ZOGENIX, INC.
Form 10-Q
May 15, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012

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: 001-34962

Zogenix, Inc.

(Exact Name of Registrant as Specified in its Charter)

Delaware	**20-5300780**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
12400 High Bluff Drive, Suite 650	
San Diego, California	**92130**
(Address of Principal Executive Offices)	**(Zip Code)**

858-259-1165

(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. x 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 x 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 the definitions 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 x (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

The number of outstanding shares of the registrant s common stock, par value $0.001 per share, as of May 1, 2012 was 65,372,792.

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ZOGENIX, INC.

FORM 10-Q

For the Quarterly Period Ended March 31, 2012

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Zogenix, Inc.

Consolidated Balance Sheets

(In Thousands)

	March 31, 2012 (Unaudited)	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 39,844	$ 56,525
Trade accounts receivable, net	4,943	4,913
Inventory, net	14,256	16,251
Prepaid expenses and other current assets	2,632	2,210
Total current assets	61,675	79,899
Property and equipment, net	14,308	14,590
Other assets	6,297	6,151
Total assets	$ 82,280	$ 100,640
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 4,245	$ 5,168
Accrued expenses	13,018	11,093
Accrued compensation	3,089	3,805
Revolving credit facility	5,108	5,081
Long-term debt, current portion	11,140	9,758
Deferred revenue, current portion	0	8,462
Total current liabilities	36,600	43,367
Long-term debt, less current portion	39,157	42,070
Other long-term liabilities	6,245	5,891
Commitments and contingencies		
Stockholders equity:		
Common stock	65	65
Additional paid-in capital	292,510	291,252
Accumulated deficit	(292,297)	(282,005)
Total stockholders equity	278	9,312
Total liabilities and stockholders equity	$ 82,280	$ 100,640

See accompanying notes.

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Zogenix, Inc.

Consolidated Statements of Operations

(In Thousands, except Per Share Amounts)

(Unaudited)

	Three Months Ended March 31,	
	2012	2011
Revenue:		
Net product revenue	$ 9,885	$ 7,477
Contract revenue	8,462	1,563
Total revenue	18,347	9,040
Operating expenses:		
Cost of sales	5,062	4,875
Royalty expense	357	297
Research and development	5,964	8,524
Selling, general and administrative	14,649	12,901
Total operating expenses	26,032	26,597
Loss from operations	(7,685)	(17,557)
Other income (expense):		
Interest income	19	16
Interest expense	(2,678)	(1,254)
Change in fair value of warrant liability	49	0
Change in fair value of embedded derivatives	38	0
Other income (expense)	(30)	(181)
Total other income (expense)	(2,602)	(1,419)
Net loss before income taxes	(10,287)	(18,976)
Provision for income taxes	(5)	(7)
Net loss	$ (10,292)	$ (18,983)
Net loss per share, basic and diluted	$ (0.16)	$ (0.56)
Weighted average shares outstanding, basic and diluted	65,369	33,973

See accompanying notes.

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Zogenix, Inc.

Consolidated Statements of Cash Flows

(In Thousands)

(Unaudited)

	Three Months Ended March 31, 2012	2011
Operating activities:		
Net loss	$ (10,292)	$ (18,983)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation	1,256	951
Depreciation and amortization	393	391
Amortization of debt issuance costs and non-cash interest	681	342
Change in fair value of warrant liability	(49)	0
Change in fair value of embedded derivatives	(38)	0
Changes in operating assets and liabilities:		
Trade accounts receivable	(30)	755
Inventory, net	1,995	41
Prepaid expenses and other current assets	(431)	110
Other assets	(197)	41
Accounts payable and accrued expenses	466	(3,097)
Deferred rent	(14)	(15)
Deferred revenue	(8,462)	(3,378)
Net cash used in operating activities	(14,722)	(22,842)
Investing activities:		
Purchases of property and equipment	(111)	(119)
Net cash used in investing activities	(111)	(119)
Financing activities:		
Proceeds from revolving credit facility	5,163	2,414
Payments on borrowings of debt	(7,013)	(2,379)
Proceeds from exercise of common stock options	2	14
Net cash provided by (used in) financing activities	(1,848)	49
Net decrease in cash and cash equivalents	(16,681)	(22,912)
Cash and cash equivalents at beginning of period	56,525	49,172
Cash and cash equivalents at end of period	$ 39,844	$ 26,260

See accompanying notes.

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Zogenix, Inc.

Notes to Consolidated Financial Statements

1. Organization and Basis of Presentation

Zogenix, Inc. (the Company) is a pharmaceutical company commercializing and developing products for the treatment of central nervous system disorders and pain. The Company s first commercial product, Sumavel® DosePro® (*sumatriptan* injection) Needle-free Delivery System, offers fast-acting, easy-to-use, needle-free subcutaneous delivery of *sumatriptan* for the acute treatment of migraine and cluster headache in a pre-filled, single-use delivery system. Sumavel DosePro was approved by the U.S. Food and Drug Administration (FDA) on July 15, 2009 and was launched in the United States in January 2010.

The Company was incorporated in the state of Delaware on May 11, 2006 as SJ2 Therapeutics, Inc. and commenced operations on August 25, 2006. On August 28, 2006, the Company changed its name to Zogenix, Inc.

The Company has incurred significant net losses since inception and has relied on its ability to fund its operations through equity financings, debt financings, revenues from the sale of its product Sumavel DosePro and proceeds from business collaborations. As the Company continues to incur losses, successful transition to profitability is dependent upon achieving a level of revenues adequate to support the Company s cost structure. This may not occur and, unless and until it does, the Company will continue to need to raise additional cash. These conditions raise substantial doubt about the Company s ability to continue as a going concern. The accompanying financial statements have been prepared assuming that the Company will continue as a going concern and do not include any adjustments that might result from the outcome of this uncertainty. This basis of accounting contemplates the recovery of the Company s assets and the satisfaction of liabilities in the normal course of business.

Management expects operating losses and negative cash flows to continue for at least the next several years as the Company continues to incur costs related to the continued development of its product candidates and commercialization of its approved product. Management may pursue opportunities to raise additional capital through public or private equity offerings, debt financings, receivables financings or through collaborations or partnerships with other companies. There can be no assurance that the Company will be able to obtain any source of financing on acceptable terms, or at all. If the Company is unsuccessful in raising additional required funds, it may be required to significantly delay, reduce the scope of or eliminate one or more of its development programs or its commercialization efforts, or cease operating as a going concern. The Company also may be required to relinquish, license or otherwise dispose of rights to product candidates or products that it would otherwise seek to develop or commercialize itself on terms that are less favorable than might otherwise be available.

2. Summary of Significant Accounting Policies

Financial Statement Preparation and Use of Estimates

The unaudited consolidated financial statements contained in this Quarterly Report on Form 10-Q have been prepared by Zogenix, Inc. according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (GAPP) have been omitted.

In the opinion of management, the accompanying unaudited consolidated financial statements for the periods presented reflect all adjustments, which are normal and recurring, necessary to fairly state the financial position, results of operations and cash flows. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 filed with the SEC on March 12, 2012.

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results may differ from those estimates.

Principles of Consolidation

The unaudited interim consolidated financial statements include the accounts of Zogenix, Inc. and its wholly owned subsidiary Zogenix Europe Limited, which was incorporated under the laws of England and Wales in June 2010. All intercompany transactions and investments have been eliminated in consolidation. Zogenix Europe Limited s functional currency is the U.S. dollar, the reporting currency of its parent.

Fair Value Measurements

The carrying amount of financial instruments consisting of cash, trade accounts receivable, prepaid expenses and other current assets, accounts payable, accrued expenses (excluding warrant liability and the two annual tail payments payable by the Company to

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Astellas Pharma US, Inc. (Astellas) (See Note 4)), accrued compensation, borrowings under the revolving credit facility, and current portion of long-term debt, included in the Company s consolidated financial statements are reasonable estimates of fair value due to their short maturities. Based on the borrowing rates currently available to the Company for loans with similar terms, management believes the fair value of long-term debt approximates its carrying value. The long-term liability for the two annual tail payments due to Astellas for the termination of the Company s co-promotion agreement were measured at fair value using a present value technique, which incorporated the Company s own credit risk as measured by the most recent round of debt financing with Cowen Healthcare Royalty Partners II, L.P. (Cowen Royalty).

Authoritative guidance establishes a three-tier fair value hierarchy, which 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 the reporting entity to develop its own assumptions.

We classify our cash equivalents within Level 1 of the fair value hierarchy because we value our cash equivalents using quoted market prices. We classify our common stock warrant liability and embedded derivative liabilities within Level 3 of the fair value hierarchy because they are valued using valuation models with significant unobservable inputs. Assets and liabilities measured at fair value on a recurring basis at March 31, 2012 and December 31, 2011 are as follows (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
At March 31, 2012				
Assets				
Money market fund shares[1]	$ 30,671	0	0	$ 30,671
Liabilities				
Common stock warrant liability[2]	$ 0	0	296	$ 296
Embedded derivative liabilities[3]	$ 0	0	807	$ 807
At December 31, 2011				
Assets				
Money market fund shares[1]	$ 49,752	0	0	$ 49,752
Liabilities				
Common stock warrant liability[2]	$ 0	0	345	$ 345
Embedded derivative liabilities[3]	$ 0	0	845	$ 845

(1) Money market fund shares are included as a component of cash and cash equivalents on the consolidated balance sheet.

(2) Common stock warrants measured at fair value using the Black-Scholes option pricing valuation model are included as a component of accrued expenses on the consolidated balance sheet. The assumptions used in the Black-Scholes option pricing valuation model were: (a) a risk-free interest rate based on the rates for U.S. Treasury zero-coupon bonds with maturities similar to those of the remaining contractual term of the warrants; (b) an assumed dividend yield of zero based on the Company s expectation that it will not pay dividends in the foreseeable future; (c) an expected term based on the remaining contractual term of the warrants; and (d) given the Company s lack of relevant historical data due to the Company s limited historical experience, an expected volatility based upon the historical volatility of comparable companies whose share prices have been publicly

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available for a sufficient period of time. The significant unobservable input used in measuring the fair value of the warrant liability is the expected volatility based upon the historical volatility of comparable companies. Significant increases in the volatility of comparable companies would result in a higher fair value measurement.

(3) Embedded derivative liabilities measured at fair value using various discounted cash flow valuation models are included as a component of other long-term liabilities on the consolidated balance sheet. The assumptions used in the discounted cash flow valuation models include: (a) management s revenue projections and a revenue sensitivity analysis based on possible future outcomes; (b) probability weighted net cash flows based on the likelihood of Cowen Royalty receiving revenue interest payments over the term of the financing agreement; (c) probability of bankruptcy; (d) weighted average cost of capital that included the addition of a company specific risk premium to account for uncertainty associated with the Company achieving future cash flows; (e) the probability of a change in control occurring during the term of the Cowen Royalty financing agreement; and (f) the probability of an exercise of the embedded derivative instruments. The significant unobservable inputs used in measuring the fair value of the embedded derivatives are management s revenue projections. Significant decreases in these significant inputs would result in a higher fair value measurement.

The following table provides a reconciliation of liabilities measured at fair value using significant observable inputs (Level 3) for the three months ended March 31, 2012 (in thousands):

	Common Stock Warrant Liability	Embedded Derivative Liabilities
Balance at December 31, 2011	$ 345	$ 845
Changes in fair value	(49)	(38)
Balance at March 31, 2012	$ 296	$ 807

Changes in fair value of the liabilities shown in the table above are recorded through a change in fair value of warrant liability and change in fair value of embedded derivatives in other income (expense) in the consolidated statements of operations.

Net Loss per Share

Basic net loss per share is calculated by dividing the net loss by the weighted average number of common shares outstanding for the period reduced by weighted average shares subject to repurchase, without consideration for common stock equivalents. Diluted net loss per share is computed by dividing the net loss by the weighted average number of common share equivalents outstanding for the period determined using the treasury-stock method and as-if converted method, as applicable. For purposes of this calculation, stock options and warrants are considered to be common stock equivalents and are only included in the calculation of diluted net loss per share when their effect is dilutive.

The following table presents the computation of basic and diluted net loss per share (in thousands, except per share amounts):

	Three Months Ended March 31, 2012	2011
Numerator		
Net loss	$ (10,292)	$ (18,983)
Denominator		
Weighted average common shares outstanding	65,369	34,020
Weighted average shares subject to repurchase	0	(47)
Weighted average shares outstanding, basic and diluted	65,369	33,973
Basic and diluted net loss per share	$ (0.16)	$ (0.56)

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Potentially dilutive securities not included in the calculation of diluted net loss per share because to do so would be anti-dilutive are as follows (in thousands, of common equivalent shares):

	Three Months Ended March 31,	
	2012	2011
Common stock warrants	508	257
Common stock subject to repurchase	0	8
Common stock options and restricted stock units	3,483	2,659
	3,991	2,924

Segment Reporting

Management has determined that the Company operates in one business segment, which is the commercialization and development of pharmaceutical products.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued accounting guidance related to fair value measurements and disclosures to achieve common fair value measurements and disclosures between GAAP and International Financial Reporting Standards. This guidance clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurements that are estimated using significant unobservable (Level 3) inputs. This guidance is effective on a prospective basis for annual and interim reporting periods beginning on or after December 15, 2011. The Company adopted this guidance on January 1, 2012 and it did not have a material impact on the Company s results of operations.

In June 2011, the FASB issued an Accounting Standards Update which requires entities to present reclassification adjustments included in other comprehensive income on the face of the financial statements and allows entities to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate consecutive statements. It also eliminates the option for entities to present components of other comprehensive income as part of the statement of changes to stockholders equity. The updated guidance is effective for fiscal and interim periods beginning after December 15, 2011, with early adoption permitted. The Company adopted this guidance on January 1, 2012 and it did not have a material impact on the Company s results of operations.

3. Inventory, net (in thousands)

	March 31, 2012	December 31, 2011
Raw materials	$ 4,815	$ 5,260
Work in process	6,843	7,338
Finished goods	2,598	3,653
	$ 14,256	$ 16,251

4. Collaboration and Financing Agreements

Astellas Pharma US, Inc. Co-Promotion Agreement

In July 2009, the Company entered into the co-promotion agreement with Astellas (Co-Promotion Agreement). Under the terms of the agreement, the Company granted Astellas the co-exclusive right (with the Company) to market and sell Sumavel DosePro in the United States

(excluding Puerto Rico and the other territories and possessions of the United States) until June 30, 2013. Under the agreement, both Astellas and the Company were obligated to collaborate and fund the marketing of Sumavel DosePro and to provide annual minimum levels of sales effort directed at Sumavel DosePro during the term. In December 2011, the Company entered into an amendment to the Co-Promotion agreement with Astellas, or the amended Co-Promotion agreement, whereby the agreement terminated on March 31, 2012.

In connection with the execution of the Co-Promotion Agreement, Astellas made a non-refundable up-front payment of $2,000,000 and made an additional $18,000,000 of payments to the Company upon the achievement of a series of milestones. In consideration for Astellas performance of its commercial efforts, the Company paid Astellas a service fee on a quarterly basis that represents a fixed percentage of between 45% and 55% of Sumavel DosePro net sales to primary care physicians, OB/GYNs, emergency medicine physicians, and urologists in the United States (Astellas Segment).

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In accordance with accounting guidance for revenue arrangements with multiple deliverables, the Company identified the deliverables in the Co-Promotion Agreement and divided them into separate units of accounting as follows: (i) co-exclusive right to promote Sumavel DosePro combined with the manufacturing and supply of commercial and sample product; and (ii) sales support of Sumavel DosePro. Prior to the amendment of the Co-Promotion Agreement, the Company concluded both units of accounting required recognition ratably through the term of the Co-Promotion Agreement beginning with the date of the launch of Sumavel DosePro (January 2010) through June 30, 2013. Consequently, the Company initially recorded the $20,000,000 in upfront and milestone payments received from Astellas as deferred revenue. Beginning with the launch of Sumavel DosePro in January 2010, the Company began amortizing the upfront and milestone payments as contract revenue in the consolidated statement of operations over the term of the Co-Promotion Agreement. For the three months ended March 31, 2012 and 2011, the Company recognized $8,462,000 and $1,563,000, respectively, of contract revenue.

On December 20, 2011, the Company amended the Co-Promotion Agreement with Astellas to terminate the agreement on March 31, 2012, and will be required to make two annual tail payments to Astellas, calculated as decreasing fixed percentages (ranging from mid-twenties down to a mid-teen percentage) of net sales in the Astellas Segment in the last 12 months of its active promotion**.** The present value of such tail payments was estimated at a total of $5,291,000 and recorded as a long-term liability on the amendment date. The fair value of the tail payments will be accreted through interest expense through the dates of payment in July 2013 and July 2014. As of March 31, 2012, the tail payment liability of $4,303,000 and $157,000 of related interest expense was recognized during the three months ended March 31, 2012.

In accordance with accounting guidance for revenue arrangements with multiple deliverables, the Company determined that there was no change in the deliverables or units of accounting identified in the Co-Promotion Agreement upon amendment in December 2011. The Company further concluded that the remaining deferred revenue balance should be recognized ratably through the amended term of the Co-Promotion Agreement, and consequently, the remaining $8,462,000 of these deferred contract proceeds as of December 31, 2011 was recognized during the three months ended March 31, 2012.

Further, under the terms of the amended Co-Promotion Agreement, Astellas contributed its agreed upon portion of marketing expenses through March 31, 2012, and continued to earn a service fee based on product sales to the Astellas Segment during that period. The Company will no longer pay service fees to Astellas for sales of Sumavel DosePro beginning in the second quarter of 2012. Additionally, beginning in the second quarter of 2012, the Company s sales force assumed full responsibility for the commercialization and the continued marketing of Sumavel DosePro, expanding their focus to include headache specialists, neurologists and primary care physicians in the United States.

Amounts received from Astellas for shared marketing costs and sample product are reflected as a reduction of selling, general and administrative expenses, and amounts payable to Astellas for shared marketing expenses and service fees are reflected as selling, general and administrative expenses, inclusive of the estimated cost of the tail payments owed upon the termination of the agreement.

For the three months ended March 31, 2012 and 2011, the Company recognized shared marketing expense of $255,000 and $425,000, respectively, under the Co-Promotion Agreement. For the three months ended March 31, 2012 and 2011, the Company incurred $1,699,000 and $1,509,000 in service fee expenses.

Cowen Royalty Financing Agreement

On July 18, 2011, the Company closed the royalty financing agreement (the Financing Agreement) with Cowen Royalty. Under the terms of the Financing Agreement, the Company borrowed $30,000,000 from Cowen Royalty (the Borrowed Amount) and the Company agreed to repay such Borrowed Amount together with a return to Cowen Royalty, as described below, out of the Company s direct product sales, co-promotion revenues and out-license revenues (collectively, Revenue Interest) that the Company may record or receive as a result of worldwide commercialization of the Company s products including Sumavel DosePro, Zohydro and other future products.

In addition, upon the closing of and in connection with the Financing Agreement, the Company issued and sold to Cowen Royalty $1,500,000 of the Company s common stock, or 388,601 shares, at a price of $3.86 per share. The Company also issued to Cowen Royalty a warrant exercisable for up to 225,000 shares of the Company s common stock. The warrant is exercisable at $9.00 per share and has a term of 10 years. As the warrant contains covenants where compliance with such covenants may be outside the control of the Company, the warrant was recorded as a current liability and marked to market at each reporting date using the Black-Scholes option pricing valuation model (see Note 2).

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Under the Financing Agreement, the Company is obligated to pay to Cowen Royalty:

- 5% to 5.75% of the first $75,000,000 of Revenue Interest recorded (in the case of net product sales) or received (in the case of co-promotion revenues and license fees) by the Company in a calendar year (initially 5% and then 5.75% after the co-promotion agreement with Astellas terminated on March 31, 2012, with a reversion back to 5% if certain net sales of Sumavel DosePro are achieved or if Zohydro is commercialized in the four calendar quarters immediately following the effective date of termination);

- 2.5% of the next $75,000,000 of Revenue Interest recorded (in the case of net product sales) or received (in the case of co-promotion revenues and license fees) by the Company in a calendar year; and

- 0.5% of Revenue Interest over and above $150,000,000 recorded (in the case of net product sales) or received (in the case of co-promotion revenues and license fees) by the Company in a calendar year.

Net sales of Sumavel DosePro outside the United States are only included in the Revenue Interest if such net sales exceed $10,000,000. Once the aggregate payments, including the fixed payments described below, made by the Company to Cowen Royalty equal $75,000,000, the percentage of Revenue Interest owed to Cowen Royalty is reduced to 0.5% for the remainder of the term of the Financing Agreement, with only Sumavel DosePro and Zohydro subject to the Revenue Interest payments thereafter. The Company is also obligated to make three fixed payments of $10,000,000 on (or before at the option of the Company) each of January 31, 2015, January 31, 2016 and January 31, 2017. Prepayment requires the consent of the lenders under our $25.0 million loan and security agreement, while balances remain outstanding under that facility. Unless terminated as discussed below, the Financing Agreement terminates on March 31, 2018.

The obligation of the Company to make the Revenue Interest payments during the term of the Financing Agreement are secured under a security agreement by a second priority security interest (junior to the security interest of the lenders under our $25.0 million loan and security agreement) in all assets of the Company, including intellectual property and other rights of the Company to the extent necessary or used to commercialize the Company products. The security interest will be extinguished at the end of the term or once the aggregate payments made by the Company to Cowen Royalty equal to $75,000,000, whichever is sooner. Cowen Royalty, Oxford and SVB entered into an intercreditor agreement which governs their respective rights as secured creditors. The Company has agreed to specified positive and negative covenants in connection with the Financing Agreement.

The Company has the option to terminate the Financing Agreement at the Company s election in connection with a change of control of the Company, upon the payment of a base amount of $52,500,000, or, if higher, an amount that generates a 19% internal rate of return on the Borrowed Amount as of the date of prepayment, in each case reduced by the Revenue Interest and principal payments received by Cowen Royalty up to the date of prepayment.

Cowen Royalty has the option to terminate the Financing Agreement at its election in connection with a change of control of the Company (which includes the sale, transfer, assignment or licensing of the Company s rights in the United States to either Sumavel DosePro or Zohydro), or an event of default (which includes the occurrence of a bankruptcy event or other material adverse change in the Company s business), as defined in the Financing Agreement. Upon such a termination by Cowen Royalty, the Company is obligated to make a payment of a base amount of $45,000,000, or, if higher, an amount that generates a 17% internal rate of return on the Borrowed Amount as of the date of prepayment, in each case reduced by the Revenue Interest and principal payments received by Cowen Royalty up to the date of prepayment.

The rights of the Company and Cowen Royalty to terminate the Financing Agreement early meet the definition of an embedded derivative. As a result, the Company carved out these embedded derivatives from the Financing Agreement and determined the fair value of each derivative using various discounted cash flow valuation models taking into account the probability of these events occurring and various scenarios surrounding the potential Revenue Interest payments that would be made if these events occurred (see Note 2). The aggregate fair value of the embedded derivatives as of March 31, 2012 is $807,000 and is included in other long-term liabilities.

The Company received aggregate net proceeds of $29,485,000 from the Financing Agreement (including the purchase of common stock). The discounts, which are being amortized using the effective interest method over the term of the arrangement within interest expense, include the fair value of the common stock warrants issued to Cowen Royalty of $790,000 upon the closing of the Financing Agreement, fees payable to Cowen Royalty in connection with the execution of the arrangement of $476,000 and the fair value of embedded derivatives of $605,000 upon the closing of the Financing Agreement. The Company has recognized other income (expense) in relation to the change in the fair value of the common stock warrant and embedded derivatives of $49,000 and $38,000, respectively, for the three months ended March 31, 2012 in the

statement of operations.

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5. Stock-Based Compensation

The Company uses the Black-Scholes option-pricing model for determining the estimated fair value and stock-based compensation for stock-based awards to employees and the board of directors. The assumptions used in the Black-Scholes option-pricing model for the three months ended March 31, 2012 are as follows:

	Three Months Ended March 31,	
	2012	2011
Risk free interest rate	0.2% to 1.2%	2.2% to 2.5%
Expected term	5.0 to 6.07 years	5.3 to 6.1 years
Expected volatility	80.6%	72.3% to 89.6%
Expected dividend yield	0.0%	0.0%

The risk-free interest rate assumption was based on the rates for U.S. Treasury zero-coupon bonds with maturities similar to those of the expected term of the award being valued. The assumed dividend yield was based on the Company s expectation of not paying dividends in the foreseeable future. The weighted average expected term of options was calculated using the simplified method as prescribed by accounting guidance for stock-based compensation. This decision was based on the lack of relevant historical data due to the Company s limited historical experience. In addition, due to the Company s limited historical data, the estimated volatility was calculated based upon the historical volatility of comparable companies whose share prices have been publicly available for a sufficient period of time.

The Company recognized stock-based compensation expense as follows (in thousands):

	Three Months Ended March 31,	
	2012	2011
Cost of sales	$ 29	$ 39
Research and development	195	145
Selling, general and administrative	1,032	767
Total	$ 1,256	$ 951

As of March 31, 2012, there was approximately $8,637,565 of total unrecognized compensation costs related to outstanding options, which is expected to be recognized over a weighted average period of 2.68 years.

6. Subsequent Events

In April 2012, the Company entered into a new operating lease for approximately 13,124 rentable square feet of office space located in San Diego, California. The Company intends to use the leased premises as its new corporate headquarters, and the new space replaces the Company s former San Diego office lease that expired in April 2012. The term of the lease commenced on April 23, 2012 and will expire on November 27, 2014. The initial base rent will be $34,122 per month, with rent being abated for the second, third and fourth months of the lease term. The base rent will increase approximately 3% on an annual basis throughout the term. The lease also requires the Company to pay, following the first 12 lease months, additional rent consisting of a portion of common area and pass-through expenses in excess of base year amounts.

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. These forward looking statements include, but are not limited to, statements about:

- our ability to maintain and increase market demand for, and sales of, Sumavel DosePro;
- our ability to successfully execute our sales and marketing strategy for the commercialization of Sumavel DosePro;
- the progress and timing of clinical trials for our product candidates;
- the timing of submissions to, and decisions made by, the FDA and other regulatory agencies, including foreign regulatory agencies, and demonstrating the safety and efficacy of Zohydro or any other product candidates to the satisfaction of the FDA and such other agencies;
- adverse side effects or inadequate therapeutic efficacy of Sumavel DosePro that could result in product recalls, market withdrawals or product liability claims;
- the safety and efficacy of Zohydro and our other product candidate;
- the market potential for migraine treatments, and our ability to compete within that market;
- the goals of our development activities and estimates of the potential markets for our product candidates, and our ability to compete within those markets;
- estimates of the capacity of manufacturing and other facilities to support our product and product candidates;
- our ability to ensure adequate and continued supply of Sumavel DosePro to successfully meet anticipated market demand;
- our expected third party research and development costs for Zohydro remaining through potential regulatory approval from the FDA;
- our and our licensors ability to obtain, maintain and successfully enforce adequate patent and other intellectual property protection of our products and product candidates and the ability to operate our business without infringing the intellectual property rights of others;

our ability to obtain and maintain adequate levels of coverage and reimbursement from third-party payors for Sumavel DosePro or any of our other product candidates that may be approved for sale, the extent of such coverage and reimbursement and the willingness of third-party payors to pay for our products versus less expensive therapies;

the impact of healthcare reform legislation; and

projected cash needs and our expected future revenues, operations and expenditures.

The forward-looking statements are contained principally in the sections entitled Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations. In some cases, you can identify forward-looking statements by the following words: may, will, could, would, should, expect, intend, plan, anticipate, believe, estimate, predict, project, potential, continue, ongoin terms or other comparable terminology, although not all forward-looking statements contain these words. These statements relate to future events or our future financial performance or condition and involve known and unknown risks, uncertainties and other factors that could cause our actual results, levels of activity, performance or achievement to differ materially from those expressed or implied by these forward-looking statements. We discuss many of these risks, uncertainties and other factors in this Quarterly Report on Form 10-Q in greater detail under the heading Item 1A Risk Factors.

Given these risks, uncertainties and other factors, we urge you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. You should read this Quarterly Report on Form 10-Q completely and with the understanding that our actual future results may be materially different from what we expect. For all forward-looking statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. We undertake no obligation to revise or update publicly any forward-looking statements, whether as a result of new information, future events or otherwise, unless required by law.

DosePro®, Intraject®, Relday , Sumavel®, Zogenix and Zohydro are our trademarks. All other trademarks, trade names and service marks appearing in this Quarterly Report on Form 10-Q are the property of their respective owners. Use or display by us of other parties trademarks, trade dress or products is not intended to and does not imply a relationship with, or endorsements or sponsorship of, us by the trademark or trade dress owner.

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Unless the context requires otherwise, references in this Quarterly Report on Form 10-Q to Zogenix, we, us and our refer to Zogenix, Inc., including, as of June 7, 2010, its consolidated subsidiary.

The interim consolidated financial statements and this Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2011 and the related Management s Discussion and Analysis of Financial Condition and Results of Operations, both of which are contained in our Annual Report on Form 10-K for the year ended December 31, 2011.

Overview

Background

We are a pharmaceutical company commercializing and developing products for the treatment of central nervous system disorders and pain. Our first commercial product, Sumavel DosePro (*sumatriptan* injection) Needle-free Delivery System, offers fast-acting, easy-to-use, needle-free subcutaneous administration of *sumatriptan* for the acute treatment of migraine and cluster headache in a pre-filled, single-use delivery system. We launched the commercial sale of Sumavel DosePro in the United States in January 2010 with our co-promotion partner, Astellas Pharma US, Inc., or Astellas. Our sales and marketing organization is comprised of approximately 115 professionals. Our field sales force of approximately 95 representatives has historically promoted Sumavel DosePro primarily to neurologists and other prescribers of migraine medications, including headache clinics and headache specialists. Our promotional efforts have been complemented by our collaboration with Astellas and approximately 400 of its sales representatives, who have promoted Sumavel DosePro primarily to primary care physicians, OB/GYNs, emergency medicine physicians and urologists in the United States. Our collaboration with Astellas terminated on March 31, 2012, at which time we assumed full responsibility for the commercialization of Sumavel DosePro. During the first quarter of 2012, we began to assume responsibility from Astellas for marketing Sumavel DosePro to selected high-prescribing primary care physicians and other Astellas-targeted physicians and professionals within the Astellas Segment pursuant to a promotion transition plan. We are currently evaluating potential co-promotion partners who could complement our sales force efforts for the commercial sale of Sumavel DosePro. We also have entered into a partnership for Sumavel DosePro with Desitin Arzneimittel GmbH, or Desitin, to accelerate development and regulatory approvals in Europe and further enhance the global commercial potential of Sumavel DosePro.

On May 1, 2012, we submitted a New Drug Application, or NDA, to the U.S. Food and Drug Administration, or FDA, for our lead product candidate, Zohydro (*hydrocodone* bitartrate). Zohydro is a 12-hour extended-release formulation of *hydrocodone* without acetaminophen for the treatment of moderate to severe chronic pain requiring around-the-clock opioid therapy. We completed Phase 3 development of Zohydro in 2011, and we in-licensed exclusive U.S. rights to Zohydro from Alkermes plc (formerly Elan Pharma International Limited) in 2007.

In March 2012, we entered into a co-marketing and option agreement with Battelle Memorial Institute, or Battelle, to accelerate the out-licensing efforts of our DosePro drug delivery technology. Under this co-marketing and option agreement, Battelle will have the exclusive right to co-market our DosePro drug delivery technology to a specified list of Battelle s pharmaceutical clients. In addition, we granted Battelle the option to enter into an exclusive co-development and commercialization agreement with us related to our 1.2 mL DosePro drug delivery technology.

In July 2011, we entered into a development and license agreement with Durect Corporation, or the Relday license agreement, pursuant to which we will be responsible for the clinical development and commercialization of Relday, a proprietary, long-acting injectable formulation of risperidone using Durect s SABER controlled-release formulation technology in combination with our DosePro needle-free, subcutaneous drug delivery system. Risperidone is used to treat the symptoms of schizophrenia and bipolar disorder in adults and teenagers 13 years of age and older. Relday will be developed to address unmet clinical needs in this patient population and is being developed to be a once-monthly, subcutaneous antipsychotic product. We expect to initiate clinical studies for the new product candidate in patients with schizophrenia in 2012 following filing of an investigational new drug application in the second quarter of 2012.

We have experienced net losses and negative cash flow from operating activities since inception, and as of March 31, 2012, had an accumulated deficit of $292.3 million. We expect to continue to incur net losses and negative cash flow from operating activities for at least the next several years primarily as a result of the expenses incurred in connection with our regulatory filings for Zohydro, the initiation of clinical development for Relay, any additional required testing for Zohydro, and the cost of the sales and marketing expense associated with Sumavel DosePro, and, if approved, Zohydro. As of March 31, 2012, we had cash and cash equivalents of $39.8 million. Although it is difficult to predict future liquidity requirements, we believe that our cash and cash equivalents as of March 31, 2012, estimated future product revenues and borrowings available under our $10.0 million revolving credit facility, will be sufficient to fund our operations into the first quarter of 2013. We will need to obtain additional capital to finance our operations beyond that point. We intend to raise additional capital through debt or equity financings or through collaborations or partnerships with other companies. If we are not able to raise additional capital on terms acceptable to us, or at all, as and when needed, we may be

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required to reduce or curtail our operations and costs, and we may be unable to continue as a going concern. In its report on our consolidated financial statements for the year ended December 31, 2011, our independent registered public accounting firm included an explanatory paragraph expressing substantial doubt regarding our ability to continue as a going concern.

Astellas Co-Promotion Agreement

Under our co-promotion agreement with Astellas that we entered into in July 2009, or the co-promotion agreement, Astellas primarily promoted Sumavel DosePro to primary care physicians (including internal medicine, family practice and general practice), OB/GYNs, emergency medicine physicians and urologists, or collectively, the Astellas Segment, in the United States. Our sales force historically promoted Sumavel DosePro primarily to neurologists and other key prescribers of migraine medications, including headache clinics and headache specialists in the United States. We jointly shared in the cost of advertising, marketing and other promotional activities related to the Sumavel DosePro brand and were required to provide minimum levels of sales effort to promote Sumavel DosePro. In December 2011, we entered into an amendment to the co-promotion agreement with Astellas, or the amended co-promotion agreement, whereby the agreement terminated on March 31, 2012.

Under the terms of the amended co-promotion agreement, we will be required to make two annual tail payments to Astellas, estimated as a total of $5.5 million, calculated as decreasing fixed percentages (ranging from a mid-twenties down to a mid-teen percentage) of net sales in the Astellas Segment in the last 12 months of its active promotion. The present value of such tail payments was recorded as a long-term liability on the amendment date and is payable in July 2013 and July 2014. The fair value of the tail payments will be accreted through interest expense on a monthly basis through the date of payment. As of March 31, 2012, the long-term tail payment liability was $4.3 million, net of the discount, and there was $0.2 million of related interest expense recognized during the three months ended March 31, 2012. Additionally, beginning in the second quarter of 2012, our sales force assumed full responsibility for the continued marketing of Sumavel DosePro, expanding our focus to include a portion of the high-prescribing primary care physicians previously covered by Astellas under the co-promotion agreement. We expect to seek another co-promotion partner to compliment our sales to promote Sumavel DosePro, if available.

At the inception of the co-promotion agreement and in exchange for the right to promote Sumavel DosePro, Astellas made a non-refundable up-front payment of $2.0 million to us and made an additional $18.0 million of payments to us upon the achievement of a series of milestones. These proceeds are reflected as $8.5 million of deferred revenues on our consolidated balance sheet at December 31, 2011. Beginning with the launch of Sumavel DosePro in January 2010, we began recognizing these proceeds as contract revenues on a ratable basis over 42 months (the original term of the agreement). Upon amendment of the co-promotion agreement on December 20, 2011, the remaining deferred proceeds were recognized as contract revenues on a ratable basis over 3.4 months (the remaining term of the amended agreement). This acceleration in the recognition of the contract proceeds resulted in the recognition of $8.5 million of contract revenue during the three months ended March 31, 2012.

In consideration for Astellas performance of its commercial efforts, we were required to pay Astellas a service fee on a quarterly basis that represents a fixed percentage of between 45% and 55% of Sumavel DosePro net sales to the Astellas Segment through the date of termination. Astellas paid us a fixed fee for all sample units they ordered for distribution to their sales force. Amounts received from Astellas for shared marketing costs and sample product are reflected as a reduction of selling, general and administrative expenses, and amounts payable to Astellas for shared marketing expenses and service fees are reflected as selling, general and administrative expenses. For the three months ended March 31, 2012 and 2011, we incurred $1.7 million and $1.5 million, respectively, in service fee expenses. For the three months ended March 31, 2012 and 2011, we recognized shared marketing expense of $0.3 million and $0.4 million, respectively.

We record the revenues related to all products sales, including sales generated by the Astellas sales force. Consequently, we record cost of sales for all product sales. For the three months ended March 31, 2012 and 2011, the Astellas Segment represented approximately 31% and 40%, respectively, of our prescription demand.

Based on third-party data, approximately 86% of the prescription demand in the Astellas Segment was concentrated to a population of approximately 500 physicians, which we believe our sales force will be able to support after our transition plan utilizing our Phase IV data, toolbox and other promotional activities. As such, we do not expect that all of the prescription demand contributed by the Astellas sales force will be foregone as a result of the early termination of the co-promotion agreement. However, in the event we are unsuccessful in transitioning the Astellas Segment to our sales force, our net product sales and financial results could be negatively impacted.

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Revenues

For the three months ended March 31, 2012 and 2011 we recognized $9.9 million and $7.5 million, respectively, in net product revenues. For the three months ended March 31, 2012 and 2011 we recognized $8.5 million and $1.6 million, respectively, in contract revenues associated with license and milestone payments made to us by Astellas under the co-promotion agreement.

We sell Sumavel DosePro product in the United States to wholesale pharmaceutical distributors and retail pharmacies, or collectively, our customers, subject to rights of return. Prior to the third quarter of 2011, Sumavel DosePro had a limited sales history, and we could not reliably estimate expected returns of the product at the time of shipment. Accordingly, we deferred recognition of revenue on product shipments of Sumavel DosePro until the right of return no longer existed, which occurred at the earlier of the time Sumavel DosePro units were dispensed through patient prescriptions or expiration of the right of return. Units dispensed are generally not subject to return, except in the rare cases where the product malfunctions or the product is damaged in transit. We estimate patient prescriptions dispensed using an analysis of third-party information, including third-party market research data.

Beginning in the third quarter of 2011, we began recognizing Sumavel DosePro product sales at the time title transfers to our customer, and providing for an estimate of future product returns at that time. We believe that our estimated product return allowances for Sumavel DosePro require a high degree of judgment and are subject to change based on our experience and certain quantitative and qualitative factors. Sumavel DosePro currently has a shelf life of 24 months from the date of manufacture. We accept unused product from our customers that are within six months before and up to one year after its expiration date for a credit at the then-current whole acquisition cost, or WAC, reduced by a nominal fee for processing the return. Our initial product inventories reached expiration in 2011.

We have monitored actual return history on an individual product lot basis since product launch. Actual product return experience in 2011 included a disproportionately high amount of returns from a single retail chain. In addition, we have also experienced a high level of returned product from our initial launch stocking initiatives. We may experience higher levels of returns upon the termination of the co-promotion agreement with Astellas on March 31, 2012 due to fall-off of prescription demand in territories that may no longer be supported with direct promotional efforts. We consider these factors as well as the dating of our product at the time of shipment into the distribution channel, prescription trends and changes in the estimated levels of inventory within the distribution channel to estimate our exposure for returned product. Because of the shelf life of Sumavel DosePro and our return policy of issuing credits on returned product that is within six months before and up to one year after its product expiration date, there may be a significant period of time between when the product is shipped and when we issue credits on returned product. Accordingly, we may have to adjust these estimates, which could have an effect on product sales and earnings in the period of adjustments. A 1% increase or decrease in our returns reserve as a percentage of product shipped in the first quarter of 2012 would have a cumulative financial statement impact of approximately $0.1 million for the three months ended March 31, 2012.

We permit certain wholesale pharmaceutical distributors to purchase limited quantities of product after the announcement of an increase to the WAC of our product and prior to the effectiveness of the increase. In turn, WAC price increases can result in accelerated purchases by wholesalers relative to anticipated retail and prescription demand. The timing of purchases made by wholesale distributors and retail pharmacies are subject to fluctuations for these reasons among others. Absent accelerated purchasing by wholesalers or other periodic changes in buying patterns, the wholesale channel has historically contained two to three weeks of product on hand. As of March 31, 2012, wholesale distributors reported approximately three weeks of our product on hand.

Cost of Sales

Cost of sales consist primarily of materials, third-party manufacturing costs, freight and indirect personnel and other overhead costs associated with sales of Sumavel DosePro based on units dispensed through patient prescriptions, as well as reserves for excess, dated or obsolete commercial inventories and production manufacturing variances. For the three months ended March 31, 2012 and 2011, our cost of sales was $5.1 million and $4.9 million, respectively. Our product gross margin for the three months ended March 31, 2012 and 2011 was 49% and 35%, respectively.

Royalty Expense

Royalty expense consists of the amortization of the $4.0 million milestone payment paid by us to Aradigm Corporation upon the first commercial sale of Sumavel DosePro in the United States (which occurred in January 2010) and royalties payable to Aradigm based on net sales of Sumavel DosePro by us or one of our licensees. We are not required to make any further milestone payments to Aradigm. Our ongoing royalty obligation payable to Aradigm is set forth in the asset purchase agreement we entered into with Aradigm in August 2006 pursuant to which we acquired the rights to the DosePro technology. During the three months ended March 31, 2012 and 2011, we incurred $0.4 million and $0.3 million, respectively, in royalty expense to Aradigm.

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Research and Development Expenses

Our research and development expenses consist of expenses incurred in developing, testing and seeking marketing approval of our product candidates, including:

- payments made to Durect for the license to and further development of Relday;
- milestone payments made to Alkermes in connection with development and regulatory milestones of Zohdyro;
- payments made to third-party contract research organizations, or CROs, and investigational sites, which conduct our trials on our behalf, and consultants;
- expenses associated with regulatory submissions, pre-clinical development and clinical trials;
- payments to third-party manufacturers, which produce our active pharmaceutical ingredient and finished product;
- payments made to third-party CROs, laboratories and consultants in connection with pre-clinical studies;
- personnel related expenses, such as salaries, benefits, travel and other related expenses, including stock-based compensation; and
- facility, maintenance, depreciation and other related expenses.

We expense all research and development costs as incurred.

In March 2010, we initiated our Phase 3 clinical development program for Zohydro. We utilize CROs, contract laboratories and independent contractors for the conduct of pre-clinical studies and clinical trials. In 2010, we began tracking third party costs by type of study being conducted. We recognize the expenses associated with the services provided by CROs based on the percentage of each study completed at the end of each reporting period. We coordinate clinical trials through a number of contracted investigational sites and recognize the associated expense based on a number of factors, including actual and estimated subject enrollment and visits, direct pass-through costs and other clinical site fees. For the three months ended March 31, 2012 and 2011, we incurred $3.0 million and $6.5 million in third party research and development costs related to Zohydro, respectively.

Relday is currently in the pre-clinical development phase and we plan to initiate clinical development of Relday in 2012. We recognize the costs of pre-clinical work as it is performed. Under the Relday license agreement, Durect is responsible for non-clinical, formulation, chemistry, and manufacturing and controls development for Relday. We paid a non-refundable upfront fee to Durect of $2.25 million in July 2011. In addition, we incurred $1.1 million in research and development costs payable to Durect during the three months ended March 31, 2012.

We use our employee and infrastructure resources across our product and product candidate development programs. Therefore, we have not tracked salaries, other personnel related expenses, facilities or other related costs to our product development activities on a program-by-program basis. The following table illustrates, for each period presented, our research and development costs broken down by our major development programs, as well as other expenses not tracked on a program-by-program basis, as described above, and expenses associated with all other product candidates:

	Three Months Ended March 31,	
	2012	2011
	(In Thousands)	
Research and development expenses:		
Zohydro	$ 3,045	$ 6,499
Relday	1,329	503
Sumavel DosePro	142	92
Other (1)	1,448	1,430
Total	$ 5,964	$ 8,524

(1) Other research and development expenses include development costs incurred for the DosePro technology sound enhancement and other product candidate development, as well as employee and infrastructure resources that are not tracked on a program-by-program basis.

We expect our research and development costs for 2012 to decrease over amounts incurred in 2011 as we completed the Phase 3 clinical trials for Zohydro in December 2011. We are obligated to pay Alkermes a $1.0 million milestone payment in the second quarter of 2012 in connection with the submission of the NDA for Zohydro to the FDA. We may be obligated to pay Alkermes up to

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$2.75 million in total additional future milestone payments with respect to Zohydro depending upon the achievement of other various development and regulatory events. These future milestone payments include a payment of $0.8 million upon successful completion of an FDA pre-approval inspection of our manufacturing facility. If Zohydro is approved, we are also required to pay a mid single-digit percentage royalty on its net sales for a specified period of time and continue to pay royalties on net sales of the product thereafter at a reduced low single-digit percentage rate in accordance with the terms of the license agreement.

While we submitted an NDA for Zohydro with the FDA early in the second quarter of 2012, the successful development and commercialization of Zohydro is highly uncertain. We also expect to incur customary regulatory costs associated with the NDA, which will be significant. If Zohydro is approved, we also expect to incur significant expenses related to manufacturing and marketing activities. However, at this time, we cannot reasonably estimate or know the nature, specific timing and estimated costs of the efforts that will be necessary to complete the remainder of the development of Zohydro after submission of our NDA filing, if or when Zohydro will receive regulatory approval and, if approved, if and when material net cash inflows may commence from Zohydro or the amount of any such inflows. This is due to the numerous risks and uncertainties associated with developing and commercializing drugs, including the uncertainty of:

- the costs, timing and outcome of regulatory review of Zohydro;
- the costs, timing and outcome of any additional pre-clinical studies and clinical trials for Zohydro, if required;
- the costs of commercialization activities, including product marketing, sales and distribution;
- the potential for future collaborations, when such arrangements will be secured, if at all, and to what degree such arrangements would affect our development and commercialization plans and capital requirements;
- the costs of preparing, filing and prosecuting patent applications and maintaining, enforcing and defending intellectual property-related claims;
- the emergence of competing technologies and products and other adverse marketing developments;
- the effect on our product development activities of actions taken by the FDA or other regulatory authorities; and
- our degree of success in commercializing Zohydro, if approved.

A change in the outcome of any of these variables with respect to the development of Zohydro could mean a significant change in the costs and timing associated with these efforts.

We also expect to incur costs associated with clinical studies for our early-stage product candidates and manufacturing development for our DosePro technology. We expect to incur total research and development costs of approximately $3.0 million to $4.0 million in 2012 for initial clinical studies planned for Relday. We also expect to incur total research and development costs of approximately $0.1 million to $0.3 million in 2012 for the development of the Sumavel DosePro 4 mg line extension and sound enhancement of the DosePro technology.

Selling, General and Administrative Expenses

Our selling expenses, which includes sales and marketing costs, consist primarily of salaries and benefits of sales and marketing management and sales representatives, shared marketing and advertising costs under our co-promotion agreement with Astellas, sample product costs, and consulting fees. Our selling expenses may further increase in connection with a new co-promotion agreement with another third party.

Our general and administrative expenses consist primarily of salaries and related costs for personnel in executive, finance, accounting, business development and internal support functions. In addition, general and administrative expenses include facility costs and professional fees for legal, consulting and accounting services. We do not expect a significant change in general and administrative expense in 2012 as compared to 2011 levels.

Interest Income

Interest income consists of interest earned on our cash and cash equivalents.

Interest Expense

Interest expense consists of interest or revenue interest payments incurred in connection with our $30.0 million royalty financing agreement, or the Cowen Financing agreement, with Cowen Healthcare Royalty Partners II, L.P., or Cowen Royalty, our $10.0 million revolving credit facility with Oxford Finance LLC, or Oxford, and Silicon Valley Bank, or SVB, our $25.0 million loan and security agreement, or the Oxford/SVB loan agreement, the $4.5 million borrowed under our loan and security agreement with General

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Electric Capital Corporation, or GE Capital, and non-cash interest expense associated with amortization of debt discount and debt issuance costs, the estimated cost of revenue interest payments calculated under the effective interest method, and imputed interest from the two annual tail payments to Astellas. The outstanding principal balance of the GE Capital agreement was repaid in full on June 30, 2011.

We expect that interest expense will increase over 2011 levels due to a full year of borrowing under our $30.0 million Cowen Financing agreement that we entered into in July 2011, and the recognition of imputed interest from the two annual tail payments to Astellas related to the termination of our co-promotion agreement.

Change in Fair Value of Warrant Liability

Change in fair value of warrant liability represents non-cash income associated with the changes in the fair value of the warrants to purchase common stock issued in connection with our Cowen Financing agreement.

Change in Fair Value of Embedded Derivatives

Change in fair value of embedded derivatives represents non-cash income from changes in the fair value of the embedded derivatives associated with the Cowen Financing agreement.

Other Income (Expense)

Other income (expense) consists of foreign currency transaction gains and losses. All of our revenues are currently generated in U.S. dollars while a majority of our manufacturing expenses are payable in foreign currencies, primarily U.K. pounds sterling and the Euro.

Provision for Income Taxes

Income tax expense primarily consists of costs related to the taxable income generated by our wholly-owned subsidiary, Zogenix Europe Limited.

Internal Control Over Financial Reporting

Assessing our staffing and training procedures to improve our internal control over financial reporting is an ongoing process. For the year ending December 31, 2012, pursuant to Section 404 of the Sarbanes-Oxley Act, management is required to deliver a report that assesses the effectiveness of our internal control over financial reporting. Pursuant to Section 404(c) of the Sarbanes-Oxley Act, our independent registered public accounting firm will be required to deliver an attestation report on the effectiveness of our internal control over financial reporting for the year ending December 31, 2012 if we are no longer a non-accelerated filer.

Critical Accounting Policies and Estimates

There have been no significant changes in critical accounting policies during the three months ended March 31, 2012, as compared to the critical accounting policies described in *Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Significant Judgments and Estimates* in our Annual Report on Form 10-K for the year ended December 31, 2011.

Results of Operations

Comparison of the three months ended March 31, 2012 and 2011

Revenue. Revenue for the three months ended March 31, 2012 was $18.3 million and $9.0 million for the three months ended March 31, 2011. Product revenue for the three months ended March 31, 2012 and 2011 consists of $9.9 million and $7.5 million, respectively. During the third quarter of 2011, we began to recognize net product sales upon the shipment of product to wholesale pharmaceutical distributors and retail pharmacies because we had developed sufficient historical experience and data to reasonably estimate future returns of Sumavel DosePro. Prior to the third quarter of 2011, we recognized product revenue based on product dispensed to patients as estimated by independent third party data providers, which amounts were recorded net of estimated wholesaler and retail pharmacy discounts, stocking allowances, prompt pay discounts, chargebacks, rebates and patient discount programs, as applicable. As a result, product revenue for the three months ended March 31, 2011 represents product revenue based on product dispensed to patients net of product-related discounts and allowances, as applicable, and product revenue for the three months ending March 31, 2012 consists of Sumavel DosePro shipped to wholesale distributors and retail pharmacies, net of

product-related discounts, allowances and product returns, as applicable. The aggregate $2.4 million, or 32%, increase in net product revenue is

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primarily due to an increase in prescription volume, offset by a decrease in our average selling price per unit. This decrease in our average selling price per unit was driven by an increase of $2.7 million in product sales allowances through increased third-party payor contracting/rebates and patient incentives, and in charges related to estimated product returned in the first quarter of 2012.

Contract revenue for the three months ended March 31, 2012 and 2011 consists of $8.5 million and $1.6 million, respectively. Contract revenue represents amortization of license fee payments and milestone payments we received in connection with the co-promotion agreement we entered into with Astellas in July 2009 and which we began recognizing upon the commencement of sales of Sumavel DosePro in January 2010. On December 20, 2011 we amended our co-promotion agreement with Astellas whereby the agreement terminated on March 31, 2012, rather than the initial termination date of June 30, 2013. Based upon this revised termination date, all deferred contract revenue was recognized ratably on an accelerated basis, from the date of the amendment through March 31, 2012.

Cost of Sales. Cost of sales for the three months ended March 31, 2012 was $5.1 million and $4.9 million for the three months ended March 31, 2011. Product gross margin for the three months ended March 31, 2012 was 49% compared to 35% for the three months ended March 31, 2011. Cost of sales represents the cost of Sumavel DosePro units recognized as net product revenues in the period and the impact of underutilized production capacity (if any) and other manufacturing variances. The improvement in product gross margin of 14% was primarily a result of a 32% increase in net product sales of Sumavel DosePro during the three months ended March 31, 2012 as compared to 2011, and a decrease in excess capacity charges of our contract manufacturing organizations during the three months ended March 31, 2012 as compared to the three months ended March 31, 2011. Additionally, the Company capitalized $0.6 million related to overhead variances at a third party manufacturer which are expected to be absorbed by the end of 2012.

Royalty Expense. Royalty expense increased to $0.4 million for the three months ended March 31, 2012 from $0.3 million for the three months ended March 31, 2011. Royalty expense represents the amortization of a $4.0 million milestone payment we made in connection with the asset purchase agreement with Aradigm payable on the first commercial sale of Sumavel DosePro, which occurred in January 2010, as well as royalties payable to Aradigm from net sales of Sumavel DosePro during the period. The $0.1 million increase in royalty expense is primarily due to the increase in net product sales.

Research and Development Expenses. Research and development expenses decreased to $6.0 million for the three months ended March 31, 2012 compared to $8.5 million for the three months ended March 31, 2011. This decrease of $2.6 million primarily was due to:

- a decrease of $3.5 million in third party research and development costs related to the Phase 3 clinical trials for Zohydro, which were initiated in March 2010 and completed in December 2011; offset by
- an increase of $0.8 million in research and development costs related to the pre-clinical studies and formulation and stability testing for Relday; and
- an increase of $0.1 million in other development expenses primarily related to the development of our other product candidates and costs related to our employee and infrastructure resources that are not tracked on a program-by-program basis.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased to $14.6 million for the three months ended March 31, 2012 compared to $12.9 million for the three months ended March 31, 2011. Selling expenses were $11.4 million for the three months ended March 31, 2012 compared to $9.9 million for the three months ended March 31, 2011. General and administrative expenses were $3.2 million for the three months ended March 31, 2012 compared to $3.0 million for the three months ended March 31, 2011. The increase of $1.7 million in selling, general and administrative expenses primarily was due to:

- an increase of $1.5 million in sales and marketing expense primarily as a result of $0.8 million increase in sales force costs due to an increase in the average number of sales representatives, $0.5 million increase in sampling efforts, a $0.3 million increase in marketing and other pre-commercial preparatory costs for Zohydro, $0.2 increase in service fees to Astellas, and $0.1 million increase in non-cash stock-based compensation charges, offset by $0.4 million decrease in general advertising and promotional efforts for Sumavel DosePro; and

an increase of $0.2 million of general and administrative expenses primarily as a result of $0.2 million increase in personnel costs due to an increase in headcount and $0.1 million increase in non-cash stock-based compensation charges, offset by $0.1 million decrease in professional service related costs, such as legal and accounting and advisory services.

Interest Income. Interest income increased to $19,000 for the three months ended March 31, 2012 compared to $16,000 for the three months ended March 31, 2011. This increase of $3,000 was due primarily to the increase in average cash and cash equivalent balances.

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Interest Expense. Interest expense increased to $2.7 million for the three months ended March 31, 2012 compared to $1.3 million for the three months ended March 31, 2011. The increase of $1.4 million was due primarily to:

- an increase of $0.5 million in revenue interest payments related to the $30.0 million borrowed from Cowen Royalty and $0.8 million in accrued non-cash interest expense based on our estimate of future revenue interest payments on this facility; and
- an increase of $0.2 million in non-cash interest expense related to imputed interest from the two annual tail payments to Astellas; offset by
- a decrease of $0.1 million in interest expense due to a lower average debt balance associated with our revolving credit facility.

Change in Fair Value of Warrant Liability. Change in fair value of warrant liability resulted in $49,000 of non-cash income during the three months ended March 31, 2012, which was due to the change in fair value of warrant liability established in connection with the Cowen Financing agreement in July 2011.

Change in Fair Value of Embedded Derivatives. Change in fair value of embedded derivatives resulted in $38,000 of non-cash income during the three months ended March 31, 2012, which was due to the change in fair value of the embedded derivatives associated with the Cowen Financing agreement in July 2011.

Other Income (Expense). Other income (expense) decreased to $30,000 of expense for the three months ended March 31, 2012 compared to $0.2 million of expense for the three months ended March 31, 2011. Changes in other income (expense) were primarily related to foreign currency transaction gains and losses which primarily related to the settlement of our liabilities payable in Euro and U.K pound sterling.

Liquidity and Capital Resources

We have experienced net losses and negative cash flow from operations since inception, and as of March 31, 2012, had an accumulated deficit of $292.3 million, and we expect our losses to continue for at least the next several years as a result of the expenses incurred in connection with our regulatory filings for Zohydro, the initiation of clinical development for Relday, any additional required testing for Zohydro, and and the cost of the sales and marketing expense associated with Sumavel DosePro, and, if approved, Zohydro.

As of March 31, 2012, we had cash and cash equivalents of $39.8 million. Although it is difficult to predict future liquidity requirements, we believe that our cash and cash equivalents as of March 31, 2012, together with estimated future product revenue and borrowings available under our $10.0 million revolving credit facility, will be sufficient to fund our operations into the first quarter of 2013. We will need to obtain additional capital to finance our operations beyond that point or possibly earlier. We intend to raise additional capital through public or private equity offerings, debt financings, receivables financings or through collaborations or partnerships with other companies. If we are unsuccessful in raising additional required funds, we may be required to significantly delay, reduce the scope of or eliminate one or more of our development programs or our commercialization efforts, or cease operating as a going concern. We also may be required to relinquish, license or otherwise dispose of rights to product candidates or products that we would otherwise seek to develop or commercialize ourselves on terms that are less favorable than might otherwise be available.

In its report on our consolidated financial statements for the year ended December 31, 2011, our independent registered public accounting firm included an explanatory paragraph expressing substantial doubt regarding our ability to continue as a going concern. A going concern opinion means, in general, that our independent registered public accounting firm has substantial doubt about our ability to continue our operations without continuing infusions of capital from external sources and this opinion could impair our ability to finance our operations through the sale of debt or equity securities or commercial bank loans. Our ability to continue as a going concern depends, in large part, on our ability to generate positive cash flow from operations and obtain additional financing, neither of which is certain, as well as the continued availability of borrowings under our amended Oxford/SVB loan agreement. If we are unable to achieve these goals, our business would be jeopardized and we may not be able to continue operations and have to liquidate our assets and may receive less than the value at which those assets were carried on our financial statements, and it is likely that investors will lose all or part of their investment.

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Since inception, our operations have been financed primarily through equity and debt financings, the issuance of convertible notes and payments received from Astellas under our co-promotion agreement. Through March 31, 2012, we received aggregate net cash proceeds of approximately $274.8 million from the sale of shares of our preferred and common stock, including the following recent financing transactions:

- in July 2011, we entered into the Cowen Financing agreement pursuant to which we sold 388,601 shares of our common stock, resulting in $1.4 million of net proceeds; and

- in September 2011 and October 2011, we issued and sold a total of 30,711,566 shares of common stock in a follow-on public offering, including shares issued upon the exercise of the underwriters option to purchase shares, for aggregate net proceeds of $57.9 million.

On June 30, 2011, we amended the existing loan agreement with Oxford and SVB to provide for, among other things, the addition of intellectual property to the collateral securing the Oxford/SVB loan and deferral of principal repayment to commence on February 1, 2012. In connection with entering into the amended Oxford/SVB loan agreement, we issued to Oxford and SVB warrants exercisable into an aggregate of 26,455 shares of our common stock. The warrants are exercisable at $3.78 per share of common stock and have a term of 7 years. The amended Oxford/SVB Agreement consists of a $25.0 million term loan and a $10.0 million revolving credit facility. The obligations under the amended Oxford/SVB loan agreement are collateralized by our intellectual property (including among other things, copyrights, patents, patent applications, trademarks, service marks and trade secret rights) and personal property (including, among other things, accounts receivable, equipment, inventory, contract rights, rights to payment of money, license agreements, general intangibles and cash).

The amended Oxford/SVB loan agreement includes financial covenants requiring that we achieve, as of the last day of each month measured on a trailing three-month basis, actual revenue of at least a specified percentage of our projected revenue as provided to Oxford and SVB in the event we fail to maintain a liquidity ratio (defined, in general, as the ratio of (a) cash and cash equivalents deposited with SVB plus unused borrowing capacity under that agreement to (b) all debt, capital lease obligations and contingent obligations owed to the lenders) of 1.25 to 1.00. The agreement also includes a covenant that the audit report accompanying our year-end consolidated financial statements not include a going concern qualification in addition to other limitations as defined in the agreement. In March 2012, we obtained a waiver from Oxford and SVB for the breach caused by the receipt of the 2011 audit report from our independent registered public accounting firm, which includes a modification of their standard report for the going concern uncertainty. The agreement also provides that an event of default will occur if, among other customary events of default as defined in the agreement, there is a material adverse change in our business, operations or condition (financial or otherwise) or material impairment in the prospects of us repaying any portion of our obligations under the agreement.

The $25.0 million term loan bears an interest rate of 12.06% per annum. Payments consist of monthly interest only payments for the first 18 months followed by principal and interest payments for the subsequent 30 months. The term loan requires a final payment of $1.2 million, in addition to the repayment of unpaid principal, at the loan maturity date, which is January 1, 2014. We have the option to prepay the outstanding balance of the term loan in full subject to certain fees as well as the $1.2 million final payment. Under the terms of the revolving credit facility, we may borrow up to $10.0 million, but not more than a specified percentage of our eligible accounts receivable and inventory balances (as defined in the agreement). Amounts outstanding under the revolving credit facility accrue interest payable monthly at a floating rate per annum equal to the greater of 3.29% above SVB s prime rate or 7.29%. In addition, we pay a monthly fee equal to 0.5% per annum of the average unused portion of the revolving credit facility. If the revolving credit facility is terminated, a nominal final payment is depending upon when the termination occurs.

On July 18, 2011, we closed the Cowen Financing agreement. Under the terms of the Cowen Financing agreement, we borrowed $30.0 million and we are obligated to repay such borrowed amount together with a specified return to Cowen Royalty, through the payment of tiered royalties ranging from .5% to 5% of our direct product sales, co-promotion revenues and out-license revenues, or collectively, revenue interest, that we may record or receive as a result of worldwide commercialization of our products including Sumavel DosePro, Zohydro and other future products. Pursuant to the terms of the Cowen Financing agreement, our royalty rate increased to 5.75% in April 2012 in connection with the early termination of the co-promotion agreement with Astellas, with a reversion back to 5% if certain net sales of Sumavel DosePro are achieved or if Zohydro is commercialized in the four calendar quarters immediately following the effective date of termination.

We are also obligated to make three fixed payments of $10.0 million on (or before at our option) each of January 31, 2015, January 31, 2016 and January 31, 2017. Prepayment requires the consent of the lenders under the amended Oxford/SVB loan agreement while balances remain outstanding under that facility.

We have the option to terminate the Cowen Financing agreement at our election in connection with a change of control of our company, upon the payment of a base amount of $52.5 million, or, if higher, an amount that generates a 19% internal rate of return on the borrowed amount as of the date of prepayment, in each case reduced by the revenue interest and principal payments received by Cowen Royalty up to the date of prepayment.

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Cowen Royalty has the option to terminate the Cowen Financing agreement at its election in connection with a change of control of our company (which includes the sale, transfer, assignment or licensing of our rights in the United States to either Sumavel DosePro or Zohydro), or an event of default (which includes the occurrence of a bankruptcy event or other material adverse change in our business), as defined in the Cowen Financing agreement. Upon such a termination by Cowen Royalty, we are obligated to make a payment of a base amount of $45.0 million, or, if higher, an amount that generates a 17% internal rate of return on the borrowed amount as of the date of prepayment, in each case reduced by the Revenue Interest and principal payments received by Cowen Royalty up to the date of prepayment.

Unless terminated earlier as discussed above, the Cowen Financing agreement terminates on March 31, 2018.

We depend in part upon borrowings available under the revolving credit facility provided under the amended Oxford/SVB loan agreement. Any termination of our debt agreements, or any requirement that we repay any of our outstanding term loans or the borrowed amount under the Cowen Financing agreement, whether as the result of our default under the applicable agreement or otherwise, could have a material adverse effect on our business, results of operations and financial condition.

Cash and Cash Equivalents. Cash and cash equivalents totaled $39.8 million and $56.5 million at March 31, 2012 and December 31, 2011, respectively.

The following table summarizes our cash flows from (used in) operating, investing and financing activities for the three months ended March 31, 2012 and 2011:

	Three Months Ended March 31,	
	2012	2011
	(In Thousands)	
Statement of Cash Flows Data:		
Total cash provided by (used in):		
Operating activities	$ (14,722)	$ (22,842)
Investing activities	(111)	(119)
Financing activities	(1,848)	49
Decrease in cash and cash equivalents	$ (16,681)	$ (22,912)

Operating Activities. Net cash used in operating activities was $14.7 million and $22.8 million for the three months ended March 31, 2012 and 2011, respectively. Net cash used for the three months ended March 31, 2012 and 2011 primarily reflects the use of $8.2 million and $17.2 million, respectively, for operations (excluding non-cash items), which includes personnel-related costs, research and development costs (primarily related to the development of Zohydro and Relday), sales and marketing expenses for Sumavel DosePro and other professional services. Net cash used for the three months ended March 31, 2012 and 2011 also includes investments of $2.0 million and $41,000, respectively, in commercial inventory of Sumavel DosePro, and $8.5 million and $5.6 million, respectively, for other working capital uses.

Investing Activities. Net cash used in investing activities was $0.1 million for the three months ended March 31, 2012 and 2011. These amounts are the result of the purchase of property and equipment primarily for use in manufacturing Sumavel DosePro.

We expect to incur capital expenditures of approximately $0.5 million to $1.0 million in 2012. These planned capital expenditures primarily relate to further investments in our manufacturing operations in support of the sound enhancement version of the DosePro technology expected to be commercially available in 2013 and toward enhancing our existing manufacturing technology and equipment.

Financing Activities. Net cash provided by (used in) financing activities was $1.8 million used for the three months ended March 31, 2012 and $49,000 provided for the three months ended March 31, 2011. Net cash used in financing activities for the three

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months ended March 31, 2012 relates to payments of $7.0 million on our borrowings of debt, offset by net proceeds of $5.2 million from our revolving credit facility. Net cash provided by financing activities for the three months ended March 31, 2011 relates to net proceeds from our revolving credit facility.

Our sources of liquidity include our cash balances, cash receipts from the sale of Sumavel DosePro and our debt facilities. As of March 31, 2012, we had $39.8 million in cash and cash equivalents. Other potential sources of near-term liquidity include (i) entering into a co-promotion agreement for Sumavel DosePro; (ii) entering into a commercialization agreement for Zohydro or a licensing arrangement on our DosePro technology, (iii) equity, debt or other financing or (iv) leveraging our sales force capacity to promote a new product.

Since inception, our operations have been financed primarily through equity and debt financings, the issuance of convertible notes and payments received from Astellas under our co-promotion agreement. Through March 31, 2012, we received aggregate net cash proceeds of approximately $274.8 million from the sale of shares of our preferred and common stock. Although we will continue to be opportunistic in our efforts to obtain cash, there is no guarantee that additional funding will be available or that, if available, such funding will be adequate or available on terms that we or our stockholders view as favorable. In addition, as a result of our outstanding loan with Oxford and SVB and our Cowen Financing agreement, our ability to engage in debt financing transactions is subject to certain limitations and certain debt financing transactions, if consummated, may accelerate our repayment obligations to Oxford and SVB and Cowen Royalty.

Successful transition to profitability is dependent upon achieving a level of product revenues adequate to support our cost structure. We will continue to monitor and evaluate our sales progress, the level of our research, development, manufacturing, sales and marketing and general and administrative expenditures and may adjust such expenditures based upon a variety of factors, such as our available cash, our ability to obtain additional cash, the results and progress of our Sumavel DosePro commercialization efforts, results and progress in our clinical program, the time and costs related to clinical trials and regulatory decisions, as well as the U.S. economic environment.

As described above, under our amended Oxford/SVB loan agreement, we are subject to financial covenants and other covenants and obligations under that agreement. Likewise, the amended Oxford/SVB loan agreement permits the lenders to demand the immediate repayment of all borrowings and other amounts outstanding thereunder if, among other customary events of default, the lender determines, in its sole discretion that a material adverse change with respect to us has occurred. We have also agreed to specified positive and negative covenants under the Cowen Financing agreement and upon a termination by Cowen Royalty, we are obligated to make a payment of a base amount of $45.0 million, or, if higher, an amount that generates a 17% internal rate of return on the borrowed amount as of the date of prepayment, in each case reduced by the payments received by Cowen Royalty up to the date of prepayment. If we were required to accelerate the payment of these amounts upon a default, we would be required to find an alternate source of capital from which to draw funds and there can be no assurances that we would be able to do so on terms acceptable to us, or at all.

If we fail to pay amounts owing under either the amended Oxford/SVB loan agreement or the Cowen Financing agreement when due, if we breach our other covenants or obligations under either of these agreements, or if other events of default under either of these agreements occur, the applicable lenders would be entitled to demand immediate repayment of all borrowings and other obligations thereunder and to seize and sell the collateral pledged as security under the agreements to satisfy those obligations. If we were to breach our covenants and obligations and we were unable to obtain a waiver or amendment from the lender, we would be required to seek additional equity or debt financing to refinance our obligations under the agreement. Additional debt or equity financing may not be available to us in amounts or on terms we consider acceptable, or at all. In that regard, we have from time to time been required to obtain waivers and amendments under our debt instruments in order to avoid breaches or other defaults. For example, in each of 2010, 2011 and 2012 we were required to obtain amendments or waivers under our credit facilities.

We cannot be certain if, when and to what extent we will generate positive cash flow from operations from the commercialization of our product and, if approved, product candidates. We expect our development and commercialization expenses to be substantial and to increase over the next few years as we continue to grow the Sumavel DosePro brand and continue to advance our Zohydro product potentially through commercialization and initiate clinical development of Relday.

Although it is difficult to predict future liquidity requirements, we believe that our cash and cash equivalents as of March 31, 2012, together with estimated future product revenue and borrowings available under our $10.0 million revolving credit facility, will be sufficient to fund our operations into the first quarter of 2013. We will need to obtain additional capital to finance our operations beyond that point through public or private equity or debt financings. Although we are currently not a party to any agreement or letter of intent with respect to potential investments in, or acquisitions of, businesses, services or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. There can be no assurance that we will be able to raise additional funds from any of these sources on terms we deem acceptable, or at all. In addition, future issuance

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of equity, convertible or other equity-linked securities could materially dilute the ownership interests of holders of our common stock and additional debt financing could result in a material increase in the amount of cash necessary to fund debt service payments and also could require that we comply with financial and other covenants that limit our flexibility and operations. In addition, the fact that we have pledged substantially all of our assets to secure our existing loan facilities will likely increase the cost, perhaps substantially, of any additional debt financing we may obtain or prevent us from obtaining additional debt financing altogether.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board, or FASB, issued accounting guidance related to fair value measurements and disclosures to achieve common fair value measurements and disclosures between GAAP and International Financial Reporting Standards. This guidance clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurements that are estimated using significant unobservable (Level 3) inputs. This guidance is effective on a prospective basis for annual and interim reporting periods beginning on or after December 15, 2011. We adopted this guidance on January 1, 2012 and it did not have a material impact on our results of operations.

In June 2011, the FASB issued an Accounting Standards Update which requires entities to present reclassification adjustments included in other comprehensive income on the face of the financial statements and allows entities to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate consecutive statements. It also eliminates the option for entities to present components of other comprehensive income as part of the statement of changes to stockholders equity. The updated guidance is effective for fiscal and interim periods beginning after December 15, 2011, with early adoption permitted. We adopted this guidance on January 1, 2012 and it did not have a material impact on our results of operations.

Off-Balance Sheet Arrangements

We have not engaged in any off-balance sheet activities.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

Our cash and cash equivalents as of March 31, 2012 consisted of cash and money market funds. Our primary exposure to market risk is interest income sensitivity, which is affected by changes in the general level of U.S. interest rates. The primary objective of our investment activities is to preserve principal. Instruments that meet this objective include commercial paper, money market funds and government and non-government debt securities. Some of the investment securities available-for-sale that we invest in may be subject to market risk. This means that a change in prevailing interest rates may cause the value of the investment securities available-for-sale to fluctuate. To minimize this risk, we intend to continue to maintain our portfolio of cash and money market funds. Due to the short-term nature of our investments and our ability to hold them to maturity, we believe that there is no material exposure to interest rate risk.

Our $10.0 million revolving credit facility with Oxford and SVB bears interest at the greater of 3.29% above SVB s prime rate or 7.29%. As of March 31, 2012, we had $5.1 million outstanding on this revolving credit facility.

Foreign Exchange Risk

All of the revenues we have generated to date have been paid in U.S. dollars and we expect that our revenues will continue to be generated primarily in U.S. dollars for at least the next several years. Payments to our material suppliers and contract manufactures are denominated in the Euro and U.K. pounds sterling, thereby increasing our exposure to exchange rate gains and losses on non-U.S. currency transactions. Foreign currency gains and losses associated with these expenditures have not been significant to date. However, fluctuations in the rate of exchange between the U.S. dollar and these or other foreign currencies could adversely affect our financial results in the future, particularly to the extent we increase production to support Sumavel DosePro sales demands. For the three months ended March 31, 2012, approximately $4.4 million (based on exchange rates as of March 31, 2012) of our materials and contract manufacturing costs were denominated in foreign currencies. We do not currently hedge our foreign currency exchange rate risk. As a result, we are exposed to gains and/or losses as the exchange rate of certain foreign currencies fluctuates. A 10% increase or decrease in the average rate of the Euro or the U.K. pound sterling during the three months ended March 31, 2012 would have resulted in approximately $0.2 million or $0.3 million in gains or losses, respectively. We intend to evaluate various options to mitigate the risk of financial exposure from transacting in foreign currencies in the future.

Item 4. Controls and Procedures

Conclusions Regarding the Effectiveness of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the timelines specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can only provide reasonable assurance of achieving the desired control objectives, and in reaching a reasonable level of assurance, management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of March 31, 2012 at the reasonable assurance level.

Changes in Disclosure Controls and Procedures

There were no changes in our internal control over financial reporting during the fiscal quarter ended March 31, 2012 that have 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

We are not currently a party to any legal proceedings.

Item 1A. Risk Factors

We operate in a dynamic and rapidly changing environment that involves numerous risks and uncertainties. Certain factors may have a material adverse effect on our business prospects, financial condition and results of operations, and you should carefully consider them. Accordingly, in evaluating our business, we encourage you to consider the following discussion of risk factors, in its entirety, in addition to other information contained in this Quarterly Report on Form 10-Q and our other public filings with the Securities and Exchange Commission, or SEC. Other events that we do not currently anticipate or that we currently deem immaterial may also affect our business, prospects, financial condition and results of operations.

We have marked with an asterisk (*) those risk factors that reflect substantive changes from the risk factors included in our previously filed Annual Report on Form 10-K for the year ended December 31, 2011.

Risks Related to Our Business and Industry

We will require additional funding and may be unable to raise capital when needed, which would force us to delay, reduce or eliminate our product development programs or commercialization efforts.*

Our operations have consumed substantial amounts of cash since inception. To date, our operations have been primarily financed through the proceeds from the issuance of our common and preferred stock, including the proceeds from our initial public offering completed in November 2010, our follow-on public offering completed in September 2011, and borrowings under our loan and financing agreements with Cowen Healthcare Royalty Partners II, L.P, or Cowen Royalty, Oxford Finance LLC, as successor in interest to Oxford Finance Corporation, or Oxford, Silicon Valley Bank, or SVB, and until June 30, 2011, General Electric Capital Corporation, or GE Capital. Although it is difficult to predict future liquidity requirements, we believe that our cash and cash equivalents as of March 31, 2012, together with estimated future product revenue and borrowings available under our $10.0 million revolving credit facility, will be sufficient to fund our operations into the first quarter of 2013. We will need to obtain additional funds to finance our operations beyond that point in order to:

- maintain and continue to increase our sales and marketing activities for Sumavel DosePro, particularly in light of the termination of our co-promotion agreement with Astellas Pharma US, Inc., or Astellas, in March 2012;
- qualify secondary sources for the manufacturing of Sumavel DosePro;
- fund our operations, initiate additional clinical trials for Relday and fund development of Zohydro and any other product candidate to support potential regulatory approval of marketing applications; and
- commercialize any of our product candidates or any products or product candidates that we may develop, in-license or otherwise acquire, if any of these product candidates receive regulatory approval.

In addition, our estimates of the amount of cash necessary to fund our business and development and commercialization activities may prove to be wrong, and we could spend our available financial resources much faster than we currently expect. Our future funding requirements will depend on many factors, including, but not limited to:

- the commercial success of Sumavel DosePro;

the timing of regulatory approval, if granted, of Zohydro or any other product candidates;

the rate of progress and cost of our clinical trials and other product development programs for Relday and our other product candidates and any other product candidates that we may develop, in-license or acquire;

the costs of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights associated with Sumavel DosePro, Zohydro, Relday and any of our other product candidates;

the costs and timing of completion of outsourced commercial manufacturing supply arrangements for any product candidate;

the costs of maintaining and expanding our sales and marketing infrastructure or establishing distribution capabilities;

the effect of competing technological and market developments; and

the terms and timing of any additional collaborative, licensing, co-promotion or other arrangements that we may establish.

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In its report on our consolidated financial statements for the year ended December 31, 2011, our independent registered public accounting firm included an explanatory paragraph expressing substantial doubt regarding our ability to continue as a going concern. A going concern opinion means, in general, that our independent registered public accounting firm has substantial doubt about our ability to continue our operations without continuing infusions of capital from external sources and this opinion could impair our ability to finance our operations through the sale of debt or equity securities or commercial bank loans.

Until we can generate a sufficient amount of product revenue and cash flow from operations and achieve profitability, we expect to finance future cash needs through public or private equity offerings, debt financings, receivables financings or corporate collaboration and licensing arrangements. We cannot be certain that additional funding will be available on acceptable terms, or at all. If we are unsuccessful in raising additional required funds, we may be required to significantly delay, reduce the scope of or eliminate one or more of our development programs or our commercialization efforts, or cease operating as a going concern. We also may be required to relinquish, license or otherwise dispose of rights to product candidates or products that we would otherwise seek to develop or commercialize ourselves on terms that are less favorable than might otherwise be available. If we raise additional funds by issuing equity securities, substantial dilution to existing stockholders would result. If we raise additional funds by incurring debt financing, the terms of the debt may involve significant cash payment obligations as well as covenants and specific financial ratios that may restrict our ability to operate our business. If we are unable to maintain sufficient financial resources, including by raising additional funds when needed, our business, financial condition and results of operations will be materially and adversely affected and we may be unable to continue as a going concern.

Our independent registered public accounting firm has expressed substantial doubt as to our ability to continue as a going concern.

In its report accompanying our audited consolidated financial statements for the year ended December 31, 2011, our independent registered public accounting firm included an explanatory paragraph stating that our recurring losses from operations and lack of sufficient working capital raise substantial doubt as to our ability to continue as a going concern. A going concern opinion could impair our ability to finance our operations through the sale of debt or equity securities or commercial bank loans. Our ability to continue as a going concern will depend, in large part, on our ability to generate positive cash flow from operations and obtain additional financing, neither of which is certain. If we are unable to achieve these goals, our business would be jeopardized and we may not be able to continue operations and may have to liquidate our assets and may receive less than the value at which those assets are carried on our consolidated financial statements, and it is likely that investors will lose all or a part of their investment. In addition, our amended Oxford/SVB loan agreement includes a covenant that the audit reports accompanying our annual consolidated financial statements for fiscal year 2010 and thereafter not include a going concern qualification and any breach of that covenant would permit the lenders to demand immediate repayment of all loans outstanding under the agreement and to seize and sell the collateral pledged to secure these loans. In March 2012, we obtained a waiver from Oxford and SVB for the breach caused by the receipt of the 2011 audit report from our independent registered public accounting firm which includes a going concern qualification.

We are largely dependent on the commercial success of Sumavel DosePro and although we have generated revenue from sales of Sumavel DosePro, we may never significantly increase these sales or become profitable.

We anticipate that, for at least the next several years, our ability to generate revenues and become profitable will depend in large part on the commercial success of our only marketed product, Sumavel DosePro, which in turn, will depend on several factors, including our ability to:

- successfully maintain and increase market demand for, and sales of, Sumavel DosePro through our sales and marketing efforts by expanding our sales force and/or through a new co-promotion partner, if available, as our co-promotion agreement with Astellas terminated on March 2012;
- obtain greater acceptance of Sumavel DosePro by physicians and patients;
- maintain adequate levels of coverage and reimbursement for Sumavel DosePro from commercial health plans and government health programs, which we refer to collectively as third-party payors, particularly in light of the availability of other branded and generic competitive products;
- maintain compliance with regulatory requirements;

establish and maintain agreements with wholesalers and distributors on commercially reasonable terms;

maintain commercial manufacturing arrangements with third-party manufacturers as necessary to meet commercial demand for Sumavel DosePro and continue to manufacture commercial quantities at acceptable cost levels; and

successfully maintain intellectual property protection for Sumavel DosePro.

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We cannot be certain that our continued marketing of Sumavel DosePro will result in increased demand for, and sales of, the product. For example, while we have generally experienced quarterly growth in total prescriptions from the launch of Sumavel DosePro in January 2010 through March 31, 2012, we have at certain times experienced a reduction in total and new prescriptions month over month. Further, if we are unsuccessful in continuing to expand our sales force and/or partnering with a new co-promotion partner, we may be unable to successfully maintain or increase sales of Sumavel DosePro. If we fail to successfully maintain and increase sales of Sumavel DosePro, we may be unable to generate sufficient revenues to grow or sustain our business and we may never become profitable, and our business, financial condition and results of operations will be materially adversely affected.

We are at an early stage of commercialization and have a history of significant net losses and negative cash flow from operations. We cannot predict if or when we will become profitable and anticipate that our net losses and negative cash flow from operations will continue for at least the next several years.*

We were organized in 2006, have a limited operating history and there is little historical basis upon which to assess how we will respond to competitive, economic or technological challenges. Our business and prospects must be considered in light of the risks and uncertainties frequently encountered by pharmaceutical companies in the early stages of commercialization.

We have generated substantial net losses and negative cash flow from operations since our inception in 2006. For example, for the three months ended March 31, 2012 and the years ended 2011 and 2010, we incurred net losses of $10.3 million, $83.9 million and $73.6 million, respectively, our net cash used in operating activities was $14.7 million, $80.5 million and $72.0 million, respectively, and, at March 31, 2012, our accumulated deficit was $292.3 million. We expect our losses and negative cash flow to continue for at least the next several years as a result of expenses incurred in connection with our NDA submission for Zohydro, commercialization activities for Zohydro, any additional clinical development required for Zohydro, the cost of clinical development for Relday and the cost of the sales and marketing expense associated with Sumavel DosePro and, if approved, Zohydro. Our ability to generate revenues from Sumavel DosePro or any of our product candidates will depend on a number of factors, including, in the case of Sumavel DosePro, the factors described in the following two risk factors and, in the case of our product candidates, our ability to successfully complete clinical trials, obtain necessary regulatory approvals and negotiate arrangements with third parties to help finance the development of, and market and distribute, any product candidates that receive regulatory approval. In addition, we will be subject to the risk that the marketplace will not accept our products.

Because of the numerous risks and uncertainties associated with our product development and commercialization efforts, we are unable to predict the extent of our future losses or when or if we will become profitable and it is possible we will never become profitable. Our failure to increase sales of Sumavel DosePro or to successfully commercialize any of our product candidates that may receive regulatory approval would likely have a material adverse effect on our business, results of operations, financial condition and prospects and could result in our inability to continue operations.

We may not be successful in executing our sales and marketing strategy for the commercialization of Sumavel DosePro, including as a result of the termination of our collaboration with Astellas in March 2012, and we may not be able to generate significant revenue.*

Prior to the launch of Sumavel DosePro in January 2010, we built a commercial sales and marketing organization including sales, marketing, communications, managed markets, trade and distribution functions, which is now focused exclusively on marketing and selling Sumavel DosePro primarily to physicians, nurses and other healthcare professionals in the United States. Our field sales force includes approximately 95 sales representatives who have historically promoted Sumavel DosePro primarily to neurologists and other prescribers of migraine medications, including headache clinics and headache specialists in the United States.

To complement our sales force, we entered into an exclusive co-promotion agreement with Astellas in July 2009 under which Sumavel DosePro has been promoted primarily to primary care physicians, OB/GYNs, emergency medicine physicians and urologists, or collectively the Astellas Segment, in the United States by approximately 400 Astellas sales representatives. This co-promotion agreement terminated on March 31, 2012, and beginning in the second quarter of 2012 our sales force assumed full responsibility for the continued promotion of Sumavel DosePro. We have expanded the focus of our existing sales force to include targeting a portion of the high-prescribing primary care physicians previously part of the Astellas Segment under the co-promotion agreement. Although we believe we have adequately sized our sales force in order to reach our historically targeted audience, our existing sales force may be unable to effectively target these additional primary care physicians. We are also currently evaluating potential co-promotion partners who could complement our sales force efforts for the commercial sale of Sumavel DosePro. We may not be able to enter into co-promotion arrangements with third parties in a timely manner, on acceptable terms or at all. To the extent that we enter into another co-promotion or other licensing arrangement, our portion of retained product revenues is likely to be lower than if we directly marketed and sold Sumavel DosePro solely on our own, and a portion of those revenues generated will depend upon the efforts of such third parties similar to our dependence on Astellas, and these efforts may not be successful. Further, to the extent that we enter into a new co-promotion agreement, it will take time and resources to train and deploy a new partners sales force, which may strain

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our managerial resources and may have an adverse affect on our own sales and marketing efforts and revenues. If we are unable to find another partner for the promotion of Sumavel DosePro in the primary care segment in the United States, we may lack the financial and managerial resources to increase the size of our sales and marketing organization to adequately promote and commercialize Sumavel DosePro in this segment and any such expansion could, in any event, substantially increase our expenses and capital requirements. In addition, we may lack the financial and managerial resources to increase the size of our sales and marketing organization to adequately promote and commercialize Sumavel DosePro. For the three months ended March 31, 2012 and the years ended December 31, 2011 and 2010, the Astellas Segment represented approximately 31%, 38% and 40% of our prescription demand, respectively. Any inability to adequately replace coverage of the Astellas Segment by a new co-promotion partner or through our own sales force may have a material adverse affect on our ability to maintain or increase revenues in the future.

If we are unable to successfully implement our commercialization plans and drive adoption by patients and physicians of Sumavel DosePro through our sales, marketing and commercialization efforts, then we will not be able to generate significant revenue which will have a material adverse effect on our business, results of operations, financial condition and prospects.

If Sumavel DosePro, and, if approved, Zohydro and Relday, or any other product candidate for which we receive regulatory approval does not achieve broad market acceptance or coverage by third-party payors, the revenues that we generate will be limited.

The commercial success of Sumavel DosePro, and, if approved, Zohydro and Relday, or any other product candidates for which we obtain marketing approval from the FDA or other regulatory authorities will depend upon the acceptance of these products by physicians, patients, healthcare payors and the medical community. Coverage and reimbursement of our approved product by third-party payors is also necessary for commercial success. The degree of market acceptance of Sumavel DosePro and any other product candidates for which we may receive regulatory approval will depend on a number of factors, including:

- our ability to provide acceptable evidence of safety and efficacy;
- acceptance by physicians and patients of the product as a safe and effective treatment;
- the relative convenience and ease of administration;
- the prevalence and severity of adverse side effects;
- limitations or warnings contained in a product s FDA-approved labeling;
- the clinical indications for which the product is approved;
- in the case of product candidates that are controlled substances, the U.S. Drug Enforcement Agency, or DEA, scheduling classification;
- availability and perceived advantages of alternative treatments;
- any negative publicity related to our or our competitors products;

the effectiveness of our or any current or future collaborators sales, marketing and distribution strategies;

pricing and cost effectiveness;

our ability to obtain sufficient third-party payor coverage or reimbursement; and

the willingness of patients to pay out of pocket in the absence of third-party payor coverage.

For example, while we believe the needle-free nature of our DosePro technology will appeal to patients, some patients may not react favorably to the subcutaneous delivery of drug products by DosePro. Our experience indicates that some patients will experience pain upon injection with the DosePro technology and/or reactions at the site of injection. Any undesirable side effects have the potential to limit market acceptance of our product candidates.

In addition, products used to treat and manage pain, especially in the case of opioids, are from time to time subject to negative publicity, including political influences, illegal use, overdoses, abuse, diversion, serious injury and death. These events have led to heightened regulatory scrutiny. Controlled substances are classified by the DEA as Schedule I through V substances, with Schedule I substances being prohibited for sale in the United States, Schedule II substances considered to present the highest risk of abuse and Schedule V substances being considered to present the lowest relative risk of abuse. Zohydro contains *hydrocodone*, and we anticipate it will be regulated as a Schedule II controlled substance, and despite the strict regulations on the marketing, prescribing and dispensing of such substances, illicit use and abuse of *hydrocodone* is well-documented. Thus, the regulatory approval process and the marketing of Zohydro may generate public controversy that may adversely affect regulatory approval and market acceptance of Zohydro.

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Our efforts to educate the medical community and third-party payors on the benefits of Sumavel DosePro, and, if approved, Zohydro and Relday or any of our other product candidates for which we obtain marketing approval from the FDA or other regulatory authorities and gain broad market acceptance may require significant resources and may never be successful. If our products do not achieve an adequate level of acceptance by physicians, third-party payors and patients, we may not generate sufficient revenue from these products to become or remain profitable.

Our business and operations would suffer in the event of system failures.

Despite the implementation of security measures, our internal computer systems and those of our current and any future partners, contractors and consultants are vulnerable to damage from cyber-attacks, computer viruses, unauthorized access, natural disasters, terrorism, war and telecommunication and electrical failures. For example, we have experienced failures in our information systems and computer servers in the past, which may have been the result of a cyber-attack. These failures resulted in an interruption of our normal business operations and required substantial expenditure of financial and administrative resources to remedy. We cannot be sure that similar failures will not occur in the future. System failures, accidents or security breaches can cause interruptions in our operations, and can result in a material disruption of our commercialization activities, drug development programs and our business operations. The loss of clinical trial data from completed or future clinical trials could result in delays in our regulatory approval efforts and significantly increase our costs to recover or reproduce the data. Similarly, we rely on a large number of third parties to supply components for and manufacture our product and product candidates, warehouse and distribute Sumavel DosePro and conduct clinical trials, and similar events relating to their computer systems could also have a material adverse effect on our business. To the extent that any disruption or security breach were to result in a loss of, or damage to, our data or applications, or inappropriate disclosure of confidential or proprietary information, we could incur liability and the commercialization of Sumavel DosePro and development of Zohydro, Relday or any of our other product candidates could be delayed.

Our short operating history makes it difficult to evaluate our business and prospects.

We commenced our operations on August 25, 2006. Our operations to date have been limited to organizing and staffing our company, scaling up manufacturing operations with our third-party contract manufacturers, building a sales and marketing organization, conducting product development activities for our product and product candidates, in-licensing rights to Zohydro and Relday, and commercializing Sumavel DosePro. Moreover, Sumavel DosePro is our only product that is approved for sale. Consequently, any predictions about our future performance may not be as accurate as they could be if we had a history of successfully developing and commercializing pharmaceutical products.

We depend on wholesale pharmaceutical distributors for retail distribution of Sumavel DosePro, and if we lose any of our significant wholesale pharmaceutical distributors, our business could be harmed.*

The majority of our sales of Sumavel DosePro are to wholesale pharmaceutical distributors who, in turn, sell the products to pharmacies, hospitals and other customers. Two wholesale pharmaceutical distributors, McKesson Corporation and Cardinal Health, Inc., individually comprised 40% and 35%, respectively, of our total gross sales of Sumavel DosePro for the three months ended March 31, 2012, which may result in substantial fluctuations in our results of operations from period to period. The loss of any of these wholesale pharmaceutical distributors accounts or a material reduction in their purchases could have a material adverse effect on our business, results of operations, financial condition and prospects.

In addition, these wholesale customers comprise a significant part of the distribution network for pharmaceutical products in the United States. This distribution network has undergone, and may continue to undergo, significant consolidation marked by mergers and acquisitions. As a result, a small number of large wholesale distributors control a significant share of the market. Consolidation of drug wholesalers has increased, and may continue to increase, competitive and pricing pressures on pharmaceutical products. In addition, at times, wholesaler purchases may exceed customer demand, resulting in reduced wholesaler purchases in later quarters, which may result in substantial fluctuations in our results of operations from period to period. We cannot ensure that we can manage these pricing pressures or that wholesaler purchases will not decrease as a result of this potential excess buying.

Our sales can be greatly affected by the inventory levels our wholesalers carry. We monitor wholesaler inventory of Sumavel DosePro using a combination of methods. Pursuant to distribution service agreements with our three largest wholesale customers, we receive inventory level reports. For most other wholesalers where we do not receive inventory level reports, however, our estimates of wholesaler inventories may differ significantly from actual inventory levels. Significant differences between actual and estimated inventory levels may result in excessive production (requiring us to hold substantial quantities of unsold inventory), inadequate supplies of products in distribution channels, insufficient product available at the retail level, and unexpected increases or decreases in orders from our wholesalers. These changes may cause our revenues to fluctuate significantly from quarter to quarter, and in some cases may cause our operating results for a particular quarter to be below our expectations or the expectations of securities analysts or investors. If our financial results are below expectations for a particular period, the market price of our common stock may drop significantly.

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We face intense competition, including from generic products, and if our competitors market and/or develop treatments for migraine, pain or psychotic disorders that are marketed more effectively, approved more quickly than our product candidates or demonstrated to be safer or more effective than our products, our commercial opportunities will be reduced or eliminated.

The pharmaceutical industry is characterized by rapidly advancing technologies, intense competition and a strong emphasis on proprietary therapeutics. We face competition from a number of sources, some of which may target the same indications as our product or product candidates, including large pharmaceutical companies, smaller pharmaceutical companies, biotechnology companies, academic institutions, government agencies and private and public research institutions, many of which have greater financial resources, sales and marketing capabilities, including larger, well-established sales forces, manufacturing capabilities, experience in obtaining regulatory approvals for product candidates and other resources than us. Many large, well-capitalized companies offer products in the United States that compete with Sumavel DosePro. Sumavel DosePro currently competes with branded products in the triptan class such as Imitrex and Treximet marketed by GlaxoSmithKline, or GSK, as well as six other branded triptan therapies being sold by AstraZeneca plc, Endo Pharmaceuticals Holdings Inc., Johnson & Johnson, Merck & Co., Inc., and Pfizer Inc. In addition to those migraine therapeutics, there are other marketed non-triptan migraine therapeutics such as Cambia sold by Nautilus Neurosciences, Inc. and Migranal sold by Valeant Pharmaceutical International. We also face competition from generic *sumatriptan* oral tablets and *sumatriptan* injection, now marketed in the United States as an authorized generic of the Imitrex STATdose System, or Imitrex STATdose, by Par Pharmaceutical Companies, Inc. and Sandoz Inc. (a Novartis AG company). In addition, in June 2010 the FDA approved Alsuma (*sumatriptan* injection), a needle-based autoinjector which was developed and is manufactured and marketed by Pfizer and its subsidiary, Meridian Medical Technologies. Finally, generic injectable *sumatriptan* in the form of vials and prefilled syringes is available from a number of pharmaceutical companies, and most recently, the FDA granted approval for a needle-based generic *sumatriptan* auto-injector from Sun Pharmaceutical Industries Limited in June 2011. Although these products may not be directly substituted for Sumavel DosePro, generic versions of *sumatriptan* injection and alternative autoinjector forms of *sumatriptan* injection may reduce the future adoption of Sumavel DosePro by third-party payors and consumers, as financial pressure to use generic products may encourage the use of a generic product over Sumavel DosePro. Sumavel DosePro is currently more expensive on a per dose basis than most of the competing branded and all of the generic triptan products for migraine, which may also limit the coverage and reimbursement by third-party payors, which could adversely affect adoption by physicians and patients.

If approved for the treatment of moderate to severe chronic pain, we anticipate that Zohydro would compete against other marketed branded and generic pain therapeutics. Opioid therapeutics generally fall into two classes: *codeines*, which include *oxycodones* and *hydrocodones,* and *morphines*. Zohydro is a *hydrocodone*, the most commonly prescribed opioid in the United States, and we expect Zohydro will compete with therapeutics within both the *codeine* and *morphine* classes. These therapeutics include both Schedule II and Schedule III products (meaning that they are considered controlled substances by the DEA) being marketed by companies such as Endo Pharmaceuticals Holdings Inc., Johnson & Johnson, Mallinckrodt Inc., Pfizer, Purdue Pharma L.P., Teva Pharmaceutical Industries Limited and Watson Pharmaceuticals, Inc.

In addition to already marketed therapeutics, we also face competition from product candidates that are or could be under development by many of the above-mentioned entities and others. For example, there are several products for the treatment of migraine under development by large pharmaceutical companies such as GSK and Merck & Co., and other smaller companies such as NuPathe, Inc. and MAP Pharmaceuticals, Inc. If approved, Zohydro may also compete with at least 15 opioid product candidates under development, including abuse and diversion resistant formulations of currently available opioids, novel opioids and alternative delivery forms of various opioids under development at other pharmaceutical companies, including single-entity extended-release *hydrocodone* product candidates being developed by Egalet A/S, Pfizer, Purdue Pharma L.P. and Teva Pharmaceutical Industries Limited. Zohydro may also face competition from non-opioid product candidates including new chemical entities, as well as alternative delivery forms of non-steroidal anti-inflammatory drugs. These new opioid and non-opioid product candidates are being developed by companies such as Acura Pharmaceuticals, Inc., Altea Therapeutics Corporation, Collegium Pharmaceutical, Inc., Eli Lilly and Company, Elite Pharmaceuticals, Inc., Hospira Inc., Inspirion Delivery Technologies, Inc, LLC, Intellipharmaceuticals International, Inc., Pfizer and QRxPharma Ltd.

If approved for the treatment of schizophrenia, we anticipate that Relday will compete against other marketed, branded and generic, typical and atypical antipsychotics, including both long-acting injectable and oral products. Currently marketed long-acting injectable atypical antipsychotic products include Risperdal Consta, and Invega Sustenna marketed by Johnson & Johnson, and Zyprexa Relprevv marketed by Eli Lilly & Company. Currently approved and marketed oral atypical antipsychotics include Risperdal (*risperidone*) and Invega (*paliperidone*) marketed by Johnson & Johnson, generic *risperidone*, Zyprexa (*olanzapine*) marketed by Eli Lilly and Company, Seroquel (*quetiapine*) marketed by AstraZeneca plc, Abilify (*aripiprazole*) marketed by BMS/Otsuka

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Pharmaceutical Co., Ltd., Geodon (*ziprasidone*) marketed by Pfizer, Fanapt (*iloperidone*) marketed by Novartis AG, Saphris (*asenapine*) marketed by Merck & Co., Latuda (*lurasidone*) marketed by Dainippon Sumitomo Pharma, and generic *clozapine*. Finally, in addition to these currently marketed products, we may also face competition from additional long-acting injectable product candidates that could be developed by the large companies listed above, as well and by other pharmaceutical companies such as Alkermes plc, NuPathe, Inc. and Novartis AG, each of which has announced they are developing long-acting antipsychotic product candidates.

We expect Sumavel DosePro and, if approved, Zohydro, Relday and any of our other product candidates to compete on the basis of, among other things, product efficacy and safety, time to market, price, patient reimbursement by third-party payors, extent of adverse side effects and convenience of treatment procedures. One or more of our competitors may develop needle-free injectable products, products to address chronic pain or other products that compete with ours, obtain necessary approvals for such products from the FDA, or other agencies, if required, more rapidly than us or develop alternative products or therapies that are safer, more effective and/or more cost effective than any products developed by us. If any of our product candidates receive the requisite regulatory approval and classification and are marketed, the competition which we will encounter will have, and the competition we are currently encountering with our Sumavel DosePro product has had and will continue to have, an effect on our product prices, market share and results of operations. We may not be able to differentiate any products that we are able to market from those of our competitors, successfully develop or introduce new products that are less costly or offer better results than those of our competitors, or offer purchasers of our products payment and other commercial terms as favorable as those offered by our competitors.

In addition, competitors may seek to develop alternative formulations of our product candidates and/or alternative drug delivery technologies that address our targeted indications. The commercial opportunity for Sumavel DosePro and our product candidates could be significantly harmed if competitors are able to develop alternative formulations and/or drug delivery technologies outside the scope of our products. Compared to us, many of our potential competitors have substantially greater:

- capital resources;
- research and development resources and experience, including personnel and technology;
- drug development, clinical trial and regulatory resources and experience;
- sales and marketing resources and experience;
- manufacturing and distribution resources and experience;
- name recognition; and
- resources, experience and expertise in prosecution and enforcement of intellectual property rights.

As a result of these factors, our competitors may obtain regulatory approval of their products more rapidly than we are able to or may obtain patent protection or other intellectual property rights that limit or block us from developing or commercializing our product candidates. Our competitors may also develop drugs that are more effective, more useful, better tolerated, subject to fewer or less severe side effects, more widely prescribed or accepted or less costly than ours and may also be more successful than us in manufacturing and marketing their products. If we are unable to compete effectively with the marketed therapeutics of our competitors or if such competitors are successful in developing products that compete with Sumavel DosePro or any of our product candidates that are approved, our business, results of operations, financial condition and prospects may be materially adversely affected.

We are dependent on numerous third parties in our supply chain, all of which are currently single source suppliers, for the commercial supply of Sumavel DosePro and for the clinical supply of Zohydro and Relday, and if we experience problems with any of these suppliers, the manufacturing of Sumavel DosePro, Zohydro and Relday could be delayed.

While we own most of the specialized equipment used to manufacture critical components of Sumavel DosePro, we do not own or operate manufacturing facilities and currently lack the in-house capability to manufacture Sumavel DosePro, Zohydro, Relday or any other product candidates. Our DosePro device and Sumavel DosePro are manufactured by contract manufacturers, component fabricators and secondary service providers. Aseptic fill, finish, assembly and packaging of Sumavel DosePro are performed at Patheon UK Limited, Swindon, United Kingdom, a specialist in the aseptic fill/finish of injectables and other sterile pharmaceutical products. In May 2012, Patheon announced plans to wind down or transfer over a period of 24 to 36 months its commercial production capacity for a number of products at this facility. While we cannot be sure of the impact of these plans on the continued fill, finish, assembly and packaging of Sumavel DosePro, we believe that we will have sufficient time to identify alternative contract suppliers for these services or negotiate alternative arrangements with Patheon for continued services at this or another facility. In addition, Nypro Limited, located in Bray, Ireland, manufactures the actuator assemblies and injection molded components for our DosePro device and MGlas AG, located in Münnerstadt, Germany, manufactures the specialized glass capsule that houses the *sumatriptan* active pharmaceutical ingredient, or API, in our DosePro device. Each of these manufacturers and each other company that supplies, fabricates or manufactures any component used in our DosePro device is currently the only qualified source of their respective components. We currently rely on Dr. Reddy s Laboratories as the only supplier of *sumatriptan* API for use in Sumavel DosePro. We also outsource all manufacturing and packaging of the clinical trial materials for Zohydro and Relday to third parties. Although we plan to qualify additional manufacturers and suppliers of some of the components used in Sumavel DosePro, there can be no assurance that we will be able to do so and the current manufacturers and suppliers of these components will likely be single

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source suppliers to us for a significant period of time. Similarly, under our license agreements, Alkermes plc, or Alkermes, is the exclusive manufacturer of Zohydro and Durect is the exclusive manufacturer of Relday for all clinical trials through Phase 2 clinical trials and has the option to supply Relday for Phase 3 clinical trials and, if approved, commercial distribution. We may never be able to establish additional sources of supply for Zohydro or Relday.

Manufacturers and suppliers are subject to regulatory requirements covering, among other things, manufacturing, testing, quality control and record keeping relating to our product and product candidates, and are subject to ongoing inspections by regulatory agencies. Failure by any of our manufacturers or suppliers to comply with applicable regulations may result in long delays and interruptions to our manufacturing supply, and increase our costs, while we seek to secure another supplier who meets all regulatory requirements. Accordingly, the loss of any of our current third-party manufacturers or suppliers could have a material adverse effect on our business, results of operations, financial condition and prospects.

Reliance on third-party manufacturers and suppliers entails risks to which we would not be subject if we manufactured Sumavel DosePro or our product candidates ourselves, including:

- reliance on the third parties for regulatory compliance and quality assurance;
- the possible breach of the manufacturing agreements by the third parties because of factors beyond our control or the insolvency of any of these third parties or other financial difficulties, labor unrest, natural disasters or other factors adversely affecting their ability to conduct their business; and
- the possibility of termination or non-renewal of the agreements by the third parties, at a time that is costly or inconvenient for us, because of our breach of the manufacturing agreement or based on their own business priorities.

If our contract manufacturers or suppliers fail to deliver the required commercial quantities of Sumavel DosePro and its various components, the quantities of Zohydro, Relday or any of our other product candidates required for our clinical trials and, if approved, for commercial sale, on a timely basis and at commercially reasonable prices, and we are unable to find one or more replacement manufacturers or suppliers capable of production at a substantially equivalent cost, in substantially equivalent volumes and quality, and on a timely basis, we would likely be unable to meet demand for our products and would have to delay or terminate our pre-clinical or clinical trials, and we would lose potential revenue. It may also take a significant period of time to establish an alternative source of supply for our product, product candidates and components and to have any such new source approved by the FDA or any applicable foreign regulatory authorities. Furthermore, any of the above factors could cause the delay or suspension of initiation or completion of clinical trials, regulatory submissions or required approvals of our product candidates, cause us to incur higher costs and could prevent us from commercializing our product candidates successfully.

We may encounter delays in the manufacturing of Sumavel DosePro or fail to generate revenue if our supply of the components of our DosePro drug delivery system is interrupted.

Our DosePro drug delivery system is sourced, manufactured and assembled by multiple third parties across different geographic locations in Europe, including the United Kingdom, Germany and Ireland. All contract manufacturers and component suppliers have been selected for their specific competencies in the manufacturing processes and materials that make up the DosePro system. The components of DosePro include the actuator subassembly, capsule subassembly, and the setting mechanism. The actuator subassembly is comprised of nine individual components which are collectively supplied by six different third-party manufacturers. The capsule subassembly that houses the sterile drug formulation *sumatriptan* is comprised of five different components also supplied by four third-party manufacturers. Each of these third-party manufacturers is currently the single source of their respective components. If any of these manufacturers is unable to supply its respective component for any reason, including due to violations of the FDA s Quality System Regulation, or QSR, requirements, our ability to manufacture the finished DosePro device will be adversely affected and our ability to meet the distribution requirements for any product sales of Sumavel DosePro and the resulting revenue therefrom will be negatively affected. Accordingly, there can be no assurance that any failure in any part of our supply chain will not have a material adverse effect on our ability to generate revenue from Sumavel DosePro, which in turn could have a material adverse effect on our business, results of operations, financial condition and prospects.

We rely on third parties to perform many necessary services for our commercial products, including services related to the distribution, invoicing, storage and transportation of our products.

We have retained third-party service providers to perform a variety of functions related to the sale and distribution of our products, key aspects of which are out of our direct control. For example, we rely on Cardinal Health 105, Inc. (a/k/a Specialty Pharmaceutical Services) to provide key services related to logistics, warehousing and inventory management, distribution, contract administration and chargeback processing, accounts receivable management and call center management, and, as a result, most of our inventory is stored at a single warehouse maintained by the service provider. We place substantial reliance on this provider as well as other third-party providers that perform services for us, including entrusting our inventories of products to their care and handling. If

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these third-party service providers fail to comply with applicable laws and regulations, fail to meet expected deadlines, or otherwise do not carry out their contractual duties to us, or encounter physical damage or natural disaster at their facilities, our ability to deliver product to meet commercial demand would be significantly impaired. In addition, we utilize third parties to perform various other services for us relating to sample accountability and regulatory monitoring, including adverse event reporting, safety database management and other product maintenance services. If the quality or accuracy of the data maintained by these service providers is insufficient, our ability to continue to market our products could be jeopardized or we could be subject to regulatory sanctions. We do not currently have the internal capacity to perform these important commercial functions, and we may not be able to maintain commercial arrangements for these services on reasonable terms.

The perception that our DosePro needle-free drug delivery system should be pain free may limit patient adoption.

We believe that there is a perception among some patients, physicians and other customers that a needle-free delivery system should be pain free. While our experience indicates that some patients will experience pain upon injection with the DosePro technology, this pain sensation is consistent with the pain sensation associated with injection with a fine gauge needle and can be generally characterized as transient mild discomfort. In addition, some patients will experience local injection site signs and reactions following injection with DosePro. The fact that the use of our DosePro system may be accompanied by a certain amount of pain upon injection and local injection site signs and reactions may limit its adoption by patients, physicians and other customers.

Zohydro and Relday are subject to extensive regulation, and we cannot give any assurance that they or any of our other product candidates will receive regulatory approval or be successfully commercialized.*

We currently are developing Zohydro for the treatment of moderate to severe chronic pain and we plan to initiate clinical studies for Relday to treat the symptoms of schizophrenia. The research, testing, manufacturing, labeling, approval, sale, marketing and distribution of opioid drug products, among other things, are subject to extensive regulation by the FDA, the DEA (in the case of Zohydro) and other regulatory authorities in the United States. We are not permitted to market Zohydro, Relday or any of our other product candidates in the United States unless and until we receive regulatory approval from the FDA. We cannot provide any assurance that we will obtain regulatory approval for Zohydro, Relday or any of our other product candidates, or that any such product candidates will be successfully commercialized.

While we submitted an NDA for Zohydro to the FDA in May 2012, we have not yet received marketing approval for Zohydro. Obtaining approval of an NDA is a lengthy, expensive and uncertain process. Although we have submitted our NDA for Zohydro, the FDA has the ability to formally file or refuse to file an application within 60 days of the completion of the submission. If the FDA determines the application is sufficiently complete to permit a substantive review, and none of the reasons for refusing to file the application apply, the FDA will accept the NDA for filing. The FDA has not yet determined whether to accept our NDA for Zohydro for filing and the FDA may refuse to file the NDA. Neither the acceptance or non-acceptance of an NDA for filing is a determination of the ultimate approvability of the drug product at issue. The FDA may request additional information and refuse to file the NDA. If the FDA refuses to file our NDA, that refusal will delay the approval process for Zohydro. If our NDA submission is accepted for filing, the FDA will begin an in-depth review of the NDA and this process can take substantial time and require the expenditure of substantial and unanticipated resources.

Under the policies agreed to by the FDA under The Prescription Drug User Fee Act, or PDUFA, the FDA has a goal to complete its review of a standard NDA and respond to the applicant within ten months from the date of submission of an NDA. The review process and the PDUFA goal date may be extended by three months if the FDA requests or the NDA sponsor otherwise provides additional information or clarification regarding information already provided in the submission within the three months prior to the PDUFA goal date. The FDA s review goals are subject to change, and it is unknown whether the review of our NDA for Zohydro, or an NDA filing for any of our other product candidates, will be completed within the FDA s review goals or will be delayed. Moreover, the duration of the FDA s review may depend on the number and type of other NDAs that are submitted with the FDA around the same time period.

Under the policies agreed to by the FDA under The Prescription Drug User Fee Act, or PDUFA, the FDA is subject to a two-tiered system of review times Standard Review and Priority Review. For drugs subject to standard review, such as Zohyrdo, the FDA has a goal to complete its review of the NDA and respond to the applicant within ten months from the date of receipt of an NDA. The review process and the PDUFA goal date may be extended by three months if the FDA requests or the NDA sponsor otherwise provides additional information or clarification regarding information already provided in the submission within the three months prior to the PDUFA goal date. The FDA may also refer applications for novel products or products which present difficult questions of safety or efficacy to an advisory committee, typically a panel that includes clinicians and other experts, for review, evaluation and a recommendation as to whether the application should be approved. The FDA is not bound by the recommendation of an advisory committee, but it generally follows such recommendations. The FDA s review goals are subject to change, and it is unknown whether the review of our NDA for Zohydro, or an NDA filing for any of our other product candidates, will be completed within the FDA s review goals or will be delayed. Moreover, the duration of the FDA s review may depend on the number and type of other NDAs that are submitted with the FDA around the same time period.

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As part of its review of the NDA, the FDA will inspect the facility or the facilities where the drug is manufactured. If the FDA s evaluations of the NDA and the clinical and manufacturing procedures and facilities are favorable, the FDA will issue an action letter, which will be either an approval letter, authorizing commercial marketing of the drug for a specified indication, or a complete response letter containing the conditions that must be met in order to secure approval of the NDA. These conditions may include deficiencies identified in connection with the FDA s evaluation of the NDA submission or the clinical and manufacturing procedures and facilities. Until any such conditions or deficiencies have been resolved, the FDA may refuse to approve the NDA. If and when those conditions have been met to the FDA s satisfaction, the FDA will issue an approval letter. The FDA has substantial discretion in the drug approval process, including the ability to delay, limit or deny approval of a product candidate for many reasons. For example:

- the FDA may not deem a product candidate safe and effective;
- the FDA may not find the data from pre-clinical studies and clinical trials sufficient to support approval;
- the FDA may require additional pre-clinical studies or clinical trials;
- the FDA may not approve of our third-party manufacturers processes and facilities; or
- the FDA may change its approval policies or adopt new regulations.

Zohydro has undergone Phase 1 pharmacokinetics studies, Phase 2 clinical trials, and a Phase 3 clinical development program. However, some of these studies and trials were conducted by a third party and, accordingly, we did not directly participate in their design or execution. We initiated the Phase 3 clinical development program for Zohydro in March 2010 and reported positive top-line results from our pivotal Phase 3 efficacy trial, Study 801, in August 2011 and completed our Phase 3 safety trial, Study 802, in December 2011, which showed Zohydro to be safe and generally well tolerated. However, product candidates such as Zohydro may not be approved even if they achieve their specified endpoints in clinical trials. The FDA may disagree with our trial design and our interpretation of data from clinical trials, or may change the requirements for approval even after it has reviewed and commented on the design for our clinical trials. The FDA may also approve a product candidate for fewer or more limited indications than we request, or may grant approval contingent on the performance of costly post-approval clinical trials. In addition, the FDA may not approve the labeling claims that we believe are necessary or desirable for the successful commercialization of our product candidates. Approval may be contingent on a Risk Evaluation and Mitigation Strategy, or REMS, that limits the labeling, distribution or promotion of a drug product. Relday and any of our other product candidates may fail to achieve their specified endpoints in clinical trials. Although we have not yet begun clinical studies for Relday, the development of Relday will be subject to most of the risks described in this paragraph.

We believe that we have planned, designed and completed an adequate Phase 3 clinical trial program for Zohydro, and we presented the trial design for our Phase 3 trials to the FDA at our End of Phase 2 meeting in June 2008. Although we believe the FDA has generally agreed with the design of our Phase 3 clinical trial program, the FDA could still determine that it is not satisfied with our plan, the details of our pivotal clinical trial protocols and designs or the results of our studies. In addition, we concluded our pre-NDA meetings with the FDA in December 2011 during which we discussed the non-clinical, clinical and chemistry, manufacturing and controls, or CMC, development of Zohydro, and agreed on the submission requirements for the NDA under 505(b)(2) of the Federal Food, Drug, and Cosmetic Act, or FFDCA. While the FDA has provided us with a written record of our discussions and responses to our questions at our End of Phase 2 meeting and our pre-NDA meetings, such records and responses do not guarantee that the FDA will deem our trial design to be sufficient for the purpose of obtaining marketing approval for Zohydro. We did not seek a Special Protocol Assessment from the FDA for our pivotal Phase 3 efficacy study for Zohydro (Study 801).

If we are unable to obtain regulatory approval for Zohydro, Relday or any other product candidates on the timeline we anticipate, we will not be able to execute our business strategy effectively and our ability to generate additional revenues beyond Sumavel DosePro will be limited, which would have a material adverse impact on our business, results of operations, financial condition and prospects.

Our clinical trials may fail to demonstrate acceptable levels of safety and efficacy for Zohydro, Relday or any of our other product candidates, which could prevent or significantly delay their regulatory approval.

Our Zohydro, Relday and any other product candidates are prone to the risks of failure inherent in drug development. Before obtaining U.S. regulatory approval for the commercial sale of Zohydro, Relday or any other product candidate, we must gather substantial evidence from well-controlled clinical trials that demonstrate to the satisfaction of the FDA that the product candidate is safe and effective, and similar regulatory approvals would be necessary to commercialize the product candidate in other countries.

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In light of widely publicized events concerning the safety risk of certain drug products, particularly opioid drug products, regulatory authorities, members of Congress, the Government Accountability Office, medical professionals and the general public have raised concerns about potential drug safety issues. These events have resulted in the withdrawal of drug products, revisions to drug labeling that further limit use of the drug products and establishment of risk management programs that may, for instance, restrict distribution of drug products after approval. In addition, the FFDCA, as amended by the Food and Drug Administration Amendments Act of 2007, grants significant expanded authority to the FDA, much of which is aimed at improving the safety of drug products before and after approval. In particular, the FFDCA authorizes the FDA to, among other things, require post-approval studies and clinical trials, mandate changes to drug labeling to reflect new safety information and require a REMS, for certain drugs, including certain currently approved drugs. It also significantly expands the federal government s clinical trial registry and results databank, which we expect will result in significantly increased government oversight of clinical trials. Under the FFDCA, companies that violate these and other provisions of the law are subject to substantial civil monetary penalties, among other regulatory, civil and criminal penalties.

The increased attention to drug safety issues may result in a more cautious approach by the FDA in its review of our clinical trials. Data from clinical trials may receive greater scrutiny with respect to safety, which may make the FDA or other regulatory authorities more likely to terminate clinical trials before completion, or require longer or additional clinical trials that may result in a delay or failure in obtaining approval or approval for a more limited indication than originally sought.

With regard to Zohydro, top-line results from our pivotal Phase 3 efficacy clinical trial in patients with chronic lower back pain has shown what we believe is a clinically acceptable efficacy and safety profile which supports submission of an NDA for the treatment of moderate to severe pain in patients requiring around-the-clock opioid therapy. The trial successfully met the primary efficacy endpoint of the study in demonstrating a significant difference (p=0.008) between the mean changes in daily pain intensity Numeric Rating Scale (NRS) scores between Zohydro and placebo groups. The two key secondary endpoints were also met, specifically, the proportion of patients with at least 30% improvement in pain intensity and the improvement of overall satisfaction of medication. In the pivotal Phase 3 efficacy trial, the observed adverse events were similar to the side effects we observed in prior Phase 2 trials of Zohydro and consistent with the reported side effects of opioids currently prescribed for chronic pain. The incidence of adverse events was 33.7% and 28.8% in the open-label titration and double blind treatment periods, respectively. Overall, the most commonly reported adverse events (2%) were constipation, nausea, somnolence, vomiting, diarrhea, insomnia, fatigue, headache, dizziness and dry mouth. These results may not be predictive of results obtained in our safety trial or any other required future trials, and we may be unable to demonstrate sufficient safety and efficacy to obtain the requisite regulatory approvals or approvals for commercially viable uses. In addition, the top-line data we have reported and may continue to report from our Zohydro clinical trials is based on preliminary analysis of key efficacy and safety data, and such data may change following a more comprehensive review of the data related to the applicable clinical trial, and may also change in connection with the continued review of such data as part of our submission and the FDA s review of our NDA. A number of companies in the biotechnology and pharmaceutical industries have suffered significant setbacks in advanced clinical trials, even after promising results in earlier trials. If Zohydro or any of our other product candidates are not shown to be safe and effective in clinical trials, the program could be delayed or terminated, which could have a material adverse effect on our business, results of operations, financial condition and prospects.

Delays in the commencement or completion of any additional testing for Zohydro, if required, or pre-clinical or clinical testing for Relday or any of our other product candidates could result in increased costs to us and delay or limit our ability to pursue regulatory approval for, or generate revenues from, such product candidates.

Clinical trials are very expensive, time consuming and difficult to design and implement. Delays in the commencement or completion of any additional testing for Zohydro, if required, or pre-clinical or clinical testing for Relday or any of our other product candidates could significantly affect our product development costs and business plan. We expect to initiate clinical testing for Relday in patients with schizophrenia in 2012. In addition, we do not know whether this or any other pre-clinical or clinical trials will begin on time or be completed on schedule, if at all. The commencement and completion of clinical trials can be delayed for a number of reasons, including delays related to:

- obtaining regulatory authorization to commence a clinical trial;

- reaching agreement on acceptable terms with prospective clinical research organizations, or CROs, clinical investigators and trial sites, the terms of which can be subject to extensive negotiation and may vary significantly among different CROs, clinical investigators and trial sites;

manufacturing or obtaining sufficient quantities of a product candidate for use in clinical trials;

obtaining institutional review board, or IRB, approval to initiate and conduct a clinical trial at a prospective site;

identifying, recruiting and training suitable clinical investigators;

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identifying, recruiting and enrolling subjects to participate in clinical trials for a variety of reasons, including competition from other clinical trial programs for the treatment of pain, migraine or similar indications;

retaining patients who have initiated a clinical trial but may be prone to withdraw due to side effects from the therapy, lack of efficacy, personal issues, or for any other reason they choose, or who are lost to further follow-up;

uncertainty regarding proper dosing; and

scheduling conflicts with participating clinicians and clinical institutions.

In addition, if a significant number of patients fail to stay enrolled in any of our future clinical trials of Relday or any of our other product candidates and such failure is not adequately accounted for in our trial design and enrollment assumptions, our clinical development program could be delayed. Clinical trials may also be delayed or repeated as a result of ambiguous or negative interim results or unforeseen complications in testing. In addition, a clinical trial may be suspended or terminated by us, the FDA, the IRB overseeing the clinical trial at issue, any of our clinical trial sites with respect to that site, or other regulatory authorities due to a number of factors, including:

failure to design appropriate clinical trial protocols;

failure by us, our employees, our CROs or their employees to conduct the clinical trial in accordance with all applicable FDA, DEA or other regulatory requirements or our clinical protocols;

inspection of the clinical trial operations or trial sites by the FDA or other regulatory authorities resulting in the imposition of a clinical hold;

discovery of serious or unexpected toxicities or side effects experienced by study participants or other unforeseen safety issues;

lack of adequate funding to continue the clinical trial, including the incurrence of unforeseen costs due to enrollment delays, requirements to conduct additional trials and studies and increased expenses associated with the services of our CROs and other third parties;

lack of effectiveness of any product candidate during clinical trials;

slower than expected rates of subject recruitment and enrollment rates in clinical trials;

failure of our CROs or other third-party contractors to comply with all contractual requirements or to perform their services in a timely or acceptable manner;

inability or unwillingness of medical investigators to follow our clinical protocols; and

unfavorable results from on-going clinical trials and pre-clinical studies.

Additionally, changes in applicable regulatory requirements and guidance may occur and we may need to amend clinical trial protocols to reflect these changes. Amendments may require us to resubmit our clinical trial protocols to IRBs for reexamination, which may impact the costs, timing or successful completion of a clinical trial. All of the above risks will be applicable to Zohydro to the extent we are required by the FDA to conduct any additional clinical trials. If we experience delays in completion of, or if we terminate, any of our clinical trials, the commercial prospects for Zohydro, Relday and our other product candidates may be harmed, which may have a material adverse effect on our business, results of operations, financial condition and prospects.

Our competitors could receive FDA approval for an extended-release hydrocodone product before we receive FDA approval for Zohydro, and thus could be granted regulatory exclusivity that could significantly delay our ability to receive approval for and commercialize Zohydro and therefore dramatically reduce its market potential. Our competitors could also pursue regulatory and other strategies to combat competition from 505(b)(2) products, which also may negatively affect the approval and commercialization of Zohydro and any of our other product candidates.

The Drug Price Competition and Patent Term Restoration Act of 1984, also known as the Hatch-Waxman Amendments, added Section 505(b)(2) to the FFDCA, or Section 505(b)(2). Section 505(b)(2) permits the filing of an NDA where at least some of the information required for approval comes from studies not conducted by or for the applicant and for which the applicant has not obtained a right of reference. For example, we obtained FDA marketing approval of Sumavel DosePro under Section 505(b)(2), and we submitted the NDA for Zohydro under Section 505(b)(2), and as such the NDA will rely, in part, on the FDA s previous findings of safety and effectiveness for *hydrocodone*.

Certain of our competitors may file a 505(b)(2) application for extended-release *hydrocodone* shortly after we submitted our own NDA for Zohydro. The first approved 505(b)(2) applicant for a particular condition of use, or change to a marketed product, such as a new extended-release formulation for a previously approved product, may be granted three-year Hatch-Waxman exclusivity if one

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or more clinical studies, other than bioavailability or bioequivalence studies, was essential to the approval of the application and was conducted/sponsored by the applicant. Three-year Hatch-Waxman exclusivity delays the FDA s approval of other 505(b)(2) applicants for the same condition of use or change to the drug product that was granted exclusivity, regardless of the date of submission of each NDA. We believe that several competitors are developing extended-release *hydrocodone* products, and if the FDA approves a competitor s 505(b)(2) application for its extended-release *hydrocodone* product before our application, and granted the competitor three-year exclusivity, the FDA would be precluded from making effective our NDA for Zohydro until after that three-year exclusivity period has run, and such delay would dramatically reduce our expected market potential for Zohydro. Additionally, even if our 505(b)(2) application for extended-release *hydrocodone* is approved first, we may still be subject to competition by other *hydrocodone* products, including approved products or other 505(b)(2) applications for different conditions of use that would not be restricted by the three-year exclusivity.

In addition, approval under Section 505(b)(2) generally requires the absence of any other patents covering the product candidate in question and competitors and others have the ability to take numerous steps to block or delay approval of product candidates under Section 505(b)(2), including:

- extending patent protection for existing products that would block Section 505(b)(2) approval of the product candidate by pursuing new patents for existing products that may be granted just before the expiration of one patent, which could extend patent protection for a number of years or otherwise delay the launch of generic, 505(b)(2) or other competing products;

- submitting Citizen Petitions to request the FDA to take adverse administrative action with respect to approval of a generic, 505(b)(2) or other competing product;

- filing patent infringement lawsuits, whether or not meritorious, to trigger up to a 30-month stay in the approval of a generic, 505(b)(2) or other competing product; and

- engaging in state-by-state initiatives to enact legislation or regulatory policies that restrict the substitution of some generic, 505(b)(2) or other competing drugs for brand-name drugs.

If any of these strategies are successful, our ability to obtain approval of and commercialize Zohydro and any of our other product candidates for which we rely on Section 505(b)(2) will be adversely affected.

We rely on third parties to conduct our pre-clinical and clinical trials. If these third parties do not successfully carry out their contractual duties or meet expected deadlines, we may not be able to obtain regulatory approval for or commercialize our product candidates and our business could be substantially harmed.

We conducted our Phase 3 trials for Zohydro under agreements with third-party CROs, and anticipate that we may enter into agreements with third-party CROs in the future regarding Relday or any of our other product candidates. We rely heavily on these parties for the execution of our clinical and pre-clinical studies, and control only certain aspects of their activities. Nevertheless, we are responsible for ensuring that each of our studies is conducted in accordance with the applicable protocol. We and our CROs are required to comply with current good clinical practices, or GCPs. The FDA enforces these GCP regulations through periodic inspections of trial sponsors, principal investigators and trial sites. If we or our CROs fail to comply with applicable GCP regulations, the data generated in our clinical trials may be deemed unreliable and the FDA may require us to perform additional clinical trials before approving our marketing applications. We cannot assure you that, upon inspection, the FDA and similar foreign regulators will determine that any of our clinical trials comply or complied with GCP regulations. In addition, our clinical trials must be conducted with product produced under current good manufacturing practices, or cGMPs, regulations, and require a large number of test subjects. Our failure to comply with these regulations may require us to repeat clinical trials, which would delay the regulatory approval process.

If any of our relationships with these third-party CROs terminate, we may not be able to enter into arrangements with alternative CROs on commercially reasonable terms, or at all. If CROs do not successfully carry out their contractual duties or obligations or meet expected deadlines, if they need to be replaced or if the quality or accuracy of the clinical data they obtain is compromised due to the failure to adhere to our clinical protocols or regulatory requirements or for other reasons, our clinical trials may be extended, delayed or terminated and we may not be able to obtain regulatory approval for or successfully commercialize our product candidates. As a result, our results of operations and the commercial prospects for our product candidates would be harmed, our costs could increase and our ability to generate additional revenues could

be delayed.

Switching or adding additional CROs can involve substantial cost and require extensive management time and focus. In addition, there is a natural transition period when a new CRO commences work. As a result, delays may occur, which can materially impact our ability to meet our desired clinical development timelines. Though we carefully manage our relationships with our CROs, there can be no assurance that we will not encounter similar challenges or delays in the future or that these delays or challenges will not have a material adverse impact on our business, results of operations, financial condition and prospects.

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The development of a REMS for Zohydro could cause significant delays in the approval process for Zohydro and will add additional layers of regulatory requirements, including the requirement for a Medication Guide and educational requirements for prescribers and patients, which could significantly impact our ability to commercialize Zohydro and dramatically reduce its market potential.

The Food and Drug Administration Amendments Act, or FDAAA, added Section 505-1 to the FFDCA. Section 505-1 permits FDA to require a REMS for a drug product to ensure the safe use of the drug. A REMS is a strategic safety program that the FDA requires to ensure that the benefits of a drug outweigh its risks. In determining whether a REMS is necessary, the FDA must consider the size of the population likely to use the drug, the seriousness of the disease or condition to be treated, the expected benefit of the drug, the duration of treatment, the seriousness of known or potential adverse events, and whether the drug is a new molecular entity. If the FDA determines a REMS is necessary, the drug sponsor must agree to the REMS plan at the time of approval. A REMS may be required to include various elements, such as a medication guide or patient package insert, a communication plan to educate health care providers of the drug s risks, limitations on who may prescribe or dispense the drug, requirements that patients enroll in a registry or undergo certain health evaluations or other measures that the FDA deems necessary to assure the safe use of the drug. In addition, the REMS must include a timetable to assess the strategy at 18 months, three years and seven years after the strategy s approval.

In February 2009, the FDA informed drug manufacturers that it will require a class-wide REMS for all long-acting and sustained-release opioid drug products. The FDA has since initiated efforts to develop a new standardized REMS for these opioid medications to ensure their safe use. In April 2011, the FDA announced that it had finalized the elements of a class-wide REMS for these products. The central component of the opioid REMS program is an education program for prescribers and patients. Specifically, the REMS for these products must include a Medication Guide available for distribution to patients who are dispensed the drug, as well as a number of elements to assure safe use. These elements include training for prescribers who prescribe the drug; information provided to prescribers that prescribers can use to educate patients in the safe use, storage, and disposal of opioids; and information provided to prescribers of the existence of the REMS and the need to successfully complete the necessary training. The FDA expects that the prescriber training required as part of the REMS is to be conducted by accredited, independent continuing education providers, without cost to the healthcare professionals, under unrestricted grants to accredited continuing education providers funded by the sponsor. In November 2011, the FDA issued a draft blueprint for this prescriber education that outlines the core messages that the FDA believes should be conveyed to prescribers in a basic two to three hour educational module. Once finalized and approved as part of the REMS, this blueprint will be available for use by continuing education providers in developing continuing education courses. Moreover, the REMS must include a timetable for submission of assessments that shall be no less frequent than 6 months, 12 months, and annually after the REMS is approved to assess the extent to which the elements to assure safe use are meeting the goals of the REMS and whether the goals or elements should be modified. The FDA expects that manufacturers of long-acting and extended-release opioids work together to provide educational materials as part of a class-wide single shared system to reduce the burden of the REMS on the healthcare system.

An extended-release formulation of *hydrocodone*, such as Zohydro, will be required to have a REMS that contains the elements of the recently-issued class-wide REMS for long-acting and sustained-release opioids. We submitted a REMS at the time of the NDA submission for Zohydro. The REMS submission could cause significant delays in the approval process for the Zohydro NDA, and the educational requirements and requirements for a Medication Guide for patients could significantly impact our ability to commercialize Zohydro and dramatically reduce its market potential.

Our commercialization partner for Sumavel DosePro in the European Union and three other countries, Desitin Arzneimittel GmbH, or Desitin, may not successfully develop, obtain approval for or commercialize Sumavel DosePro in those territories, which may adversely affect our ability to commercialize Sumavel DosePro both inside and outside the United States.

In March 2008, we entered into a licensing and distribution agreement with Desitin pursuant to which we granted Desitin the exclusive right under our intellectual property rights related to Sumavel DosePro to develop, use, distribute, sell, offer for sale, and import Sumavel DosePro and any potential modified versions of Sumavel DosePro in the European Union, Norway, Switzerland and Turkey. In that regard, Desitin is not obligated under the agreement to pursue regulatory approval or commercialization of Sumavel DosePro in any of these countries except for Germany. Since we will depend on Desitin to develop, obtain regulatory approval for and, if regulatory approval is granted, commercialize Sumavel DosePro in these countries, we will have limited control over the success of Desitin s development, regulatory approval and commercialization efforts. Desitin submitted a Marketing Authorization Application for Sumavel DosePro to the Federal Institute for Drugs and Medical Devices (Bundesinstitut für Arzneimittel und Medizinprodukte (BfArM)) in Germany, the reference member state, through the Decentralized Procedure in October 2009, following completion of a European pivotal bioequivalence trial comparing needle-free Sumavel DosePro to a traditional needle-based autoinjector, Imigran-Inject, the European brand of Imitrex STATdose. In November 2010, Denmark became the first member of the European Union to approve marketing of Sumavel DosePro in that country. Subsequently, Sumavel DosePro has received marketing approval in Germany, Sweden, the United Kingdom, Norway and France.

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Any additional clinical studies Desitin may be required to conduct as part of the regulatory approval process may not corroborate the results of the clinical studies we have conducted or may have adverse results or effects on our ability to maintain regulatory approvals in the United States or obtain them in other countries. In addition, although we believe that the U.S. market represents the largest commercial opportunity for Sumavel DosePro, Desitin may not develop Sumavel DosePro as fast or generate as large of a market as we would like or as the market may expect and Desitin may not seek to develop, obtain approval for or commercialize Sumavel DosePro in countries for which it has exclusive rights, other than in Germany, where Desitin is required to develop, seek approval for and commercialize Sumavel DosePro. Any failure by Desitin to successfully commercialize Sumavel DosePro or to successfully obtain applicable foreign regulatory approval for Sumavel DosePro would limit our opportunity to receive revenue from the territories licensed to Desitin. Furthermore, negative developments occurring in those territories controlled by Desitin could have a negative impact on physician and patient impressions of our product in the United States and elsewhere.

Our failure to successfully establish new partnerships with pharmaceutical companies or contract sales organizations to co-promote Sumavel DosePro and any additional product candidates that may receive regulatory approval may impair our ability to effectively market and sell such product candidates.*

Major pharmaceutical companies usually employ groups of sales representatives numbering in the thousands to call on the large number of primary care physicians. In connection with the launch of Sumavel DosePro in January 2010 we built a sales and marketing organization to promote Sumavel DosePro in the United States, including a focused sales force currently comprised of approximately 95 representatives primarily targeting neurologists and other prescribers of migraine medications, including headache clinics and headache specialists. In July 2009, we entered into an exclusive agreement with Astellas under which Sumavel DosePro was also being marketed by Astellas in the United States and promoted primarily to primary care physicians, OB/GYNs, emergency medicine physicians and urologists by approximately 400 Astellas sales representatives. Our Astellas agreement terminated on March 31, 2012, and in order to maintain and expand the market opportunity for Sumavel DosePro into the broader primary care physician audiences we may, and in order to promote any additional product candidates that receive regulatory approval to these physician audiences we will, need to expand our sales and marketing personnel and commercial infrastructure and/or establish partnerships with pharmaceutical companies or contract sales organizations to co-promote such product and/or product candidates. We currently, and on an ongoing basis will have to, compete with other pharmaceutical and biotechnology companies to recruit, hire, train and retain sales and marketing personnel. We also face competition in our search for collaborators and potential co-promoters. To the extent we rely on additional third parties to co-promote or otherwise commercialize any product and/or product candidates that may receive regulatory approval, we are likely to receive less revenue than if we commercialized these products ourselves. Further, by entering into strategic partnerships or similar arrangements, we may rely in part on such third parties for financial and commercialization resources. Even if we are able to identify suitable partners to assist in the commercialization of our product and/or product candidates, they may fail to devote the resources necessary to realize the full commercial potential of our products. In addition, we may lack the financial and managerial resources to increase the size of our sales and marketing organization to adequately promote and commercialize Sumavel DosePro and any product candidates that may be approved, and any increase in our sales force would result in an increase in our expenses, which could be significant before we generate revenues from any newly approved product candidate. If we are unable to expand our sales and marketing infrastructure or enter into a third-party arrangement, we would not be able to successfully commercialize any approved products. Even if we are able to expand our sales and marketing personnel or successfully establish partnership arrangements, such sales force and marketing teams may not be successful in commercializing our products, which would adversely affect our ability to generate revenue for such products, which will have a material adverse effect on our business, results of operations, financial condition and prospects.

Our failure to successfully acquire, develop and market additional product candidates or approved products would impair our ability to grow our business. In that regard, our DosePro delivery system cannot be used with drug formulation volumes greater than 0.5 mL, which will likely limit its use with drugs requiring larger formulation volumes.*

As part of our growth strategy we intend to seek to expand our product pipeline by exploring acquisition or in-licensing opportunities of proven drugs that can be paired with our DosePro needle-free drug delivery system. However, the current version of our DosePro drug delivery system cannot be used with drug formulation volumes greater than 0.5 mL. Many marketed and development-stage injectable products, including most biologics, have formulation volumes greater than 0.5 mL and would require reformulation, if possible, to accommodate the approved doses in smaller volumes that are compatible with DosePro. Any reformulation may increase the risk of failure during development, extend the development timelines, increase development costs and add complexity to the regulatory approval process and in some cases reformulation may not be possible. If we are not able to identify additional drug compounds that can be delivered via the current version of our DosePro technology, or if we are unable to successfully develop higher dose versions of this technology, our ability to develop additional product candidates and grow our business would be adversely affected. We and Battelle Memorial Institute, or Battelle, our technology co-marketing partner, are also seeking

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opportunities to out-license the DosePro technology to partners seeking to enhance, differentiate, or extend the life-cycle of their injectable products. However, there can be no assurance that our or Battelle s efforts to secure such a partnership will be successful. If we are unable to secure partnerships with companies that have compounds that can be delivered via the current version of our DosePro technology, or if we are unable to successfully develop higher dose versions of this technology, we will not be able to generate revenues from out-licensing our DosePro technology.

We have initiated early stage design and development of a larger volume, second generation version of our DosePro technology to accommodate drug formulation volumes greater than 0.5 mL, which if successfully developed, would allow for a broader range of potential applications for our technology. However, the full development of such technology will require substantial investment and we may enter into a third-party collaboration in order to obtain additional financing to help fully develop such technology. For example, under our co-marketing and option agreement with Battelle, we granted Battelle an option to enter into an exclusive co-development and commercialization arrangement with us related to a 1.2 mL DosePro drug delivery technology. There is no guarantee that we or any potential future third-party collaborator, including Battelle should it exercise its option, will be able to successfully develop such a device technology, whether for financial or technical reasons or otherwise.

Furthermore, we intend to in-license, acquire, develop and/or market additional products and product candidates in the areas of pain and central nervous system, or CNS, disorders. For example, in July 2011, we entered into a development and license agreement with Durect Corporation for a proprietary, long-acting, injectable formulation of *risperidone* using Durect s SABER controlled-release formulation technology in combination with our DosePro technology. Durect will be responsible for non-clinical, formulation and CMC development responsibilities. As a result, we will be dependent on Durect s successful completion of its responsibilities for Relday. In addition, because our internal research and development capabilities are limited, we may be dependent upon other pharmaceutical and biotechnology companies, academic scientists and other researchers to sell or license products or technology to us. The success of this strategy depends partly upon our ability to identify and select promising pharmaceutical product candidates and products, negotiate licensing or acquisition agreements with their current owners and finance these arrangements.

The process of proposing, negotiating and implementing a license or acquisition of a product candidate or approved product is lengthy and complex. Other companies, including some with substantially greater financial, marketing, sales and other resources, may compete with us for the license or acquisition of product candidates and approved products. We have limited resources to identify and execute the acquisition or in-licensing of third-party products, businesses and technologies and integrate them into our current infrastructure. Moreover, we may devote resources to potential acquisitions or licensing opportunities that are never completed, or we may fail to realize the anticipated benefits of such efforts. We may not be able to acquire the rights to additional product candidates, or license the rights to our DosePro technology, on terms that we find acceptable, or at all.

Further, any product candidate that we acquire may require additional development efforts prior to commercial sale, including pre-clinical or clinical testing and approval by the FDA and applicable foreign regulatory authorities. We expect to initiate clinical testing for Relday in patients in schizophrenia in 2012. We may not be able to obtain necessary approvals to initiate such clinical testing in a timely manner or at all. In addition, all product candidates are prone to risks of failure typical of pharmaceutical product development, including the possibility that a product candidate will not be shown to be sufficiently safe and effective for approval by regulatory authorities. In addition, we cannot provide assurance that any products that we develop or approved products that we acquire will be manufactured or sold profitably or achieve market acceptance.

If we are unable to license or acquire additional product candidates or approved products and successfully develop and commercialize them, or if we are otherwise unable to pair our DosePro delivery system with other drugs or out-license the DosePro technology to others, it would likely have a material adverse effect on our business, results of operations, financial condition and prospects.

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We may need to continue to increase the size of our organization, and we may experience difficulties in managing and financing growth.*

We increased our full-time employees from 48 as of October 31, 2009 to 157 as of March 31, 2012. In addition, we have expanded our sales force in the United States from approximately 80 sales representatives to approximately 95 sales representatives as of March 31, 2012 and we intend to increase our sales force if Zohydro is approved by the FDA. Any such increases in our sales force could substantially increase our expenses. We may need to continue to expand our managerial, operational and other resources in order to grow, manage and fund our existing business. Our management and personnel, systems and facilities currently in place may not be adequate to support this recent and any future growth, and we may be unable to fund the costs and expenses required to increase our necessary headcount and infrastructure. Our need to effectively manage our operations, any future growth and various projects requires that we:

- manage our internal and external commercialization efforts for Sumavel DosePro effectively while carrying out our contractual obligations to third parties and complying with all applicable laws, rules and regulations;
- manage our internal development efforts for Zohydro, Relday and our other product candidates effectively while carrying out our contractual obligations to licensors, collaborators and other third parties and complying with all applicable laws, rules and regulations;
- continue to improve our operational, financial and management controls, reporting systems and procedures; and
- attract and retain sufficient numbers of talented employees.

We may be unable to successfully implement or fund these tasks on a larger scale and, accordingly, may not achieve our commercialization and development goals. In addition, our management may have to divert a disproportionate amount of its attention away from day-to-day activities and towards managing these growth-related activities. Likewise, any increase in our sales force would increase our expenses, perhaps substantially. Our future financial performance and our ability to execute on our business plan will depend, in part, on our ability to effectively manage any future growth and our failure to effectively manage any growth could have a material adverse effect on our business, results of operations, financial condition and prospects.

If we are unable to attract and retain key personnel, we may not be able to manage our business effectively or develop our product candidates or commercialize our product.

Our success depends on our continued ability to attract, retain and motivate highly qualified management and key clinical development, regulatory, sales and marketing and other personnel. We are highly dependent on the development, regulatory, commercial and financial expertise of our senior management team. We may not be able to attract or retain qualified management and scientific and clinical personnel in the future due to the intense competition for qualified personnel among biotechnology, pharmaceutical and other businesses, particularly in the areas in Southern and Northern California, where we currently operate. Our industry has experienced a high rate of turnover of management personnel in recent years. If we are not able to attract, retain and motivate necessary personnel to accomplish our business objectives, we may experience constraints that will significantly impede the achievement of our development and commercialization objectives, our ability to raise additional capital and our ability to implement our business strategy. The loss of the services of any members of our senior management team, especially our Chief Executive Officer, Roger L. Hawley, and President and Chief Operating Officer, Stephen J. Farr, Ph.D., could negatively impact the commercialization of Sumavel DosePro and could delay or prevent the development and commercialization of any other product candidates, including Zohydro or Relday. In addition, under the terms of our amended and restated loan and security agreement with Oxford and SVB, or the amended Oxford/SVB loan agreement, if our Chief Executive Officer, Chief Financial Officer or President resigns, is terminated or is no longer actively involved in his or her current position and is not replaced by a person acceptable to our board of directors within 120 days, an event of default would be triggered under the agreement, and the lenders would be able to demand immediate repayment of all borrowings outstanding under the agreement. Further, if we lose any members of our senior management team, we may not be able to find suitable replacements, and our business may be harmed as a result. In addition to the competition for personnel, our locations in California in particular are characterized by a high cost of living. As such, we could have difficulty attracting experienced personnel to our company and may be required to expend significant financial resources in our employee recruitment and retention efforts.

Although we have employment agreements with each of our executive officers, these agreements are terminable by them at will at any time with or without notice and, therefore, do not provide any assurance that we will be able to retain their services. We do not maintain key man insurance policies on the lives of our senior management team or the lives of any of our other employees. In addition, we have clinical advisors who assist us in formulating our clinical strategies. These advisors are not our employees and may have commitments to, or consulting or advisory contracts with, other entities that may limit their availability to us, or may have arrangements with other companies to assist in the development of products that may compete with ours. If we are unable to attract and retain key personnel, our business, results of operations, financial condition and prospects will be adversely affected.

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We may engage in strategic transactions that could impact our liquidity, increase our expenses and present significant distractions to our management.

From time to time we may consider strategic transactions, such as acquisitions of companies, asset purchases and out-licensing or in-licensing of products, product candidates or technologies. Additional potential transactions that we may consider include a variety of different business arrangements, including spin-offs, strategic partnerships, joint ventures, restructurings, divestitures, business combinations and investments. Any such transaction may require us to incur non-recurring or other charges, may increase our near and long-term expenditures and may pose significant integration challenges or disrupt our management or business, which could adversely affect our operations and financial results. For example, these transactions may entail numerous operational and financial risks, including:

- exposure to unknown liabilities;
- disruption of our business and diversion of our management s time and attention in order to develop acquired products, product candidates or technologies;
- incurrence of substantial debt or dilutive issuances of equity securities to pay for acquisitions;
- higher than expected acquisition and integration costs;
- write-downs of assets or goodwill or impairment charges;
- increased amortization expenses;
- difficulty and cost in combining the operations and personnel of any acquired businesses with our operations and personnel;
- impairment of relationships with key suppliers or customers of any acquired businesses due to changes in management and ownership; and
- inability to retain key employees of any acquired businesses.

Accordingly, although there can be no assurance that we will undertake or successfully complete any transactions of the nature described above, any transactions that we do complete could have a material adverse effect on our business, results of operations, financial condition and prospects.

If we are unable to achieve and maintain adequate levels of coverage and reimbursement for Sumavel DosePro, Zohydro, if approved, or any of our other product candidates for which we may receive regulatory approval on reasonable pricing terms, their commercial success may be severely hindered.

Successful sales of our products depend on the availability of adequate coverage and reimbursement from third-party payors. Patients who are prescribed medicine for the treatment of their conditions generally rely on third-party payors to reimburse all or part of the costs associated with their prescription drugs. Adequate coverage and reimbursement from governmental healthcare programs, such as Medicare and Medicaid, and commercial payors is critical to new product acceptance. Coverage decisions may depend upon clinical and economic standards that disfavor new drug products when more established or lower cost therapeutic alternatives are already available or subsequently become available. Assuming coverage is approved, the resulting reimbursement payment rates might not be adequate or may require co-payments that patients find unacceptably high. Patients are unlikely to use our products unless coverage is provided and reimbursement is adequate to cover a significant

portion of the cost of our products.

In addition, the market for our products will depend significantly on access to third-party payors drug formularies, or lists of medications for which third-party payors provide coverage and reimbursement. The industry competition to be included in such formularies often leads to downward pricing pressures on pharmaceutical companies. Also, third-party payors may refuse to include a particular branded drug in their formularies or otherwise restrict patient access to a branded drug when a less costly generic equivalent or other alternative is available.

Third-party payors, whether foreign or domestic, or governmental or commercial, are developing increasingly sophisticated methods of controlling healthcare costs. In addition, in the United States, no uniform policy of coverage and reimbursement for drug products exists among third-party payors. Therefore, coverage and reimbursement for drug products can differ significantly from payor to payor.

Further, we believe that future coverage and reimbursement will likely be subject to increased restrictions both in the United States and in international markets. Third-party coverage and reimbursement for Sumavel DosePro or any of our other product candidates for which we may receive regulatory approval may not be available or adequate in either the United States or international markets, which could have a material adverse effect on our business, results of operations, financial condition and prospects.

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We face potential product liability exposure, and if successful claims are brought against us, we may incur substantial liability if our insurance coverage for those claims is inadequate.

The commercial use of our product and clinical use of our product and product candidates expose us to the risk of product liability claims. This risk exists even if a product is approved for commercial sale by the FDA and manufactured in facilities licensed and regulated by the FDA, such as the case with Sumavel DosePro, or an applicable foreign regulatory authority. Our product and product candidates are designed to affect important bodily functions and processes. Any side effects, manufacturing defects, misuse or abuse associated with Sumavel DosePro or our product candidates could result in injury to a patient or even death. For example, because our DosePro technology is designed to be self-administered by patients, it is possible that a patient could fail to follow instructions and as a result apply a dose in a manner that results in injury. In addition, Zohydro is an opioid pain reliever that contains *hydrocodone*, which is a regulated controlled substance under the Controlled Substances Act of 1970, or CSA, and could result in harm to patients relating to its potential for abuse. In addition, a liability claim may be brought against us even if our product or product candidates merely appear to have caused an injury. Product liability claims may be brought against us by consumers, health care providers, pharmaceutical companies or others selling or otherwise coming into contact with our product or product candidates, among others. If we cannot successfully defend ourselves against product liability claims we will incur substantial liabilities. In addition, regardless of merit or eventual outcome, product liability claims may result in:

- the inability to commercialize our product or product candidates;
- decreased demand for our product or, if approved, product candidates;
- impairment of our business reputation;
- product recall or withdrawal from the market;
- withdrawal of clinical trial participants;
- costs of related litigation;
- distraction of management s attention from our primary business;
- substantial monetary awards to patients or other claimants; or
- loss of revenues.

We have obtained product liability insurance coverage for commercial product sales and clinical trials with a $10 million per occurrence and a $10 million annual aggregate coverage limit. Our insurance coverage may not be sufficient to cover all of our product liability related expenses or losses and may not cover us for any expenses or losses we may suffer. Moreover, insurance coverage is becoming increasingly expensive, and, in the future, we may not be able to maintain insurance coverage at a reasonable cost, in sufficient amounts or upon adequate terms to protect us against losses due to product liability. If we determine that it is prudent to increase our product liability coverage based on sales of Sumavel DosePro, approval of Zohydro or otherwise, we may be unable to obtain this increased product liability insurance on commercially reasonable terms or at all. Large judgments have been awarded in class action or individual lawsuits based on drugs that had unanticipated side effects, including side effects that are less severe than those of Sumavel DosePro and our product candidates. A successful product liability claim or series of claims brought against us could cause our stock price to decline and, if judgments exceed our insurance coverage, could decrease our cash and have a material adverse affect our business, results of operations, financial condition and prospects.

We may be adversely affected by earthquakes or other natural disasters and our business continuity and disaster recovery plans may not adequately protect us from a serious disaster.

Our corporate headquarters and other facilities are located in San Diego and the San Francisco Bay Area, which in the past have both experienced severe earthquakes. We do not carry earthquake insurance. As a result, earthquakes or other natural disasters could severely disrupt our operations, and have a material adverse effect on our business, results of operations, financial condition and prospects.

Our enterprise financial systems are located in our San Diego, California headquarters. Our manufacturing resource planning and enterprise quality systems are located in our Emeryville, California facility. If a disaster, power outage or other event occurred that prevented us from using all or a significant portion of our headquarters or our Emeryville facility, that damaged critical infrastructure, such as enterprise financial systems or manufacturing resource planning and enterprise quality systems, or that otherwise disrupted operations at either location, it may be difficult or, in certain cases, impossible for us to continue our business for a substantial period of time. The disaster recovery and business continuity plans we have in place currently are limited and are unlikely to prove adequate in the event of a serious disaster or similar event. We may incur substantial expenses as a result of the limited nature of our disaster recovery and business continuity plans which, particularly when taken together with our lack of earthquake insurance, could have a material adverse effect on our business.

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Our business involves the use of hazardous materials and we and our third-party manufacturers and suppliers must comply with environmental laws and regulations, which can be expensive and restrict how we do business.

Our research and development activities and our third-party manufacturers and suppliers activities involve the controlled storage, use and disposal of hazardous materials owned by us, including the components of our product and product candidates and other hazardous compounds. We and our manufacturers and suppliers are subject to laws and regulations governing the use, manufacture, storage, handling and disposal of these hazardous materials. In some cases, these hazardous materials and various wastes resulting from their use are stored at our and our manufacturers facilities pending use and disposal. We cannot completely eliminate the risk of contamination, which could cause an interruption of our commercialization efforts, research and development efforts and business operations, injury to our employees and others, environmental damage resulting in costly clean-up and liabilities under applicable laws and regulations governing the use, storage, handling and disposal of these materials and specified waste products. Although we believe that the safety procedures utilized by our third-party manufacturers for handling and disposing of these materials generally comply with the standards prescribed by these laws and regulations, we cannot guarantee that this is the case or eliminate the risk of accidental contamination or injury from these materials. In such an event, we may be held liable for any resulting damages and such liability could exceed our resources. We do not currently carry biological or hazardous waste insurance coverage.

In connection with the reporting of our financial condition and results of operations, we are required to make estimates and judgments which involve uncertainties, and any significant differences between our estimates and actual results could have an adverse impact on our financial position, results of operations and cash flows.

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States, or GAAP. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. In particular, as part of our revenue recognition policy, our estimates of product returns, rebates and chargebacks require our most subjective and complex judgment due to the need to make estimates about matters that are inherently uncertain. Any significant differences between our actual results and our estimates and assumptions could negatively impact our financial position, results of operations and cash flows.

Changes in accounting standards and their interpretations could adversely affect our operating results.

GAAP are subject to interpretation by the Financial Accounting Standards Board, the American Institute of Certified Public Accountants, the SEC, and various other bodies that promulgate and interpret appropriate accounting principles. These principles and related implementation guidelines and interpretations can be highly complex and involve subjective judgments. A change in these principles or interpretations could have a significant effect on our reported financial results, and could affect the reporting of transactions completed before the announcement of a change.

Fluctuations in the value of the Euro or U.K. pound sterling could negatively impact our results of operations and increase our costs.*

Payments to our material suppliers and contract manufacturers are denominated in the Euro and U.K. pound sterling. Our reporting currency is the U.S. dollar and to date all of the revenues generated by sales of Sumavel DosePro have been in U.S. dollars. For the quarter ended March 31, 2012, $4.4 million (based on exchange rates as of March 31, 2012) of our materials, contract manufacturing costs and other manufacturing-related costs were denominated in foreign currencies. As a result, we are exposed to foreign exchange risk, and our results of operations may be negatively impacted by fluctuations in the exchange rate between the U.S. dollar and the Euro or U.K. pound sterling. A significant appreciation in the Euro or U.K. pound sterling relative to the U.S. dollar will result in higher expenses and cause increases in our net losses. Likewise, to the extent that we generate any revenues denominated in foreign currencies, or become required to make payments in other foreign currencies, fluctuations in the exchange rate between the U.S. dollar and those foreign currencies could also negatively impact our results of operations. We currently have not entered into any foreign currency hedging contracts to reduce the effect of changes in foreign currency exchange rates, and foreign currency hedging is inherently risky and may result in unanticipated losses.

Our operating results are partially dependent on freight costs and our costs may increase significantly if we are unable to ship and transport finished products efficiently and economically across long distances and international borders.

Our Sumavel DosePro product is manufactured in Europe and we transport significant volumes of that product across long distances and international borders. As a result, our operating results can be affected by changes in transportation costs. We generally ship our product by air freight, and freight rates can vary significantly due to a large number of factors beyond our control, including changes in fuel prices or general economic conditions. If demand for air freight should increase substantially, it could make it difficult for us to procure transportation space at

prices we consider acceptable.

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Because our products must cross international borders, we are subject to risk of delay due to customs inspection, if our documentation does not comply with customs rules and regulations or for similar reasons. In addition, any increases in customs duties or tariffs, as a result of changes to existing trade agreements between countries or otherwise, could increase our costs or the final cost of our products to our customers or increase our expenses. The laws governing customs and tariffs in many countries are complex, subject to many interpretations and often includes substantial penalties for noncompliance.

Risks Related to Our Financial Position and Capital Requirements

We have never generated net income or positive cash flow from operations and are dependent upon external sources of financing to fund our business and development.*

We launched our only approved product, Sumavel DosePro, in January 2010. Without a long history of sales, we may not accurately predict future sales, and we may never be able to significantly increase these sales, especially in light of the termination of our partnership with Astellas in March 2012 to co-promote Sumavel DosePro. We have financed our operations almost exclusively through the proceeds from the issuance of our common and preferred stock, including the proceeds from our initial public offering completed in November 2010, our follow-on public offering completed in September 2011, and debt, and have incurred losses and negative cash flow from operations in each year since our inception. Our net loss was $10.3 million in the first quarter of 2012, $83.9 million in 2011 and $73.6 million in 2010, and our cash used in operating activities was $14.7 million in the first quarter of 2012, $80.5 million in 2011 and $72.0 million in 2010. As of March 31, 2012, we had an accumulated deficit of $292.3 million. These losses and negative cash flow from operations have had a material adverse effect on our stockholders equity and working capital. Further, despite the revenues from Sumavel DosePro, we expect our losses to continue for at least the next several years as a result of the expenses incurred in connection with our regulatory filings for Zohydro, the initiation of clinical development for Relday, any additional required testing for Zohydro, and the cost of the sales and marketing expense associated with Sumavel DosePro. In addition, if we obtain regulatory approval for Zohydro or any of our other product candidates, we expect to incur significant sales, marketing and manufacturing expenses as well as continued development expenses. As a result, we are and will remain dependent upon external sources of financing to finance our business and the development and commercialization of our approved product and product candidates. We cannot ensure that debt or equity financing will be available to us in amounts, at times or on terms that will be acceptable to us, or at all. Any shortfall in our cash resources could require that we delay or abandon certain development and commercialization activities and could otherwise have a material adverse effect on our business, results of operations, financial condition and prospects.

Our level of indebtedness could adversely affect our