferred, \$6.60 per share in the case of the Series B Preferred, \$7.26 per share in the case of the Series C Preferred and \$9.57 per share in the case of the Series D Preferred (as adjusted for stock splits, combinations or similar events), plus the amount of any declared and unpaid dividends thereon (the "Redemption Price"). The Corporation shall give notice of the redemption of such shares by causing a notice of redemption to be mailed not earlier than 60 nor later than 30 days prior to the redemption date to the holders of record of the series of Preferred to be redeemed, addressed to each such holder at the holder's post office address appearing on the records of the Corporation or, if no address is shown, at the place where the principal executive office of the Corporation is located. The notice of redemption shall set forth: (i) the series and the number of shares of the series of Preferred to be redeemed; (ii) the redemption date; (iii) the Redemption Price; (iv) the place at which the shareholders may obtain payment of the redemption price upon surrender of their share

certificates; and (v) the date (determined in accordance with Section 3.2 below) on which the right to convert the Preferred terminates. In the case of the partial redemption of a series of Preferred, such redemption shall be pro rata based on the number of shares held by the various holders thereof. On or before the redemption date, each holder of shares to be redeemed shall surrender the certificate representing such shares to the corporation at the place designated in the redemption notice and shall thereupon be entitled to receive payment of the Redemption Price on the redemption date.

3.2. The right to convert shares of Preferred shall continue following any such notice but shall terminate at the close of business on the fifth day prior to the redemption date fixed in such notice.

3.3. If, on the redemption date, the Corporation has deposited for such purpose in trust for the benefit of the holders of the series of Preferred to be redeemed with a bank or trust company sufficient funds to pay the Redemption Price in full to the holders of all shares of any series of Preferred to be redeemed, the shares to be redeemed shall be deemed to be redeemed as of the redemption date, and no interest shall accrue on the redemption price from and after the redemption date. Any amounts so deposited on account of the Redemption Price of shares converted subsequent to the date of deposit shall be repaid to the Corporation forthwith upon the conversion of such shares. The balance of any moneys deposited by the Corporation pursuant hereto remaining unclaimed at the expiration of one year following the date of redemption shall thereafter be returned to the Corporation upon its request expressed in a resolution of its Board of Directors.

4. Voting Rights.

4.1. Vote Other than for Directors. The holders of Preferred shall be entitled to notice of any shareholders, meeting and, except as otherwise required by law or as provided in Section 7 hereof, to vote on all matters submitted to the shareholders for a vote, other than the election of directors under the circumstances set forth in Section 4.2 below, together with the holders of Common Stock, with the holders of Preferred having one vote for each full share of Common Stock into which their respective shares of Preferred are convertible on the record date for the vote or, if no such record date is established, at the date such vote is taken or any written consent of shareholders is solicited, and the holders of Common Stock having one vote per share of Common Stock. Except as otherwise expressly provided herein or as required by law, the holders of shares of Preferred and Common Stock shall vote together and not as separate classes.

4.2. Vote for Directors Under Certain Circumstances. If at any time the holders of Preferred voting pursuant to Section 4.1 are unable to elect at least two directors, then the holders of shares of Preferred shall vote together as one class with respect to the election of directors and, voting together as one class, shall be entitled to elect two directors, with the remaining directors to be elected by the affirmative vote of the holders of the Common Stock. In the case of any vacancy in the office of a director elected by the Preferred pursuant to this Section 4.2, a successor shall be elected to hold office for the unexpired term of such director by the affirmative vote of a majority of the shares of Preferred given at a special meeting of such shareholders duly called or by an action by written consent for that purpose. Subject to applicable law, any director who shall have been elected by the Preferred pursuant to this Section 4.2 may be removed during the aforesaid term of office, either for or without cause, by, and only by, the affirmative vote of the holders of a majority of the shares of Preferred given at a special meeting of such shareholders duly called or by an action by written consent for that purpose, and any such vacancy thereby created may be filled by the vote of the holders of a majority of the shares of the Preferred represented at such meeting or by an action by unanimous written consent of the holders of Preferred.

5. Certain Taxes.

The Corporation shall pay any and all issuance and other taxes (excluding any federal or state income taxes) that may be payable in respect of any issuance or delivery of shares of Common Stock on conversion of Preferred. The Corporation shall not, however, be required to pay any tax that may be payable in respect of any transfer involved in the issuance and delivery of shares of Common Stock in a name other than that in which the shares of Preferred to which such issuance relates were registered, and no such issuance or delivery shall be made unless and until the person requesting such issuance has established to the satisfaction of the Corporation that such transfer tax has been paid.

6. Conversion of Preferred Stock.

The Preferred shall be convertible into Common Stock of the Corporation as follows:

6.1. Definitions. For purposes of this Section 6 the following definitions shall apply:

6.1.1 "Issuance Date" shall mean, in the case of the Series A Preferred, January 19, 1984, in the case of the Series B Preferred, March 18, 1985, in the case of the Series C Preferred, December 20, 1985, and, in the case of the Series D Preferred, May 12, 1986.

6.1.2 "Conversion Price" shall mean each price, determined pursuant to this Section 6, at which shares of Common Stock shall be deliverable upon conversion of the Series A Preferred, Series B Preferred, Series C Preferred and Series D Preferred, respectively.

6.1.3 "Current Conversion Price" shall mean each Conversion Price immediately before the occurrence of any event, which, pursuant to Section 6.3, causes an adjustment to any such Conversion Price.

6.1.4 "Convertible Securities" shall mean any indebtedness or shares of stock convertible into or exchangeable for Common Stock, including Preferred Stock.

6.1.5 "Options" shall mean any rights, warrants or options to subscribe for or purchase Common Stock or Convertible Securities.

6.1.6 "Common Stock Outstanding" shall mean the aggregate of all Common Stock outstanding and all Common Stock issuable upon exercise of all outstanding Options and conversion of all outstanding Convertible Securities, but excluding shares as provided in Section 6.3.9.

6.1.7 "Distribution" shall mean the same as the dividends permitted under Section 173 of the Delaware General Corporation Law as in effect on the date of filing of this Certificate of Incorporation.

6.2. Right to Convert; Initial Conversion Prices. Each share of Preferred shall, at the option of the holder thereof, at any time be convertible into such number of fully-paid and non-assessable shares of Common Stock as is determined by dividing \$2.50 in the case of the Series A Preferred, \$6.00 in the case of the Series B Preferred, \$6.60 in the case of the Series C Preferred and \$8.70 in the case of the Series D Preferred, by the Conversion Price for each such series of Preferred Stock. The Conversion Price for each such series shall initially be \$2.50 in the case of the Series A Preferred, \$6.00 in the case of the Series B Preferred, \$6.60

in the case of the Series C Preferred and \$8.70 in the case of the Series D Preferred. Each such initial Conversion Price shall be subject to adjustment from time to time in certain instances as hereinafter provided. No adjustments with respect to conversion shall be made on account of any dividends that may be declared but unpaid on Preferred surrendered for conversion, but no dividends shall thereafter be paid on the Common Stock unless such unpaid dividends have first been paid to the holders entitled to payment at the time of conversion of the Preferred.

Before any holder of Preferred shall be entitled to convert the same into Common Stock, such holder shall surrender the certificate or certificates therefor, duly endorsed, to the office of the Corporation or any transfer agent for such Preferred and shall give written notice to the Corporation at such office that he elects to convert the same. The Corporation shall, as soon as practicable thereafter, issue and deliver at such office to such holder of Preferred, or to its nominee or nominees, certificates for the number of full shares of Common Stock to which he shall be entitled, together with cash in lieu of any fraction of a share as hereinafter provided, and, if less than all of the shares of Preferred represented by such certificate are converted, a certificate representing the shares of Preferred not converted. Such conversion shall be deemed to have been made as of the date of such surrender of the certificate for the Preferred to be converted, and the person or persons entitled to receive the Common Stock issuable upon such conversion shall be treated for all purposes as the record holder or holders of such Common Stock on such date.

6.3. Adjustments to Conversion Prices. Subject to Section 6.3.9, the Conversion Price for each series of Preferred in effect from time to time shall be subject to adjustment in certain cases as follows:

6.3.1 Issuance of Securities. In case the Corporation shall at any time after the Issuance Date for such series (i) issue or sell any Common Stock without consideration, or for a consideration per share less than the Current Conversion Price applicable to such series, or (ii) pay or make a dividend or other Distribution on the Common Stock (other than in cash out of its retained earnings) then, and thereafter successively upon each such Issuance, sale, dividend or other Distribution, each such Current Conversion Price shall simultaneously with such issuance, sale, dividend or other Distribution be adjusted to a new Conversion Price (calculated separately for each such Conversion Price to the nearest cent) determined by dividing

(a) an amount equal to (i) the total number of shares of Common Stock Outstanding when such Current Conversion Price became effective multiplied by such Current Conversion Price, plus (ii) the aggregate of the amount of all consideration, if any, received by the Corporation for the issuance or sale of Common Stock since such Current Conversion Price became effective, minus (iii) the aggregate amount of all dividends or Distributions on Common Stock (other than in cash out of its retained earnings) paid by the Corporation since such Current Conversion Price became effective, by

(b) the total number of shares of Common Stock Outstanding immediately after such issuance, sale, dividend, or other Distribution.

For the purposes of this subsection 6.3.1, the following provisions shall also be applicable:

6.3.1.1 Cash Consideration. In case of the issuance or sale of additional Common Stock for cash, the consideration received by the Corporation therefor shall be deemed to be the amount of cash received by the Corporation for such shares (or, if such shares are offered by the Corporation for subscription, the subscription price, or, if such shares are sold to underwriters or dealers for public offering without a subscription offering, the initial public offering price), without deducting therefrom any compensation or discount paid or allowed to underwriters or dealers or others performing similar services or for any expenses incurred in connection therewith.

6.3.1.2 Non-Cash Consideration. In case of the issuance (otherwise than upon conversion or exchange of Convertible Securities) or sale of additional Common Stock for a consideration other than cash or a consideration a part of which shall be other than cash, the fair value of such consideration as determined by the Board of Directors of the Corporation in the good faith exercise of its business judgment, irrespective of the accounting treatment thereof, shall be deemed to be the value, for purposes of this Section 6, of the consideration other than cash received by the Corporation for such securities.

6.3.1.3 Options and Convertible Securities. In case the Corporation shall in any manner issue or grant any Options or any Convertible Securities, the total maximum number of shares of Common Stock issuable upon the exercise of such Options or upon conversion or exchange of the total maximum amount of such Convertible Securities at the time such Convertible Securities first become convertible or exchangeable shall (as of the

date of issue or grant of such Options or, in the case of the issue or sale of Convertible Securities other than where the same are issuable upon the exercise of Options, as of the date of such issue or sale) be deemed to be issued and to be outstanding for the purpose of this Section 6 and to have been issued for the sum of the amount (if any) paid for such Options or Convertible Securities and the amount (if any) payable upon the exercise of such Options or upon conversion or exchange of such Convertible Securities at the time such Convertible Securities first become convertible or exchangeable; provided that, subject to the provisions of Section 6.3.2, no further adjustment of the Conversion Prices shall be made upon the actual issuance of any such Common Stock or Convertible Securities or upon the conversion or exchange of any such Convertible Securities.

6.3.1.4 Dividends in Common Stock, Options, or Convertible Securities. In the case of the issuance of additional Common Stock, Options, or Convertible Securities as a dividend or as a Distribution on Common Stock, the aggregate number of shares of Common Stock issued (or deemed issued pursuant to Section 6.3.1.3 in payment of such dividend or Distribution) shall be deemed to have been issued on the record date for such dividend or Distribution and shall be deemed to have been issued without consideration.

6.3.1.5 Other Dividends. In case of the payment or making of a dividend or other Distribution on Common Stock in property (excluding Common Stock, Convertible Securities and Options, but including all other securities), such dividend or other Distribution shall be deemed to have been paid or made on the record date for such dividend or other Distribution and in the amount of such dividend or other Distribution in property on such record date, as determined by the Board of Directors of the Corporation in the good faith exercise of its business judgment.

6.3.1.6 Reclassification. The reclassification of securities other than Common Stock into securities including Common Stock shall be deemed to involve the issuance for a consideration other than cash of such Common Stock at the close of business on the date fixed for the determination of shareholders entitled to receive such Common Stock.

6.3.1.7 Record Date. In the event that there shall be no record date for the determination of shareholders entitled to any dividend or Distribution declared by the Corporation, the first business day during which the stock transfer books of the Corporation shall be closed for the purpose of such determination shall be deemed to be the record date for the determination of shareholders entitled to such dividend or Distribution.

6.3.2 Change in Option Price or Conversion Rate. In the event that the purchase price provided for in any Option referred to in subsection 6.3.1.3, or the rate at which any Convertible Securities referred to in subsection 6.3.1.3 are convertible into or exchangeable for shares of Common Stock shall change at any time (other than under or by reason of provisions designed to protect against dilution), each Current Conversion Price in effect at the time of such event shall forthwith be readjusted to the Conversion Price that would have been in effect at such time had such Options or Convertible Securities still outstanding provided for such changed purchase price, additional consideration or conversion rate, as the case may be, at the time initially granted, issued or sold. In the event that the purchase price provided for in any such Option referred to in subsection 6.3.1.3, or the additional consideration (if any) payable upon the conversion or exchange of any Convertible Securities referred to in subsection 6.3.1.3 or the rate at which any Convertible Securities referred to in subsection 6.3.1.3. are convertible into or exchangeable for shares of Common Stock, shall be reduced at any time under or by reason of provisions with respect thereto designed to protect against dilution, then in case of the delivery of shares of Common Stock upon the exercise of any such Option or upon conversion or exchange of any such Convertible Security, each Current Conversion Price then in effect hereunder shall, upon issuance of such shares of Common Stock, be adjusted to such amount as would have obtained had such Option or Convertible Security never been issued and had adjustments been made only upon the issuance of the shares of Common Stock delivered as aforesaid and for the consideration actually received for such Option or Convertible Security and the Common Stock.

6.3.3 Termination of Option or Conversion Rights. In the event of the termination or expiration of any right to purchase Common Stock under any Option or of any right to convert or exchange Convertible Securities, the issuance of which previously resulted in an adjustment to the Conversion Price, the Current Conversion Price shall, upon such termination, be changed to the Conversion Price that would have been in effect at the time of such expiration or termination had such Option or Convertible Security, to the extent outstanding immediately prior to such expiration or termination, never been issued, and the shares of Common Stock issuable thereunder shall no longer be deemed to be Common Stock outstanding.

6.3.4 Stock Splits. In the event the outstanding Common Stock shall be subdivided into a greater number of shares of Common Stock, each Current Conversion Price shall, simultaneously with the effectiveness of such subdivision, be proportionately reduced, and conversely, in case the outstanding Common Stock shall be combined into a smaller number of shares of Common Stock, each Current Conversion Price shall, simultaneously with the effectiveness of such combination, be proportionately increased. For the purposes of subsections 6.3.1 and 6.3.4, a distribution of Common Stock to holders of Common Stock in which the number of shares distributed is twenty-five percent (25%) or more of the number of shares of Common Stock upon which the distribution is to be made shall be deemed to be a subdivision of Common Stock, and a distribution of a lesser number of shares of Common Stock shall be deemed to be a stock dividend.

6.3.5 Successive Changes. The above provisions of this Section 6 shall similarly apply to successive issuances, sales, dividends or other Distributions, subdivisions and combinations on or of the Common Stock after the Issuance Date.

6.3.6 Merger; Sale of Corporation. In the event of any consolidation of the Corporation with, or merger of the Corporation with or into, another corporation (other than a consolidation or merger in which the Corporation is the continuing corporation and which does not result in any reclassification of, or change in, the outstanding shares of Common Stock), or in the case of sale or transfer to another corporation of all or substantially all of the assets of the Corporation, the shares of each series of Preferred shall be treated for purposes of computing the Conversion Price for each such series of Preferred as if converted into Common Stock on the earlier of (x) the record date, if any, for voting by holders of Common Stock on such event and (y) the date of such event.

6.3.7 Other Events Altering Conversion Price. Upon the occurrence of any event not specifically denominated in this Section 6 as altering the Conversion Prices that, in the reasonable exercise of the business judgment of the Board of Directors of the Corporation requires, on equitable principles, the alteration of any Conversion Price, such Conversion Price will be equitably altered.

6.3.8 Miscellaneous Conversion Price Matters. The Corporation shall at all times reserve and keep available out of its authorized but unissued Common Stock the full number of shares of Common Stock deliverable upon conversion of all the then outstanding

Preferred and shall, at its own expense, take all such actions and obtain all such permits and orders as may be necessary to enable the Corporation lawfully to issue such Common Stock upon the conversion of such Preferred. No fractions of Common Stock shall be issued upon the conversion of Preferred and in lieu thereof the Corporation shall pay the holder an amount in cash equal to the fair market value of such fractional interest as determined by the Board of Directors of the Corporation in the exercise of its good faith business judgment.

6.3.9 Excluded Events. Notwithstanding anything in this Section 6 to the contrary, no Conversion Price shall be adjusted by virtue of (i) the conversion of shares of Preferred into shares of Common Stock, (ii) the repurchase of shares from the Corporation's employees, consultants, officers or directors at such person's cost (or at such other price as may be agreed to by the Corporation's Board of Directors), or (iii) the issuance and sale of, or the grant of options to purchase, an aggregate of not more than 650,000 shares of Common Stock to employees, advisors, directors, officers or consultants of the Corporation (including shares issued or sold pursuant to the exercise of any stock option assumed by this Corporation even though originally granted by the predecessor of this Corporation prior to the date of the filing of this Certificate of Incorporation, but net of any shares covered by any such options which lapse or any shares purchased by the Corporation from employees pursuant to purchases approved by the Board of Directors) and the issuance of up to 210,336 and 210,000 shares of Common Stock on exercise of non-statutory options and warrants to purchase Common Stock, respectively, assumed by this Corporation even though originally granted or issued by the predecessor of this Corporation prior to the date of filing this Certificate of Incorporation, at a price of at least \$.50 per share (as to non-statutory options to purchase 20,000 shares), \$2.50 per share (as to non-statutory options to purchase 25,000 shares), \$6.00 per share (as to non-statutory options to purchase 165,336 shares), \$2.60 per share (as to warrants to purchase 120,000 shares), \$6.60 per share (as to warrants to purchase 90,000 shares), and none of such shares shall be included in any manner in the computation from time to time of the Conversion Prices under subsection 6.3.1.

6.4. Automatic Conversion. Immediately upon the effectiveness of the first Registration Statement pursuant to which any Common Stock is sold to the public by the Corporation in a public offering registered under the Securities Act of 1933 at an aggregate public offering price of not less than \$7,500,000, to the extent the per share public offering price is not less than \$5.00 (in the case of the Series A preferred), \$12.00 (in the case of the Series B

Preferred), \$13.20 (in the case of the Series C Preferred) and \$14.55 (in the case of the Series D Preferred) (as equitably adjusted for any stock split, combination or similar event), all shares of each series of Preferred with respect to which the per share public offering price equals or exceeds the dollar amounts set forth above shall automatically be converted into shares of Common Stock at the Current Conversion Price for such series. Upon the written election by holders of the outstanding shares of any series of Preferred to convert such number of outstanding shares of such series which, when added to the number of shares of such series previously converted to Common Stock hereunder, equals at least 67% of the authorized number of shares of such series, then all remaining outstanding shares of such series shall automatically convert into Common Stock at the Current Conversion Price for such series. On and after any conversion date pursuant to this Section 6.4, notwithstanding that any certificates for Preferred shall not have been surrendered for conversion, the shares of Preferred evidenced thereby shall be deemed to be no longer outstanding, and all rights with respect thereto shall forthwith cease and terminate, except only the rights of the holder (i) to receive the shares of Common Stock to which he shall be entitled upon conversion thereof, (ii) to receive the amount of cash payable in respect of any fractional share of Common Stock to which he shall be entitled, and (iii) with respect to dividends declared but unpaid on such Preferred prior to such conversion date. In the event that any holder of Preferred presents such holder's certificate therefor for surrender to the Corporation or its transfer agent upon such conversion, a certificate for the number of shares of Common Stock into which the shares of Preferred surrendered were convertible on such conversion date promptly will be issued and delivered to such holder.

7. Covenants.

In addition to any other rights provided by law, so long as any Preferred shall be outstanding, the Corporation shall not, without first obtaining the affirmative vote or written consent of the holders of not less than a majority of such outstanding shares of Preferred:

- (a) amend or repeal any provision of, or add any provision to, the Corporation's articles of incorporation or by-laws if such action would alter or change the preferences, rights, privileges or powers of, or the restrictions provided for the benefit of, the Preferred, including provisions relating to dividends, conversion, redemption, voting, liquidation, or increase the number of shares of any series of Preferred authorized hereby;

(b) authorize or issue shares of any class or series of stock not authorized herein having any preference or priority as to dividends, redemption, liquidation or voting superior or equivalent to any such preference or priority of the Preferred, or authorize or issue shares of stock of any Class or series, or any bonds, debentures, notes or other obligations convertible into or exchangeable for, or having option rights to purchase, any shares of stock of this Corporation having any preference or priority as to dividends, redemption, liquidation or voting superior or equivalent to any such preference or priority of the Preferred;

(c) reclassify any class of series of any capital stock into shares having any preference or priority as to dividends, redemption, liquidation or voting superior or equivalent to any such preference or priority of the Preferred;

(d) apply any of its assets to Use redemption, retirement, purchase or acquisition, directly or indirectly, through subsidiaries or otherwise, of any shares of any class or series of capital stock, except for the Preferred and except from persons performing services for this Corporation on terms approved by the Board of Directors upon termination of employment or association; or

(e) agree to a merger or consolidation of the Corporation with another entity or to, the sale of all or substantially all of the Corporation's assets; provided, that no such vote or consent of the Preferred shall be required with respect to a merger or consolidation of the Corporation or any subsidiary of the Corporation in which this Corporation or any subsidiary of the Corporation is the surviving entity and the valuation of the acquired corporation represents 20% or less of the valuation (reasonably determined by the Corporation's Board of Directors) of this Corporation and its subsidiaries immediately prior to such transaction.

V. Organization.

A. Incorporator. The name and mailing address of the incorporator is as follows:

<u>NAME</u>	<u>MAILING ADDRESS</u>
Julian N. Stern	Heller, Ehrman, White & McAuliffe 333 Bush Street, Suite 3000 San Francisco, California 94104

B. Directors. The name and mailing address of each person who is to serve as a director until the first annual meeting of the stockholders or until a successor is elected and qualified, is as follows:

<u>NAME</u>	<u>MAILING ADDRESS</u>
W. Gary Whitehouse	Advanced Polymer Systems, Inc. 3696 C Haven Avenue Redwood City, California 94063
Helen Leong	Advanced Polymer Systems, Inc. 3696 C Haven Avenue Redwood City, California 94063
Marvyn Carton	Advanced Polymer Systems, Inc. 3696 C Haven Avenue Redwood City, California 94063
Jerome Farmer	Advanced Polymer Systems, Inc. 3696 C Haven Avenue Redwood City, California 94063
A. Charles Hoffman	Advanced Polymer Systems, Inc. 3696 C Haven Avenue Redwood City, California 94063
Toby Rosenblatt	Advanced Polymer Systems, Inc. 3696 C Haven Avenue Redwood City, California 94063
Gregory Turnbull	Advanced Polymer Systems, Inc. 3696 C Haven Avenue Redwood City, California 94063

VI. Limitation of Liability and Indemnification of Directors.

A. Elimination of Certain Liability of Directors. Each director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability (i) for any breach of such director's duty of loyalty to the Corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under Section 174 of the General Corporation Law of the State of Delaware, or (iv) for any transaction from which such director derived any improper personal benefit. If the General Corporation Law of the State of Delaware is amended after the filing of this Certificate of Incorporation with the Delaware Secretary of State so as to authorize corporate action further eliminating or limiting the personal liability of directors, then the liability of each director of the Corporation shall be eliminated or limited to the fullest extent permitted by the General Corporation Law of the State of Delaware, as so amended.

Any repeal or modification of the foregoing paragraph by the stockholders of the Corporation shall not adversely affect any right or protection of a director of the Corporation existing at the time of such repeal or modification.

B. Indemnification and Insurance.

(1) Right to Indemnification. Each person who was or is made a party or is threatened to be made a party to or is involved in any action, suit or proceeding, whether civil, criminal, administrative or investigative (hereinafter a "proceeding"), by reason of the fact that he or she, or a person of whom he or she is the legal representative, is or was a director or officer, of the Corporation or is or was serving at the request of the Corporation, as a director, officer, employee or agent of another corporation or of a partnership, joint venture, trust or other enterprise, including service with respect to employee benefit plans, whether the basis of such proceeding is alleged action in an official capacity as a director, officer, employee or agent or in any other capacity while serving as a director, officer, employee or agent, shall be indemnified and held harmless by the Corporation to the fullest extent authorized by the General Corporation Law of the State of Delaware, as the same exists or may hereafter be amended (but, in the case of any such amendment, only to the extent that such amendment permits the Corporation to provide broader indemnification rights than said law permitted the Corporation to provide prior to such amendment), against all expense, liability and loss (including attorneys' fees, judgments, fines, ERISA excise taxes or penalties and amounts paid or to be paid in settlement) reasonably incurred or suffered by such person in connection therewith and such indemnification shall continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of his or her heirs, executors and administrators; provided, however, that, the Corporation shall indemnify any such person seeking indemnification in connection with a proceeding (or part thereof) initiated by such person only if such proceeding (or part thereof) was authorized by the board of directors of the Corporation. The right to indemnification conferred in this Section B shall be a contract right and shall include the right to be paid by the Corporation the expenses incurred in defending any such proceeding in advance of its final disposition; provided, however, that, if the General Corporation Law of the State of Delaware requires, the payment of such expenses incurred by a director or officer in his or her

capacity as a director or officer (and not in any other capacity in which service was or is rendered by such person while a director or officer, including, without limitation, service to an employee benefit plan) in advance of the final disposition of a proceeding, shall be made only upon delivery to the Corporation of an undertaking, by or on behalf of such director or officer, to repay all amounts so advanced if it shall ultimately be determined that such director or officer is not entitled to be indemnified under this Section or otherwise. The Corporation may, by action of its board of Directors, provide indemnification to employees and agents of the Corporation with the same scope and effect as the foregoing indemnification of directors and officers.

(2) Non-Exclusivity of Rights. The right to indemnification and the payment of expenses incurred in defending a proceeding in advance of its final disposition conferred in this Section B shall not be exclusive of any other right which any person may have or hereafter acquire under any statute, provision of this Certificate of Incorporation, Bylaw, agreement, vote of stockholders or disinterested directors or otherwise.

(3) Insurance. The Corporation may maintain insurance, at its expense, to protect itself and any director, officer, employee or agent of the Corporation or another corporation, partnership, joint venture, trust or other enterprise against any such expense, liability or loss, whether or not the Corporation would have the power to indemnify such person against such expense, liability or loss under the Delaware General Corporation Law.

VII. Management of Business. The business and affairs of the Corporation shall be managed by or under the direction of the Board of Directors and the directors need not be elected by ballot unless required by the By-laws of the Corporation.

VIII. By-laws. In furtherance and not in limitation of the powers conferred by statute, the Board of Directors and the stockholders of the Corporation are each expressly authorized to adopt, amend or repeal the By-laws of the Corporation.

IX. Amendments. The Corporation reserves the right to amend and repeal any provision contained in this Certificate of Incorporation, and to take other corporate action to the extent and in the manner now or hereafter permitted or prescribed by the laws of the State of Delaware. All rights herein conferred are granted subject to this reservation.

I, THE UNDERSIGNED, being the sole incorporator hereinbefore named, for the purpose of forming a corporation pursuant to the General Corporation Law of the State of Delaware, do make this certificate hereby declaring and certifying that this is my act and deed and the facts herein stated and true, and accordingly have hereto set my hand this 4th day of February, 1987.

/s/ Julian N. Stern

Julian N. Stern

CERTIFICATE OF AMENDMENT

OF

CERTIFICATE OF INCORPORATION

ADVANCED POLYMER SYSTEMS, INC., a corporation organized and existing under and by virtue of the General Corporation Law of the State of Delaware, DOES HEREBY CERTIFY:

FIRST: That at a meeting of the Board of Directors of Advanced Polymer Systems, Inc., resolutions were duly adopted setting forth a proposed amendment to the Certificate of Incorporation of said corporation, declaring said amendment to be advisable and directing that said proposed amendment be submitted to the stockholders of said corporation for their written consent. The resolution setting forth the proposed amendment is as follows:

RESOLVED, that the Certificate of Incorporation of this corporation be amended by changing Article IV.A. thereof so that, as amended, said Article IV.A. shall be and read in its entirety as follows:

“IV. CAPITAL STOCK

A. Authorized Capital. The Corporation is authorized to issue two classes of shares of stock to be designated, respectively, ‘preferred’ and ‘common.’ The total number of shares which the Corporation is authorized to issue is Twenty-two Million Five Hundred Thousand (22,500,000), and the aggregate amount of all shares that are to have par value shall be \$225,000. The number of common shares authorized is Twenty Million (20,000,000), each such share to have a par value of \$.01 (‘Common Stock’), and the number of Preferred shares authorized is Two Million Five Hundred Thousand (2,500,000), each such share to have a par value of \$.01. On the amendment of this Article IV.A to read as herein set forth, each outstanding share of Common Stock of a par value of \$.01 is split and converted into two shares of Common Stock of a par value of \$.01.°

SECOND: That, thereafter, pursuant to resolution of the Board of Directors of said corporation, said amendment was submitted to the stockholders of said corporation for their written consent, and by such consent, the necessary number of shares as required by statute were voted in favor of the amendment.

THIRD: That said amendment was duly adopted in accordance with the provisions of Sections 228 and 242 of the General Corporation Law of the State of Delaware.

IN WITNESS WHEREOF, said ADVANCED POLYMER SYSTEMS, INC. has caused this Certificate to be signed John H. Williford, its Chief Executive Officer, and attested by Richard A. Peers, its Assistant secretary, this July 27, 1987.

By: /s/ John H. Williford
John H. Williford,
Chief Executive Officer

Attest:

/s/ Richard A. Peers
Richard A. Peers
Assistant Secretary

CERTIFICATE OF AMENDMENT

OF

CERTIFICATE OF INCORPORATION

ADVANCED POLYMER SYSTEMS, INC., a corporation organized and existing under and by virtue of the General Corporation Law of the State of Delaware, DOES HEREBY CERTIFY:

FIRST: That at a meeting of the Board of Directors of Advanced Polymer Systems, Inc., resolutions were duly adopted setting forth a proposed amendment to the Certificate of Incorporation of said corporation, declaring said amendment to be advisable and directing that said proposed amendment be submitted to the stockholders of said corporation for their approval at the next annual meeting of stockholders. The resolution setting forth the proposed amendment is as follows:

RESOLVED, that Article V of the Certificate of Incorporation of this Company shall be amended by adding to it a new paragraph C. as follows:

“C. The Board of Directors shall be and is divided into three classes: Class I, Class II and Class III, which shall be as nearly equal in number as possible. Each director shall serve for a term ending on the date of the third annual meeting of stockholders following the annual meeting at which the director was elected; provided, however, that each initial director in Class I shall hold office until the annual meeting of stockholders in 1989; each initial director in Class II shall hold office until the annual meeting of stockholders in 1990; and each initial director in Class III shall hold office until the annual meeting of stockholders in 1991. Notwithstanding the foregoing provisions of this Article, each director shall serve until his successor is duly elected and qualified or until his death, resignation or removal.”

SECOND: That, thereafter, pursuant to resolution of the Board of Directors of said corporation, said amendment was submitted to the stockholders of said corporation for their approval at the annual meeting of stockholders, and at such meeting the necessary number of shares as required by statute were voted in favor of the amendment.

THIRD: That said amendment was duly adopted in accordance with the provisions of Section 242 of the General Corporation Law of the State of Delaware.

IN WITNESS WHEREOF, said ADVANCED POLYMER SYSTEMS, INC. has caused this Certificate to be signed John H. Williford, its Chief Executive Officer, and attested by Richard A. Peers, its Assistant Secretary, this April 20, 1988.

ADVANCED POLYMER SYSTEMS, INC.

By: /s/ John H. Williford
John H. Williford,
Chief Executive Officer

Attest:

/s/ Richard A. Peers

Richard A. Peers
Assistant Secretary

CERTIFICATE OF AMENDMENT

OF

CERTIFICATE OF INCORPORATION

ADVANCED POLYMER SYSTEMS, INC., a corporation organized and existing under and by virtue of the General Corporation Law of the State of Delaware, DOES HEREBY CERTIFY:

FIRST: That, at a meeting of the Board of Directors of Advanced Polymer Systems, Inc., resolutions were duly adopted setting forth a proposed amendment of the Certificate of Incorporation of said corporation, declaring said amendment to be advisable and directing that said proposed amendment be submitted to the stockholders of said corporation for their approval at the next annual meeting of stockholders. The resolution setting forth the proposed amendment is as follows:

RESOLVED, that Article V of the Certificate of Incorporation of this Company shall be amended by deleting paragraph C therefrom in its entirety.

SECOND: That, thereafter, pursuant to resolution of the Board of Directors of said corporation, said amendment was submitted to the stockholders of said corporation for their approval at the annual meeting of stockholders, and at such meeting the necessary number of shares as required by statute were voted in favor of the amendment.

THIRD: That, said amendment was duly adopted in accordance with the provisions of Section 242 of the General Corporation Law of the State of Delaware.

IN WITNESS WHEREOF, said ADVANCED POLYMER SYSTEM, INC. has caused this Certificate to be signed by John J. Meakem, its President, and attested by Julian N. Stern, its Secretary, this 23rd day of September, 1991.

ADVANCED POLYMER SYSTEMS, INC.

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

Attest:

/s/ Julian N. Stern
Julian N. Stern
Secretary

CERTIFICATE OF AMENDMENT

OF

CERTIFICATE OF INCORPORATION

ADVANCED POLYMER SYSTEMS, INC., a corporation organized and existing under and by virtue of the General Corporation Law of the State of Delaware, DOES HEREBY CERTIFY:

FIRST: That, at a meeting of the Board of Directors of Advanced Polymer Systems, Inc., resolutions were duly adopted setting forth a proposed amendment of the Certificate of Incorporation of said corporation, declaring said amendment to be advisable and directing that said proposed amendment be submitted to the stockholders of said Corporation for their approval at the next annual meeting of stockholders. The resolution setting forth the proposed amendment is as follows:

RESOLVED, that Article IV.A. of the Certificate of Incorporation of this corporation shall be amended to read in its entirety as follows:

“IV. CAPITAL STOCK

A. Authorized Capital. The corporation is authorized to issue two classes of shares of stock to be designated, respectively, ‘preferred’ and ‘common.’ The total number of shares which the corporation is authorized to issue is Fifty-Two Million Five Hundred Thousand (52,500,000), and the aggregate amount of all shares that are to have par value shall be \$525,000. The number of common shares authorized is Fifty Million (50,000,000), each such share to have a par value of \$.01 (‘Common Stock’), and the number of Preferred shares authorized is Two Million Five Hundred Thousand (2,500,000), each such share to have a par value of \$.01.”

SECOND: That, thereafter, pursuant to resolution of the Board of Directors of said corporation, said amendment was submitted to the stockholders of said corporation for their approval at the annual meeting of stockholders, and at such meeting the necessary number of shares as required by statute were voted in favor of the amendment.

THIRD: That, said amendment was duly adapted in accordance with the provisions of Section 242 of the General Corporation Law of the State of Delaware.

IN WITNESS WHEREOF, said ADVANCED POLYMER SYSTEM, INC. has caused this Certificate to be signed by John J. Meakem, Jr., its President, and attested by Julian N. Stern, its Secretary, this 31st day of August, 1992.

ADVANCED POLYMER SYSTEMS, INC.

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

Attest:

/s/ Julian N. Stern
Julian N. Stern, Secretary

CERTIFICATE OF AMENDMENT OF
CERTIFICATE OF INCORPORATION OF
ADVANCED POLYMER SYSTEMS, INC.

Advanced Polymer Systems, Inc., a corporation duly organized and existing under the General Corporation Law of the State of Delaware (the "Corporation"), does hereby certify:

FIRST: That Article I of the Certificate of Incorporation of the Corporation is hereby amended to read in its entirety as follows:

"I: Name. The name of the corporation is AP Pharma, Inc."

SECOND: That said amendment was duly adopted in accordance with the provisions of Section 242 of the Delaware General Corporation Law.

In witness whereof, the Corporation has caused this Certificate of Amendment to be executed by its duly authorized person this 9th day of May, 2001.

/s/ Michael O'Connell

Michael O'Connell,
President and Chief Executive Officer

**CERTIFICATE OF AMENDMENT OF
CERTIFICATE OF INCORPORATION OF
A.P. PHARMA, INC.**

A.P. Pharma, Inc., a corporation duly organized and existing under the General Corporation Law of the State of Delaware (the "Corporation"), does hereby certify:

FIRST: That Article IV of the Certificate of Incorporation of the Corporation is hereby amended by adding at the end of the paragraph A the following new sentences:

"Effective as of the close of business on the day that the Certificate of Amendment which contains this provision is filed with the Office of the Secretary of State of the State of Delaware (the "Effective Time"), each four shares of Common Stock issued and outstanding at such time ("Existing Common Stock") shall be and hereby are automatically reclassified and changed into one share of Common Stock ("New Common Stock"), provided that no fractional shares of New Common Stock shall be issued, and in lieu of a fractional share of New Common Stock to which any holder is entitled, such holder shall receive a cash payment in an amount to be determined by multiplying the fractional share by the fair market value of a share of New Common Stock at the Effective Time (the "Reverse Split"). Shares of Common Stock that were outstanding prior to the Effective Time, and that are not outstanding after and as a result of the Reverse Split, shall resume the status of authorized but unissued shares of Common Stock.

From and after the Effective Time, the term "New Common Stock" as used in this Article IV shall mean Common Stock as provided in this Certificate of Incorporation. The par value of the New Common Stock shall be \$0.01 per share."

SECOND: The foregoing Certificate of Amendment has been duly adopted by this Corporation's Board of Directors and stockholders in accordance with the provisions the Corporation's Certificate of Incorporation and with the General Corporation Law of the State of Delaware by the directors and stockholders of the Corporation.

IN WITNESS WHEREOF, said Corporation has caused this Certificate of Amendment to be executed by its duly authorized officer this 23rd day of May, 2007.

/s/ Gregory Turnbull

Gregory Turnbull, President and Chief Executive Officer

CERTIFICATE OF AMENDMENT TO THE

CERTIFICATE OF INCORPORATION

OF

A.P. PHARMA, INC.

A.P. Pharma, Inc. (the “**Corporation**”), a corporation organized and existing under and by virtue of the provisions of the General Corporation Law of the State of Delaware, hereby certifies as follows:

A. Section A of Article IV of the Certificate of Incorporation of the Corporation shall be amended and restated in its entirety as follows:

“A. Authorized Capital. The corporation is authorized to issue two classes of shares of stock to be designated, respectively, “preferred” and “common.” The total number of shares which the corporation is authorized to issue is One Hundred Two Million Five Hundred Thousand (102,500,000). The number of common shares authorized to be issued is One Hundred Million (100,000,000), each such share to have a par value of \$0.01 (“Common Stock”), and the number of Preferred shares authorized to be issued is Two Million Five Hundred Thousand (2,500,000), each such share to have a par value of \$0.01.”

B. The amendment to the Certificate of Incorporation of the Corporation herein was duly adopted by this Corporation’s Board of Directors in accordance with the applicable provisions of Section 242 of the General Corporation Law of the State of Delaware, and the Corporation’s stockholders have given their written consent in accordance with Section 228 of the General Corporation Law of the State of Delaware.

C. The amendment to the Certificate of Incorporation of the Corporation herein shall be effective July 29, 2009.

(Signature Page Follows)

IN WITNESS WHEREOF, A.P. Pharma, Inc. has caused this Certificate of Amendment to the Certificate of Incorporation to be signed by its President on this 29th day of July, 2009.

A.P. PHARMA, INC.

/s/ Ronald Prentki
Ronald Prentki, President

SECTION 302 CERTIFICATIONS

I, Ronald J. Prentki, certify that:

1. I have reviewed this quarterly report on Form 10-Q of A.P. Pharma, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant is made known to us by others, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 4, 2009

/s/ Ronald J. Prentki

Ronald J. Prentki

President and Chief Executive Officer

SECTION 302 CERTIFICATIONS

I, John B. Whelan, certify that:

1. I have reviewed this quarterly report on Form 10-Q of A.P. Pharma, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant is made known to us by others, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 4, 2009

/s/ John B. Whelan

John B. Whelan

President and Chief Financial Officer

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION
906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of A.P. Pharma, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Ronald J. Prentki, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) the Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

August 4, 2009

/s/ Ronald J. Prentki

Ronald J. Prentki,
President and Chief Executive Officer

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION
906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of A.P. Pharma, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, John B. Whelan, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) the Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

August 4, 2009

/s/ John B. Whelan

John B. Whelan,
Chief Financial Officer