DEPOMED INC
Form 10-K
March 08, 2012

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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-K

**(Mark one)**

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

**For the fiscal year ended December 31, 2011**

**OR**

o **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: 001-13111**

# DEPOMED, INC.

(Exact Name of Registrant as Specified in its Charter)

| **California** | **94-3229046** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **1360 O'Brien Drive, Menlo Park, California** | **94025** |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: **(650) 462-5900**

Securities registered pursuant to Section 12(b) of the Act:

| **Title of each class** | **Name of each exchange on which registered** |
|---|---|
| Common Stock, no par value | The NASDAQ Stock Market LLC |

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No ý

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

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 ý No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer, as defined in Rule 12b-2 of the Exchange Act.

| Large accelerated filer o | Accelerated filer ý | Non-accelerated filer o (Do not check if a smaller reporting company) | Smaller reporting company o |
|---|---|---|---|

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant based upon the closing price of Common Stock on the Nasdaq Stock Market on June 30, 2011 was approximately $450,316,000. Shares of Common Stock held by each officer and director and by each person who owned 10% or more of the outstanding Common Stock as of June 30, 2011 have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares outstanding of the registrant's Common Stock, no par value, as of March 7, 2012 was 55,557,879.

**Documents Incorporated by Reference**

Portions of the registrant's Proxy Statement, which will be filed with the Securities and Exchange Commission pursuant to Regulation 14A in connection with the registrant's 2012 Annual Meeting of Shareholders, expected to be held on or about May 15, 2012, are incorporated by reference in Part III of this Form 10-K.

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**DEPOMED, INC.**

**2011 FORM 10-K REPORT**

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**NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Statements made in this Annual Report on Form 10-K that are not statements of historical fact are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). We have based these forward-looking statements on our current expectations and projections about future events. Our actual results could differ materially from those discussed in, or implied by, these forward-looking statements. Forward-looking statements are identified by words such as "believe," "anticipate," "expect," "intend," "plan," "will," "may" and other similar expressions. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Forward-looking statements include, but are not necessarily limited to, those relating to:

the commercial success and market acceptance of Gralise™ (gabapentin), our once-daily product for the management of postherpetic neuralgia;

the commercial success of Glumetza® (metformin hydrochloride extended-release tablets) in the United States, and the efforts of our Glumetza commercial partner, Santarus, Inc. (Santarus);

the results of our ongoing litigation against filers of abbreviated New Drug Applications (each, an ANDA) to market generic Gralise in the United States;

the outcome of our ongoing litigation with Sun Pharmaceutical Industries Inc. (Sun) related to its ANDA to market generic Glumetza in the United States, or the outcome of any legal or regulatory challenge to our settlement agreement with Lupin Limited (Lupin) related to marketing generic Glumetza in the United States;

any patent infringement or other litigation that has been or may be instituted related to Gralise, Glumetza or any other of our product candidates under the Hatch-Waxman Act;

our and our collaborative partners' compliance or non-compliance with legal and regulatory requirements related to the promotion of pharmaceutical products in the United States;

our plans to in-license, acquire or co-promote other products;

discussions with the U.S. Food and Drug Administration regarding the results of Breeze 3, our Phase 3 trial evaluating Serada for menopausal hot flashes that did not meet all primary endpoints;

the results and timing of our clinical trials;

the results of our research and development efforts;

submission, acceptance and approval of regulatory filings;

our need for, and ability to raise, additional capital;

our collaborative partners' compliance or non-compliance with obligations under our collaboration agreements; and

our plans to develop other product candidates.

Factors that could cause actual results or conditions to differ from those anticipated by these and other forward-looking statements include those more fully described in the "**ITEM 1A. RISK FACTORS**" section and elsewhere in this Annual Report on Form 10-K. We disclaim any intent to update or revise these forward-looking statements to reflect new events or circumstances.

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**CORPORATE INFORMATION**

The address of our Internet website is *http://www.depomed.com*. We make available, free of charge through our website or upon written request, our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and other periodic SEC reports, along with amendments to all of those reports, as soon as reasonably practicable after we file the reports with the SEC.

Unless the context indicates otherwise, "Depomed", "the Company", "we", "our" and "us" refer to Depomed, Inc. Depomed was incorporated in the State of California on August 7, 1995. Our principal executive offices are located at 1360 O'Brien Drive, Menlo Park, California 94025, and our telephone number is (650) 462-5900.

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## PART I

### ITEM 1. BUSINESS

### COMPANY OVERVIEW

Depomed is a specialty pharmaceutical company initially focused on neurology, pain and other diseases of the central nervous system. The centerpiece of our specialty pharmaceutical business is Gralise (gabapentin), a once-daily product for the management of postherpetic neuralgia that we launched and made commercially available in October 2011. We also have a portfolio of royalty and milestone producing assets based on our proprietary drug delivery technologies. The cornerstone of that portion of our business is Glumetza, a once-daily treatment for adults with type 2 diabetes that we licensed to, and is currently being commercialized by Santarus, Inc. (Santarus) in the United States. We have a number of other license and development arrangements associated with our Acuform gastroretentive drug delivery technology. In addition, we have two product candidates in clinical development, DM-1992 for Parkinson's disease and Serada for menopausal hot flashes.

We are seeking to develop and commercialize a number of pharmaceutical products for neurology, pain and other central nervous system conditions and diseases that can be promoted together effectively. We are actively seeking to expand our product portfolio through in-licensing, acquiring or obtaining co-promotion rights to commercially available products or late-stage product candidates that could be marketed and sold through our existing sales and marketing capability.

We also seek to realize value from our drug delivery technology and related intellectual property through licensing and collaborative development partnerships with other companies. Our license agreement with Santarus which we restructured in August 2011, our license and development arrangements with Covidien, Janssen Pharmaceutica N.V. (Janssen), Boehringer Ingelheim International GMBH (Boehringer Ingelheim), and Ironwood Pharmaceuticals, Inc. (Ironwood) and our license agreement with Merck & Co., Inc. (Merck) are examples of this element of our strategy.

### SIGNIFICANT DEVELOPMENTS DURING 2011

Among the significant developments in our business during 2011 were the following:

In January 2011, the FDA approved Gralise for the treatment of postherpetic neuralgia. This approval triggered a $48 million milestone payment from a subsidiary of Abbott Laboratories that we received in February 2011.

In March 2011, we received all rights to Gralise from Abbott Laboratories along with a settlement payment of $40 million, and we announced our intention to commercialize Gralise in the United States.

In March 2011, we entered into a License and Services Agreement with Boehringer Ingelheim, granting Boehringer Ingelheim a license to use our Acuform drug delivery technology for use in combination metformin products.

In April 2011, James A. Schoeneck was appointed as our President and Chief Executive Officer, following the resignation of Carl A. Pelzel, our former President and Chief Executive Officer.

In June 2011, we entered into a service agreement with Ventiv Commercial Services, LLC (Ventiv), to provide 164 full-time sales representatives dedicated to us to promote Gralise.

In July 2011, we entered into a research collaboration and license agreement with Ironwood Pharmaceuticals, Inc. granting Ironwood a license for worldwide rights to our Acuform drug delivery technology for an undisclosed Ironwood early stage development program.

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In August 2011, we entered into a commercialization agreement with Santarus, superseding our Promotion Agreement with Santarus, pursuant to which Santarus assumed commercial, manufacturing and regulatory responsibility for the commercial activities of Glumetza and agreed to pay us a royalties on net sales of 26.5% in 2011, 29.5% in 2012, 32% in 2013 & 2014, and 34.5% in 2015 and thereafter.

In September 2011, we entered into a manufacturing and supply agreement with Patheon Puerto Rico, Inc. (Patheon) for the manufacture, package and supply of commercial quantities of Gralise.

In October 2011, we made Gralise commercially available, began distributing Gralise and began promoting Gralise to physicians through our contract sales organization.

Total revenues for the year ended December 31, 2011 were $133.0 million compared to $80.8 million for the year ended December 31, 2010. Revenue for the year ended December 31, 2011 included a $48.0 million milestone from Abbott Products.

Operating expenses for the year ended December 31, 2011 were $56.7 million, compared to $69.0 million for the year ended December 31, 2010. Operating expenses for 2011 included a $40.0 million gain on termination of our agreement with Abbott related to Gralise, which reduced operating expenses for the year.

Cash, cash equivalents and marketable securities were $139.8 million as of December 31, 2011, compared to $76.9 million as of December 31, 2010.

**RECENT DEVELOPMENTS AFTER DECEMBER 31, 2011**

In January 2012, Merck received FDA approval to market Janumet XR in the United States. We are entitled to receive very low single digit royalties on net product sales of Janumet XR through the expiration date of the licensed patents.

In February 2012, we entered into a settlement and license agreement with Lupin to resolve our patent litigation with respect to Glumetza.

OUR PRODUCTS AND PRODUCT PIPELINE

The following table summarizes our marketed products and product pipeline.

***Commercialized Products***

| Product | Indication | Status |
|---|---|---|
| Gralise™ | Postherpetic neuralgia | Currently sold by Depomed in the United States.<br>*Approved by the FDA in January 2011.*<br>*Launched in October 2011.* |
| Glumetza® | Type 2 diabetes | Currently sold in the United States and Canada.<br>*United States rights held by Santarus.*<br>*Canadian rights held by Valeant.* |

***Product Pipeline***

| Product | Indication | Status |
|---|---|---|
| Serada® | Menopausal hot flashes | Three Phase 3 studies completed (Breeze 1, Breeze 2, and Breeze 3). |
| DM-1992 | Parkinson's disease | Phase 2 study commenced in January 2012. |

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**COMMERCIALIZED PRODUCTS**

***Gralise™ (gabapentin) tablets for the Management of Postherpetic Neuralgia***

***General***

Gralise (gabapentin) is our proprietary, once-daily formulation of gabapentin for the management of postherpetic neuralgia (PHN). We made Gralise commercially available in October 2011, following its FDA approval in January 2011 and our reacquisition of the product in March 2011 from Abbott Products, our former licensee. We received a $48 million approval milestone from our former licensee in February 2011, and a settlement payment of $40 million in March 2011 in connection with the termination of our Gralise license agreement.

*Postherpetic Neuralgia.* Postherpetic neuralgia (PHN) is a persistent pain condition caused by nerve damage during a shingles, or herpes zoster, viral infection. PHN afflicts approximately one in five patients diagnosed with shingles in the United States. The incidence of PHN increases in elderly patients. Three of four shingles patients over 70 years old develop PHN. Approximately 120,000 to 200,000 Americans are affected by PHN each year. The pain associated with PHN can interfere with daily activities such as sleep and recreational activities for months, and can be associated with clinical depression.

In 2006, the Centers for Disease Control and Prevention Advisory Committee on Immunization Practices recommended that adults 50 years of age be vaccinated with a shingles vaccine. While the shingles vaccine is not a treatment for PHN, it could impact the future market for therapies for PHN.

*Orphan Drug Designation.* In November 2010, the FDA granted Gralise Orphan Drug designation for the management of PHN based on a plausible hypothesis that Gralise is "clinically superior" to immediate release gabapentin due to the incidence of adverse events observed in Gralise clinical trials relative to the incidence of adverse events reported in the package insert for immediate release gabapentin. Generally, an Orphan-designated drug approved for marketing is eligible for seven years of regulatory exclusivity for the orphan-designated indication. If granted, Orphan Drug exclusivity for Gralise will run for seven years from January 28, 2011. However, the FDA has indicated to us that Gralise is not currently eligible for Orphan Drug exclusivity because the hypothesis upon which the product's Orphan Drug designation was granted has not been proven. We believe a showing of clinical superiority is not required under the statute and regulations related to Orphan Drugs in effect at the time of Gralise's Orphan Drug designation and approval. We also believe amendments to the FDA's Orphan Drug regulations proposed in October 2011 do not apply to our pending request to grant Orphan Drug exclusivity for Gralise. Although we are seeking to resolve these issues with the FDA, we may not succeed in obtaining Orphan Drug exclusivity for Gralise.

*Important Information about Gralise.* Gralise is to be titrated over a two-week period to an 1800 mg once-daily dose, given with the evening meal. Gralise tablets swell in gastric fluid and gradually release gabapentin. Gralise is not interchangeable with other gabapentin products because of differing pharmacokinetic profiles that affect the frequency of administration. The most common treatment-emergent adverse events associated with Gralise in our clinical trials were dizziness (10.9% with Gralise vs. 2.2% placebo), somnolence (4.5% vs. 2.7%) and headache (4.2% vs. 4.1%).

***Gralise Commercialization and Manufacturing Arrangements***

*Ventiv Commercial Services, LLC.* In June 2011, we entered in to a service agreement with Ventiv Commercial Services, LLC (Ventiv), pursuant to which Ventiv's outsourced sales business, inVentiv Selling Solutions, provides us with sales force recruiting, training, deployment and ongoing operational support to promote Gralise. The agreement provides for a sales force of 164 full-time sales representatives dedicated to the Company, all of whom are employees of Ventiv. The sales

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representatives were hired in September 2011 and began promoting Gralise to physicians in October 2011. Members of sales management are our employees.

Under the terms of the agreement, we incurred an upfront implementation fee, and we pay fixed monthly management fees. The monthly management fee is subject to adjustment for actual staffing levels. A portion of the monthly management fee is payable only on Ventiv's achievement of specified performance objectives. We also pay certain pass-through costs of Ventiv. The agreement will expire in October 2013, two years after the date on which sales representatives hired by Ventiv are deployed, but may be terminated by either party upon advance notice after the first anniversary of the deployment date. The agreement is also subject to early termination under certain circumstances, such as a party's uncured material breach.

*Patheon Puerto Rico, Inc.* In September 2011, we entered into a manufacturing agreement with Patheon Puerto Rico, Inc. (Patheon) pursuant to which Patheon manufactures, packages and supplies commercial quantities of Gralise. Under the agreement, we provide periodic rolling forecasts to Patheon. A portion of each rolling forecast constitutes a firm purchase order. We may obtain a portion of our product requirements from a second manufacturing source. We provide Patheon with the active pharmaceutical ingredient in Gralise. The agreement will expire on May 31, 2016, subject to early termination under certain circumstances.

***Litigation***

We are involved in patent litigation associated with Gralise that is described below under "**Legal Proceedings**".

***Former Gralise License Arrangement***

In November 2008, we entered into an exclusive license agreement with Solvay Pharmaceuticals, Inc. (Solvay) granting Solvay exclusive rights to develop and commercialize Gralise for pain indications in the United States, Canada and Mexico. The agreement became effective in January 2009 and we received a $25.0 million upfront payment from Solvay in February 2009.

In February 2010, Abbott Laboratories completed its acquisition of the pharmaceutical business of Solvay. Abbott Products, a subsidiary of Abbott Laboratories, then assumed responsibility for the Gralise license agreement. In March 2010, Abbott Products submitted a New Drug Application (NDA) for Gralise to the FDA for the management of postherpetic neuralgia. The NDA was submitted under Section 505(b)(2) of the Food, Drug and Cosmetic Act because it references certain toxicity, safety and other data of Neurontin®, the formulation of gabapentin initially approved by the FDA. In May 2010, the FDA accepted the NDA for filing, which triggered a $10.0 million milestone payment from Abbott Products that we received in June 2010. In January 2011, the FDA approved the Gralise NDA, which triggered a $48.0 million milestone payment from Abbott Products that we received in February 2011.

In March 2011, we and Abbott Products agreed to terminate the Gralise license agreement. Pursuant to the termination arrangement, we received a payment of $40.0 million from Abbott Products, and the Gralise NDA and all activities associated with the commercialization of Gralise were transitioned to us.

***Glumetza® (metformin hydrochloride extended release tablets) for Type 2 Diabetes***

***General***

Glumetza is a once-daily extended release metformin product approved in the United States for type 2 diabetes that we have licensed to Santarus, Inc. The FDA approved Glumetza for marketing in the United States in 2005, and we began selling the 500mg Glumetza in 2006. In December 2007, the FDA approved the currently marketed 1000mg Glumetza, and we began selling it in June 2008. We

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developed the 500mg Glumetza and licensed it to Valeant (formerly Biovail) in 2002. In December 2005, we reacquired the U.S. rights to Glumetza from Valeant, including an exclusive U.S. license to the 1000mg strength of Glumetza, which was developed by Valeant utilizing proprietary Valeant drug delivery technology.

***Diabetes***

Diabetes is a disease in which levels of glucose, a type of sugar found in the blood, are above normal. Diabetic patients do not produce sufficient insulin, a hormone produced in the pancreas, or do not properly use insulin, making it difficult for the body to convert food into energy. The body breaks down food into glucose, and delivers glucose to cells through the bloodstream. Cells use insulin to help process blood glucose into energy. In the case of type 2 diabetes, cells fail to use insulin properly or the pancreas cannot make as much insulin as the body requires. That causes the amount of glucose in the blood to increase, while starving cells of energy. Over time, high blood glucose levels damage nerves and blood vessels, which can lead to complications such as heart disease, stroke, blindness, kidney disease, nerve problems, gum infections and amputation.

Type 2 diabetes is the most common form of diabetes, accounting for 90 to 95 percent of all diabetes cases, according to the National Institute of Diabetes and Digestive and Kidney Diseases of the National Institutes of Health, or the NIDDK.

***Target Market***

According to the American Diabetes Association (ADA), 25.8 million people in the United States have diabetes. Of those, 18.8 million are diagnosed. The ADA estimates that 1.9 million new cases of diabetes were diagnosed in people aged 20 or older in 2010. Among adults with diagnosed diabetes, 58 percent take oral medication only, and 14 percent take both insulin and oral medication, according to the 2007-2009 National Health Interview Survey of the Centers for Disease Control and Prevention.

***Glumetza Collaboration, Commercialization and Licensing Arrangements***

*Santarus, Inc. Commercialization Agreement.* In July 2008, we entered into a promotion agreement with Santarus granting Santarus exclusive right to promote Glumetza in the United States. Santarus began promotion of Glumetza in October 2008. In August 2011, we restructured our agreement with Santarus and entered into a commercialization agreement that superseded the July 2008 promotion agreement. Under the commercialization agreement, we granted Santarus exclusive rights to manufacture and commercialize Glumetza in the United States in return for a royalty on Glumetza net sales.

During 2011, we sold Glumetza for the first eight months of the year, recognized Glumetza product sales and paid Santarus a promotion fee equal to 75% of Glumetza gross margin. In the final four months of the year, Santarus was responsible for Glumetza distribution and sales, recognized Glumetza product sales and paid us a royalty equal to 26.5% of net sales. During the first 8 months of 2011, we recognized $40.7 million in product sales of Glumetza, $3.8 million in cost of sales of Glumetza, and $27.3 million in promotion fee expense to Santarus. We recognized $9.6 million in royalty revenue during the final four months under the commercialization agreement.

Pursuant to the commercialization agreement, we transitioned to Santarus responsibility for manufacturing, distribution, pharmacovigilance and regulatory affairs. We ceased shipments of Glumetza in August 2011, and Santarus began selling Glumetza in September 2011. Santarus is responsible for advertising and promotional marketing activities for Glumetza. In November 2011, we and Santarus entered into an assignment and assumption agreement pursuant to which Santarus assumed all of our rights and obligations under our commercial manufacturing agreement with

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Patheon, which provides that Patheon will serve as Santarus' sole commercial supplier of the 500mg Glumetza in the United States.

Santarus pays us royalties on Glumetza net product sales in the United States, as follows:

- 26.5% in 2011;
- 29.5% in 2012;
- 32.0% in 2013 and 2014; and
- 34.5% in 2015 and beyond prior to generic entry of a Glumetza product.

In the event of generic entry of a Glumetza product in the United States, the parties will equally share Glumetza proceeds based on a gross margin split. Santarus has the exclusive right to commercialize authorized generic versions of Glumetza. Santarus will not pay additional sales milestones to us, as was required under the prior promotion agreement.

In connection with its assumption of distribution and sales responsibility of Glumetza, Santarus purchased our existing inventory of Glumetza and bulk metformin hydrochloride at cost. We are financially responsible for returns of Glumetza distributed by us, up to the amount of our product returns reserve account for Glumetza product returns on the date immediately before Santarus began distributing Glumetza. We are also be financially responsible for Glumetza rebates and chargebacks up to the amount of our reserve account for those items on the date immediately before Santarus began distributing Glumetza. Santarus is responsible for all other Glumetza returns, rebates and chargebacks.

We have the option to co-promote Glumetza products to physicians other than those targeted by Santarus, subject to certain limitations. If we exercise this option, we will be entitled to receive a royalty equal to 70% of net sales attributable to prescriptions generated by our called upon physician, over a pre-established baseline.

Under the commercialization agreement, we agreed to manage the patent infringement lawsuits against Sun Pharmaceutical Industries, Inc. (Sun) and Lupin Limited (Lupin), subject to certain consent rights in favor of Santarus, including with regard to any proposed settlements. Santarus reimburses us for 70% of our non-settlement out-of-pocket costs, and we reimburse Santarus for 30% of its non-settlement out-of-pocket costs related to these two existing infringement cases.

The commercialization agreement will continue in effect for so long as Santarus commercializes branded Glumetza or authorized generic products, unless terminated sooner. Subject to 60 days' prior written notice to Santarus, we may terminate the agreement if Santarus fails to meet its obligations with respect to minimum promotion and expenditure obligations and fails to cure any such breach within a specified time period. The commercialization agreement is also subject to early termination for certain other matters, such as a party's material breach or insolvency.

*Valeant (1000mg Glumetza License and Supply; Canadian License).* In December 2005, we entered into a manufacturing transfer agreement and a supply agreement with Valeant related to the 1000mg Glumetza. Under those agreements, we received an exclusive license to market the 1000mg Glumetza in the United States, and an exclusive license to the "Glumetza" trademark in the United States for the purpose of marketing Glumetza. We purchase the 1000mg Glumetza for Santarus exclusively from Valeant under the supply agreement, and Santarus reimburses us at cost. The supply agreement with Valeant has back-up manufacturing rights in our favor. If we exercise our back-up manufacturing rights, compensation to Valeant will change from a supply-based arrangement to royalties of six percent of net sales of the 1000mg Glumetza in the United States (or, if less, thirty percent of royalties and other similar payments from our licensees) under the manufacturing transfer agreement. We also pay Valeant royalties of one percent of net sales of the 500mg Glumetza in the United States (or, if less, five percent of royalties and other similar payments from our licensees).

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Valeant has an exclusive license in Canada to manufacture and market the 500mg Glumetza pursuant to an amended and restated license agreement we entered into with Valeant in December 2005. Under the agreement, we receive royalties of six percent of Canadian net sales of the 500mg Glumetza. We also receive payments from Valeant equal to one percent of Canadian net sales of the 1000mg Glumetza.

*King Pharmaceuticals (2006-2007).* King Pharmaceuticals (King) promoted Glumetza in the United States between June 2006 and October 2007 under a promotion agreement we entered into with King in June 2006. Glumetza was launched in the United States in September 2006. In October 2007, we terminated our promotion agreement with King related to Glumetza, and King paid us $29.7 million in termination and other fees.

***500mg Glumetza Recall; Litigation***

*500mg Glumetza Recall.* In June 2010, we conducted a voluntary class 2 recall of fifty-two lots of 500mg Glumetza product from wholesalers due to the presence of trace amounts of a chemical called 2,4,6-tribromoanisole (TBA) in bottles containing 500mg Glumetza tablets. In June 2010, we temporarily suspended product shipments of 500mg Glumetza product to our customers. We resumed shipments of the 500mg Glumetza to customers in January 2011. The 1000mg Glumetza product was not subject to the recall.

*Litigation.* We are involved in the patent litigation associated with Glumetza against Sun as described below under "Legal Proceedings". In February 2012, we and Santarus entered into a settlement and license agreement with Lupin to resolve patent litigation involving Glumetza. The agreement grants Lupin the right to begin selling a generic version of Glumetza on February 1, 2016, or earlier under certain circumstances. The agreement is subject to review by the U.S. Department of Justice and the Federal Trade Commission, as well as entry by the U.S. District Court for the Northern District of California of an order dismissing the litigation. We cannot be certain that the settlement agreement will ultimately be approved. Any legal or regulatory challenge to the settlement agreement by the U.S. Department of Justice and/or the Federal Trade Commission could adversely impact our business and revenues.

**LICENSE AND DEVELOPMENT COLLABORATIONS**

We have entered into a number of licenses and collaborations which involve the license of our Acuform technology to various pharmaceutical companies.

***Merck & Co., Inc.***

We have received $12.5 million in upfront and milestone payments and will receive very low single digit royalties on Merck's net sales of Janumet XR in the United States and other licensed territories through the expiration of the licensed patents under a July 2009 license agreement with Merck & Co., Inc. (Merck). The non-exclusive license agreement grants Merck a license as well as other rights to certain of our patents directed to metformin extended release technology for Janumet XR, Merck's fixed-dose combination product for type 2 diabetes containing sitagliptin and extended release metformin that was approved by the FDA in January 2012. We expect Merck to begin selling Janumet XR during the first quarter of 2012.

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***Covidien***

We have received $7.5 million in upfront and milestone payments and may receive additional development-related milestone payments and royalties pursuant to a November 2008 license agreement related to acetaminophen/opiate combination products with Mallinckrodt, Inc., a subsidiary of Covidien, Ltd. (Covidien). The license agreement grants Covidien worldwide rights to utilize our Acuform technology for the exclusive development of up to four products containing acetaminophen in combination with opiates. We received $5.5 million in upfront fees under the agreement, which included a $4.0 million upfront license fee and a $1.5 million advance payment for formulation work we performed under the agreement, and $2.0 million in development milestones to date. We may receive additional development milestone payments totaling $15.0 million per product, if achieved, as well as royalties on net sales of the products.

We have received four $0.5 million development milestone payments under the agreement. In October 2009, we received a $0.5 million milestone payment from Covidien triggered by our delivery of the first product formulation. That formulation entered clinical development in September 2010, which triggered a second $0.5 million milestone payment. In December 2009, we received a $0.5 million milestone payment from Covidien related to the development of a formulation for the second product candidate under the agreement. Although we received the milestone payment in December 2009, we continued to perform work associated with development of the second formulation until September 2010. In November 2011, we received a $0.5 million clinical development milestone associated with the second formulation entering clinical development.

Under the agreement, the development of each of the four products was to begin prior to November 2010. Covidien did not initiate development on two of the four products prior to November 2010 and the license rights to those remaining two products reverted back to us.

***Boehringer Ingelheim***

We have received $10 million in upfront payments and may receive additional development milestones, as well as royalties, pursuant to a March 2011 license and service agreement with Boehringer Ingelheim related to fixed dose combinations of extended release metformin and proprietary Boehringer Ingelheim compounds in development for type 2 diabetes. Under the agreement, we granted Boehringer Ingelheim a license to certain patents related to our Acuform drug delivery technology to be used in developing the combination products. Boehringer Ingelheim was also granted a right to reference the Glumetza NDA in regulatory submissions for the products.

In April 2011, we received $8.5 million of the $10.0 million upfront license payment. We received the remaining $1.5 million of that amount in June 2011, after it was initially withheld by German tax authorities. We are eligible to receive a $2.5 million milestone upon delivery of experimental batches of prototype formulations that meet certain specifications. The agreement provides for additional milestone payments based on regulatory filings and approval events, as well as royalties on worldwide net sales of products.

We are responsible for providing certain initial formulation work associated with the fixed dose combination products. Services performed by us under the agreement are reimbursed by Boehringer Ingelheim on an agreed-upon rate, and out-of-pocket expenses will be reimbursed.

***Janssen Pharmaceutica N.V.***

We have received $10 million in upfront and milestone payments, and are eligible for additional milestone payments and royalties under an August 2010 non-exclusive license agreement between us and Janssen Pharmaceutica N.V. (Janssen) related to fixed dose combinations of extended release metformin and Janssen's type 2 diabetes product candidate canagliflozin. Under the agreement, we

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granted Janssen a license to certain patents related to our Acuform drug delivery technology to be used in developing the combination products. We also granted Janssen a right to reference the Glumetza NDA in Janssen's regulatory filings covering the products. We also entered into a service agreement with Janssen under which we provided formulation work associated with the products.

In August 2010, Janssen paid us a $5.0 million upfront license fee. In September 2010, we achieved the first development milestone under the agreement related to formulation work, which triggered a $5.0 milestone payment we received in October 2010. We are eligible to receive additional development milestones, as well as royalties on net sales of the products.

Under the service agreement, we received a refundable $1.0 million prepayment for formulation work we performed. Our formulation work was reimbursed by Janssen on an agreed-upon FTE rate per hour plus out-of-pocket expenses. The formulation work under the agreement was completed in March 2011.

***Ironwood Pharmaceuticals, Inc.***

In July 2011, we entered into a collaboration and license agreement with Ironwood Pharmaceuticals, Inc. (Ironwood) granting Ironwood a license for worldwide rights to certain patents and other intellectual property rights to our Acuform drug delivery technology for an undisclosed Ironwood early stage development program. In connection with the research collaboration and license agreement, we received an upfront payment of $0.9 million. We may also receive milestone payments based on achievement of certain development and regulatory milestones, as well as royalties on product sales.

Under the agreement, we are responsible for assisting with initial product formulation and Ironwood is responsible for all development and commercialization of the product. The initial formulation work we perform is reimbursed by Ironwood on an agreed-upon FTE rate per hour plus out-of-pocket expenses.

**RESEARCH AND DEVELOPMENT PROGRAMS**

***Serada® for Menopausal Hot Flashes***

***General***

Serada is our proprietary extended release formulation of gabapentin in development for the treatment of menopausal hot flashes. We have completed three Phase 3 clinical trials evaluating Serada for menopausal hot flashes.

We believe that Serada may be a viable non-hormonal product candidate for this indication, based on our studies and numerous academic studies that have demonstrated that gabapentin may be effective in treating hot flashes, and the fact that gabapentin has a long history of use in other indications. We have an exclusive sublicense from PharmaNova under a United States patent owned by the University of Rochester (Pat. No. 6,310,098) to develop and commercialize in the United States a gabapentin product indicated for the treatment of menopausal hot flashes.

***Hot Flashes; Current Treatments; Target Market***

A hot flash is a sudden flushing and sensation of heat caused by dilation of skin capillaries. Hot flashes are often associated with menopausal endocrine imbalance. The occurrence and frequency of hot flashes are unpredictable. Symptoms often associated with hot flashes include sweating, irritability and frustration. Hot flashes can begin early in menopause and are most common during the first few years after menopause begins. There are over 42 million postmenopausal women more than 55 years

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old and about 2 million women enter menopause every year in the United States. Approximately 75% of all women in the United States over 50 years of age will experience hot flashes.

Currently, the leading prescription drug product for the treatment of hot flashes associated with menopause is hormone replacement therapy (HRT). HRT involves the administration of the hormone estrogen, either alone or in combination with the hormone progestin. In 2001, the HRT market represented more than $2 billion and in excess of 90 million prescriptions. In 2003, the Women's Health Initiative released the results of a clinical study that revealed an increased risk of blood clots, stroke, and breast cancer associated with HRT. Subsequently, in 2003, the HRT market decreased by more than $850 million and 34 million prescriptions relative to 2001. HRT prescriptions have declined to approximately 33 million prescriptions in 2010.

Existing non-hormonal pharmaceutical alternatives to HRT for the treatment of hot flashes include off-label administration of anti-depressants. There is also a considerable market for dietary and herbal supplements for the treatment of hot flashes, although we are not aware of any clinical study demonstrating the safety and efficacy of any such treatment.

***Clinical Program***

*Phase 3 Study-Breeze 3 Clinical Trial.* In October 2011, we announced top-line results for Breeze 3, our third Phase 3 study for Serada.

*Study Design.* Breeze 3 was a randomized, double-blind, placebo-controlled study of 600 patients. Patients were randomized into one of two treatment arms, with patients receiving either placebo or a total dose of 1800mg of Serada dosed 600mg in the morning and 1200mg in the evening. The co-primary efficacy endpoints in the study were reductions in the mean frequency of moderate-to-severe hot flashes, and the average severity of hot flashes, measured after four and 12 weeks of stable treatment. As in the prior Breeze 1 trial, the treatment duration of the study was 24 weeks, to address the FDA's view that an effective drug should also show statistically significant persistence of efficacy at 24 weeks. The trial also included a responder analysis to assess the clinical meaningfulness of any reduction in the frequency of hot flashes in the active arm relative to the placebo arm.

In August 2010, we reached agreement with the FDA regarding a Special Protocol Assessment (SPA) on the design and analysis of Breeze 3. An SPA is an agreement with the FDA that a proposed trial protocol design, clinical endpoints and statistical analyses are acceptable to support a product candidate's regulatory approval. We began enrollment in Breeze 3 in August 2010 and completed enrollment in March 2011.

*Study Results.* Under the statistical analyses set forth in the SPA, certain primary endpoints did not meet statistical significance. The primary severity endpoints were achieved with statistical significance at four weeks ($p < 0.001$) and 12 weeks ($p < 0.01$). The frequency endpoint at four weeks was achieved with statistical significance ($p < 0.001$). The frequency endpoint at 12 weeks, as well as the key secondary frequency and severity endpoints at 24 weeks, were not met.

Serada was generally well tolerated in Breeze 3. The most common adverse events were dizziness and somnolence. The incidence of dizziness in the active arm was 12.7% compared to 3.4% for the placebo arm. Somnolence was 6.0% in the active arm compared to 2.7% in the placebo arm. Withdrawals due to adverse events in the active arm were 17%, compared to 12% in the placebo arm.

We intend to meet with and discuss the results of our three completed Phase 3 clinical trials for Serada with the FDA in the first half of 2012. However, there can be no assurance that the FDA will determine the product candidate is sufficiently safe and effective to allow a New Drug Application to be submitted to the FDA. If the FDA allows us to file a New Drug Application for Serada based on

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the results of our three completed Phase 3 clinical trials, there can be no assurance the New Drug Application will be approved.

***PharmaNova Agreement***

In October 2006, we entered into a sublicense agreement with PharmaNova, Inc. Pursuant to the agreement, PharmaNova has granted us an exclusive sublicense, under United States Patent No. 6,310,098, held by the University of Rochester, to develop and commercialize in the United States a product that contains gabapentin as its active pharmaceutical ingredient, and is indicated for the treatment of hot flashes associated with menopause.

We paid PharmaNova an upfront license fee of $0.5 million upon signing of the agreement and paid an additional $0.5 million upon dosing of the first patient in our Phase 3 trials for the product. We are required to pay PharmaNova $1.0 million upon submission acceptance to the FDA of an NDA for the product, and $2.0 million upon FDA approval of an NDA. The agreement provides for royalty payments to PharmaNova on net sales of the product, and for milestone payments upon achievement of annual net sales in excess of certain thresholds. We also paid PharmaNova consultancy fees of $0.3 million over approximately ten months beginning in November 2006.

***DM-1992 for Parkinson's Disease***

***General***

DM-1992 is our investigative novel gastric retentive extended-release formulation of levodopa/carbidopa under evaluation for the treatment of motor symptoms associated with Parkinson's disease. Parkinson's disease is a chronic degenerative disorder that affects nearly one million Americans and 5 million people worldwide. The average age at onset of Parkinson's is 60, although people have been diagnosed as young as 18.

***Parkinson's Treatments; Target Market***

Current therapies are effective in addressing only the mild/moderate motor symptoms of the disease and have significant long-term side effects. Carbidopa-levodopa is the most common treatment of Parkinson's but currently has limitations with inconsistent efficacy and inconvenient dosing since it is absorbed in the upper GI tract. Carbidopa-levodopa is available as a generic (brand name Sinemet) and had approximately 4.6 million prescriptions in the United States in 2011 according to IMS Health, Inc.

***Clinical Program; Grants***

*Phase 2 Study.* In January 2012, we initiated a Phase 2 study to evaluate DM-1992 for the treatment of motor symptoms associated with Parkinson's disease. The trial will enroll up to 45 patients at 8 U.S. centers. The trial is a randomized, active-controlled, open-label, crossover study testing DM-1992 dosed twice daily against a generic version of immediate-release carbidopa-levodopa dosed as needed. The study will assess efficacy, safety and pharmacokinetic variables. The primary endpoint for the study is change in off time as measured by patient self-assessment and clinician assessment.

*Phase 1 Studies.* We have conducted two Phase 1 studies in our DM-1992 program. In January 2009, we initiated our first Phase 1 pharmacokinetic study in Parkinson's patients to provide insight into our DM-1992 formulation strategy. The trial was a randomized, open-label crossover study that enrolled 18 patients with stable Parkinson's disease at two leading neurology centers in Russia. The objective of the study was to compare the pharmacokinetics of two distinct formulations of DM-1992 and a generic version of Sinemet CR sustained-release carbidopa-levodopa, as well as the safety and tolerability of the formulations. Patients in the trial received a single dose of each of the three

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treatments being studied. A dose of the first treatment was administered at the beginning of the study, followed by a dose of a second treatment after 7 to 14 days, and a dose of the third treatment after another 7 to 14 days. Blood samples were drawn during the 24 hour period following administration of each treatment. Patients were allowed to remain on any anti-Parkinson's therapies other than carbidopa-levodopa during the trial.

We completed the study in August 2009. In the study, DM-1992 extended coverage above levodopa's efficacious threshold and extended the time to peak levodopa concentration relative to currently available sustained release carbidopa-levodopa formulations. One of our formulations extended the median time at which levodopa blood levels stayed above the efficacious threshold of 300 ng/mL to approximately nine hours, compared to approximately seven hours for the generic version of Sinemet CR tested in the study. The time to median peak levodopa blood levels in the study was extended to four hours, compared to 2.8 hours for the comparator.

In September 2010, we initiated a second pharmacokinetic-pharmacodynamic Phase 1 study for the DM-1992 program. We completed the study in February 2011. The trial was a randomized, open-label crossover study that enrolled 16 patients with stable Parkinson's disease at two leading neurology centers in Russia. The objective of the study was to compare the pharmacokinetics-pharmacodynamics of two distinct twice-daily formulations of DM-1992 and a generic version of Sinemet CR sustained release carbidopa-levodopa dosed three-times daily, as well as the safety and tolerability of the formulations. Patients in the trial received a full day's dose of each of the three treatments being studied, two doses of each DM-1992 formulation (460mg levodopa and 150mg carbidopa per dose) twelve hours apart, and three doses of generic levodopa-carbidopa over a 12 hour period (200mg of levodopa and 50mg of carbidopa per dose). During the 2 hour period following administration of each treatment, blood samples were drawn and a standard finger tapping test was given to assess efficacy. In the study, both formulations of DM-1992 maintained therapeutic blood levels above the efficacious threshold of 300 ng/mL for 24 hours. DM-1992 was well tolerated in the study.

*Grants.* In July 2008, The Michael J. Fox Foundation awarded us a preclinical development grant to support the DM-1992 program. We were awarded an additional clinical grant in October 2010 under The Michael J. Fox Foundation Clinical Intervention Awards program.

**OUR DRUG DELIVERY TECHNOLOGIES**

The Acuform technology is based on our proprietary oral drug delivery technologies and is designed to include formulations of drug-containing polymeric tablets that allow multi-hour delivery of an incorporated drug. Although our formulations are proprietary, the polymers utilized in the Acuform technology are commonly used in the food and drug industries and are included in the list of inert substances approved by the FDA for use in oral pharmaceuticals. By using different formulations of the polymers, we believe that the Acuform technology is able to provide continuous, controlled delivery of drugs of varying molecular complexity and solubility. With the use of different polymers and polymers of varying molecular weight, our Acuform tablet technology can deliver drugs by diffusion, tablet erosion, or from a bi-layer matrix. In addition, our technology allows for the delivery of more than one drug from a single tablet. If taken with a meal, these polymeric tablets remain in the stomach for an extended period of time to provide continuous, controlled delivery of an incorporated drug.

The Acuform technology's design is based in part on principles of human gastric emptying and gastrointestinal transit. Following a meal, liquids and small particles flow continuously from the stomach into the intestine, leaving behind the larger undigested particles until the digestive process is complete. As a result, drugs in liquid or dissolved form or those consisting of small particles tend to empty rapidly from the stomach and continue into the small intestine and on into the large intestine, often before the drug has time to act locally or to be absorbed in the stomach and/or upper small intestine. The drug-containing polymeric tablets of the Acuform technology are formulated into easily

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swallowed shapes and are designed to swell upon ingestion. The tablets attain a size after ingestion sufficient to be retained in the stomach for multiple hours during the digestive process while delivering the drug content at a controlled rate. After drug delivery is complete, the polymeric tablet dissolves and becomes a watery gel, which is safely eliminated through the intestine sight unseen.

The Acuform technology is designed to address certain limitations of drug delivery and to provide for orally-administered, conveniently-dosed, cost-effective drug therapy that provides continuous, controlled-delivery of a drug over a multi-hour period. We believe that the Acuform technology can provide one or more of the following advantages over conventional methods of drug administration:

*Greater Patient and Caregiver Convenience.* We believe that the Acuform technology may offer once-daily or reduced frequency dosing for certain drugs that are currently required to be administered several times daily.

*Enhanced Safety and Efficacy through Controlled Delivery.* We believe that the Acuform technology may improve the ratio of therapeutic effect to toxicity by decreasing the initial peak concentrations of a drug associated with toxicity, while maintaining levels of the drug at therapeutic, subtoxic concentrations for an extended period of time.

*More Efficient Gastrointestinal Drug Absorption.* We believe that the Acuform technology can be used for improved oral administration of drugs that are inadequately absorbed when delivered as conventional tablets or capsules. Many drugs are primarily absorbed in the stomach, duodenum or upper small intestine regions, through which drugs administered in conventional oral dosage forms transit quickly. In contrast, the Acuform technology is designed to be retained in the stomach, allowing for multi-hour flow of drugs to these regions of the gastrointestinal tract.

*Rational Drug Combinations.* We believe that the Acuform technology may allow for rational combinations of drugs with different biological half-lives. Physicians frequently prescribe multiple drugs for treatment of a single medical condition. By appropriately incorporating different drugs into an Acuform technology we believe that we can provide for the release of each incorporated drug continuously at a rate and duration (dose) appropriately adjusted for the specific biological half-lives of the drugs.

**RESEARCH AND DEVELOPMENT EXPENSES**

Our research and development expenses were $15.2 million in 2011, $20.1 million in 2010 and $34.3 million in 2009.

**COMPETITION**

*Gralise for Postherpetic Neuralgia.* Gabapentin is currently marketed by Pfizer as Neurontin and by several generic manufacturers for adjunctive therapy for epileptic seizures and for postherpetic pain. In addition, Pfizer's product, Lyrica (pregabalin), has been approved for marketing in the United States and the European Union for the management of postherpetic neuralgia, diabetic neuropathy, partial seizures and fibromyalgia. Gralise will compete against these products and other neuropathic pain treatments, such as anti-depressants, other anti-convulsants, local anesthetics used as regional nerve blockers, anti-arrythmics and opioids.

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*Glumetza for Type 2 Diabetes.* Glumetza competes against immediate release metformin, which is marketed primarily by generic manufacturers. Glumetza also competes against both branded and generic extended release versions of metformin, such as Bristol-Myers Squibb's Glucophage XR and Shinogi's Fortamet. Generic extended release metformin manufacturers include Barr Pharmaceuticals, Inc., ANDRX Corporation, Mylan Laboratories, Inc., Watson Pharmaceuticals, Inc. and Teva Pharmaceutical Industries, Ltd., among others. Glumetza also competes against oral type 2 diabetes medications other than metformin, such as Takeda's Actos (pioglitazone hydrochloride), GlaxoSmithKline's Avandia (risiglitazon), Pfizer's Glucotrol (sulfonylurea) and Merck's Januvia (sitagliptin), among others.

*Serada for Menopausal Hot Flashes.* If approved for treatment of menopausal hot flashes, Serada will compete against hormone replacement therapy or HRT, such as Pfizer's Premarin (estrogens) and Prempro (a combination of estrogens and a progestin) products, and anti-depressant medications prescribed off-label. Wyeth's anti-depressant drug candidate, Pristiq, is in pre-registration for treatment of hot flashes. We are aware that Pfizer has non-exclusively licensed from the University of Rochester rights to develop a hot flash product containing pregabalin under the same patent we have sublicensed exclusive rights to develop a menopausal hot flash product containing gabapentin. Accordingly, Pfizer may develop a competing hot flash product.

*DM-1992 for Parkinson's Disease.* If approved, DM-1992 will compete against Sinemet, a combination of levodopa and carbidopa product for treatment of Parkinson's disease and syndrome sold by Merck as well as generic Sinemet sold by various generic manufacturers. We are aware that in February 2012, the FDA accepted the submission of an NDA by Impax Laboratories, Inc. for their product candidate IPX066, an extended-release capsule formulation of carbidopa-levodopa for the treatment of idiopathic Parkinson's disease.

*Drug Delivery Technologies.* Other companies that have oral drug delivery technologies competitive with the Acuform technology include Elan Corporation, Bristol-Myers Squibb, Teva Pharmaceutical Industries, Ltd , Johnson & Johnson, SkyePharma plc, Valeant, Flamel Technologies S.A., Ranbaxy Laboratories, Ltd., and Intec Pharma, all of which develop oral tablet products designed to release the incorporated drugs over time. Each of these companies has patented technologies with attributes different from ours, and in some cases with different sites of delivery to the gastrointestinal tract.

*General.* We believe that we compete favorably in the markets described above on the basis of the safety and efficacy of our products and product candidates, and in some cases on the basis of the price of our products. However, competition in pharmaceutical products and drug delivery technologies is intense, and we expect competition to increase. There may be other companies developing products competitive with ours of which we are unaware. Competing product or technologies developed in the future may prove superior to our products or technologies, either generally or in particular market segments. These developments could make our products or technologies noncompetitive or obsolete.

Most of our principal competitors have substantially greater financial, sales, marketing, personnel and research and development resources than we do. In addition, many of our potential collaborative partners have devoted, and continue to devote, significant resources to the development of their own products and drug delivery technologies.

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**PATENTS AND PROPRIETARY RIGHTS**

Our material issued United States patents and the products and product candidates they cover are as follows:

| United States Patent No. | Expiration Date | Product(s) and Product Candidate(s) Covered |
|---|---|---|
| 6,340,475 | September 19, 2016 | Glumetza 500mg<br>Gralise<br>Serada |
| 6,635,280 | September 19, 2016 | Glumetza 500mg<br>Gralise<br>Serada |
| 6,723,340 | October 25, 2021 | Glumetza 500mg<br>Gralise<br>Serada |
| 6,488,962 | June 20, 2020 | Glumetza 500mg<br>Glumetza 1000mg<br>Gralise<br>Serada |
| 7,438,927 | February 26, 2024 | Gralise<br>Serada |
| 6,310,098(1) | July 21, 2020 | Serada |
| 7,731,989 | October 25, 2022 | Gralise<br>Serada |

(1) We have an exclusive sublicense from PharmaNova, under United States Patent No. 6,310,098, held by the University of Rochester, to develop and commercialize in the United States a product that contains gabapentin as its active pharmaceutical ingredient, and is indicated for the treatment of menopausal hot flashes.

Our success will depend in part on our ability to obtain and maintain patent protection for our technologies and to preserve our trade secrets. Our policy is to seek to protect our proprietary rights, by among other methods, filing patent applications in the United States and foreign jurisdictions to cover certain aspects of our technology. In addition to those patents noted on the above table, we have nineteen patent applications pending in the United States. We have also prepared and continue to prepare patent applications relating to our expanding technology for filing in the United States and abroad. We have also applied for patents in numerous foreign countries. Some of those countries have granted our applications and other applications are still pending. Our pending patent applications may lack priority over others' applications or may not result in the issuance of patents. Even if issued, our patents may not be sufficiently broad to provide protection against competitors with similar technologies and may be challenged, invalidated or circumvented, which could limit our ability to stop competitors from marketing related products or may not provide us with competitive advantages against competing products. We also rely on trade secrets and proprietary know-how, which are difficult to protect. We seek to protect such information, in part, through entering into confidentiality agreements with employees, consultants, collaborative partners and others before such persons or entities have access to our proprietary trade secrets and know-how. These confidentiality agreements may not be effective in certain cases, due to, among other things, the lack of an adequate remedy for

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breach of an agreement or a finding that an agreement is unenforceable. In addition, our trade secrets may otherwise become known or be independently developed by competitors.

Our ability to develop our technologies and to make commercial sales of products using our technologies also depends on not infringing others' patents or other intellectual property rights. We are not aware of any intellectual property claims against us. However, the pharmaceutical industry has experienced extensive litigation regarding patents and other intellectual property rights. For example, we are aware that patents issued to third parties relating to extended release drug formulations or particular pharmaceutical compounds could in the future be asserted against us, although we believe that we do not infringe any valid claim of any patents. If claims concerning any of our products were to arise and it was determined that these products infringe a third party's proprietary rights, we could be subject to substantial damages for past infringement or be forced to stop or delay our activities with respect to any infringing product, unless we can obtain a license, or we may have to redesign our product so that it does not infringe upon others' patent rights, which may not be possible or could require substantial funds or time. Such a license may not be available on acceptable terms, or at all. Even if we, our collaborators or our licensors were able to obtain a license, the rights may be nonexclusive, which would give our competitors access to the same intellectual property. In addition, any public announcements related to litigation or interference proceedings initiated or threatened against us, even if such claims are without merit, could cause our stock price to decline.

From time to time, we may become aware of activities by third parties that may infringe our patents. Infringement by others of our patents may reduce our market share (if a related product is approved) and, consequently, our potential future revenues and adversely affect our patent rights if we do not take appropriate enforcement action. We may need to engage in litigation in the future to enforce any patents issued or licensed to us or to determine the scope and validity of third-party proprietary rights. Our issued or licensed patents may not be held valid by a court of competent jurisdiction. Whether or not the outcome of litigation is favorable to us, defending a lawsuit takes significant time, may be expensive and may divert management attention from other business concerns. We may also be required to participate in interference proceedings declared by the United States Patent and Trademark Office for the purpose of determining the priority of inventions in connection with our patent applications or other parties' patent applications. Adverse determinations in litigation or interference proceedings could require us to seek licenses which may not be available on commercially reasonable terms, or at all, or subject us to significant liabilities to third parties. If we need but cannot obtain a license, we may be prevented from marketing the affected product.

**MANUFACTURING**

We have established internal manufacturing facilities that are in compliance with current good manufacturing practices to manufacture supplies for our clinical trials.

We are responsible for the supply and distribution of Gralise. We have entered into a manufacturing agreement with Patheon, as our sole supplier. We have two qualified suppliers for the active pharmaceutical ingredient in Gralise. However, we obtain the active pharmaceutical ingredient on a purchase order basis only.

Until August 2011, we were responsible for the supply and distribution of Glumetza. Under the commercialization agreement entered into in August 2011, we transitioned to Santarus responsibility for manufacturing and distribution of Glumetza. In November 2011, we and Santarus entered into an assignment and assumption agreement pursuant to which Santarus assumed all of our rights and obligations under our commercial manufacturing agreement with Patheon, which provides that Patheon will serve as Santarus' sole commercial supplier of the 500mg formulation of Glumetza in the United States. We have a supply agreement with Valeant, the sole supplier for the 1000mg formulation of

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Glumetza. We purchase the 1000mg Glumetza from Valeant on behalf of Santarus and are reimbursed by Santarus at cost.

We have obtained clinical and validation batches of Serada from Patheon, our third-party manufacturer and sole supplier of Serada. We currently have no long-term supply arrangements for Serada and obtain product on a purchase order basis. We have two qualified suppliers for the active pharmaceutical ingredient in Serada. However, we obtain the active pharmaceutical ingredient on a purchase order basis only.

We also obtain polyethylene oxide, one of the excipients common to Glumetza, Gralise and Serada, on a purchase order basis from Dow Chemical, a sole source for polyethylene oxide. We currently have no long-term supply arrangement with respect to polyethylene oxide.

Applicable current Good Manufacturing Practices (cGMP) requirements and other rules and regulations prescribed by foreign regulatory authorities will apply to the manufacture of products using the Acuform technology. We will depend on the manufacturers of products using the Acuform technology to comply with cGMP and applicable foreign standards. Any failure by a manufacturer of products using the Acuform technology to maintain cGMP or comply with applicable foreign standards could delay or prevent the initial or continued commercial sale of our products.

**MARKETING AND SALES**

In 2007 and 2008, our commercial organization transitioned to us the Glumetza marketing efforts previously undertaken by King and directed the efforts of a temporary contract sales organization. In July 2008, we entered into a promotion agreement with Santarus for Glumetza, and our commercial organization has transitioned the promotion and marketing efforts for Glumetza to Santarus, which began promotion in October 2008. In June 2011, we entered in to a service agreement with Ventiv Commercial Services, LLC (Ventiv), pursuant to which inVentiv Selling Solutions, Ventiv's outsourced sales business, has provided us with sales force recruiting, training, deployment and ongoing operational support to promote Gralise. The agreement provides for a sales force of 164 full-time sales representatives dedicated to the Company, all of whom are employees of Ventiv. The Ventiv sales reps began employment in September 2011 and began promoting Gralise to physicians in October 2011. Members of sales management are our employees.

We have developed capabilities in various aspects of pharmaceutical sales and marketing through our commercialization of Glumetza and Gralise, including manufacturing, quality assurance, wholesale distribution, medical affairs, managed market contracting, government price reporting, maintenance of the product NDA and review and submission of promotional materials. Our sales and marketing personnel are also engaged in the commercial and marketing assessments of Serada and other potential product candidates.

**GOVERNMENT REGULATION**

*Product Development and Manufacturing*

Numerous governmental authorities in the United States and other countries regulate our research and development activities and those of our collaborative partners. Governmental approval is required of all potential pharmaceutical products using the Acuform technology and the manufacture and marketing of products using the Acuform technology prior to the commercial use of those products. The regulatory process takes several years and requires substantial funds. If new products using the Acuform technology do not receive the required regulatory approvals or if such approvals are delayed, our business would be materially adversely affected. There can be no assurance that the requisite regulatory approvals will be obtained without lengthy delays, if at all.

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In the United States, the FDA rigorously regulates pharmaceutical products, including any drugs using the Acuform technology. If a company fails to comply with applicable requirements, the FDA or the courts may impose sanctions. These sanctions may include civil penalties, criminal prosecution of the company or its officers and employees, injunctions, product seizure or detention, product recalls and total or partial suspension of production. The FDA may withdraw approved applications or refuse to approve pending new drug applications, premarket approval applications, or supplements to approved applications.

We may be required to conduct preclinical testing on laboratory animals of new pharmaceutical products prior to commencement of clinical studies involving human beings. These studies evaluate the potential efficacy and safety of the product. If preclinical testing is required, we must submit the results of the studies to the FDA as part of an Investigational New Drug Application, which must become effective before beginning clinical testing in humans.

The products we develop generally are or will be submitted for approval under Section 505(b)(2) of the FDCA which was enacted as part of the Drug Price Competition and Patent Term Restoration Act of 1984, otherwise known as the Hatch-Waxman Act. Section 505(b)(2) permits the submission 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 instance, the NDA for Gralise relies on the FDA's prior approval of Neurontin® (gabapentin), the immediate release formulation of gabapentin initially approved by the FDA. An NDA for Serada would also rely in part on the FDA's prior approval of Neurontin®.

Typically, human clinical evaluation involves a time-consuming and costly three-phase process:

In Phase 1, we conduct clinical trials with a small number of subjects to determine a drug's early safety profile and its pharmacokinetic pattern.

In Phase 2, we conduct limited clinical trials with groups of patients afflicted with a specific disease in order to determine preliminary efficacy, optimal dosages and further evidence of safety.

In Phase 3, we conduct large-scale, multi-center, comparative trials with patients afflicted with a target disease in order to provide enough data to statistically evaluate the efficacy and safety of the product candidate, as required by the FDA.

The FDA closely monitors the progress of each phase of clinical testing. The FDA may, at its discretion, re-evaluate, alter, suspend or terminate testing based upon the data accumulated to that point and the FDA's assessment of the risk/benefit ratio to patients. The FDA may also require additional clinical trials after approval, which are known as Phase 4 trials.

The results of preclinical and clinical testing are submitted to the FDA in the form of an NDA, for approval prior to commercialization. An NDA requires that our products are compliant with cGMP. Failure to achieve or maintain cGMP standards for products using the Acuform technology would adversely impact their marketability. In responding to an NDA, the FDA may grant marketing approval, request additional information or deny the application. Failure to receive approval for any products using the Acuform technology would have a material adverse effect on the Company.

The FDA regulates not only prescription and over-the-counter drugs approved by NDAs, but also over-the-counter products that comply with monographs issued by the FDA. These regulations include:

cGMP requirements;

general and specific over-the-counter labeling requirements (including warning statements);

advertising restrictions; and

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requirements regarding the safety and suitability of inactive ingredients.

Foreign regulatory approval of a product must also be obtained prior to marketing the product internationally. Foreign approval procedures vary from country to country. The time required for approval may delay or prevent marketing in certain countries. In certain instances we or our collaborative partners may seek approval to market and sell certain products outside of the United States before submitting an application for United States approval to the FDA. The clinical testing requirements and the time required to obtain foreign regulatory approvals may differ from that required for FDA approval. Although there is now a centralized European Union (EU) approval mechanism in place, each EU country may nonetheless impose its own procedures and requirements. Many of these procedures and requirements are time-consuming and expensive. Some EU countries require price approval as part of the regulatory process. These constraints can cause substantial delays in obtaining required approval from both the FDA and foreign regulatory authorities after the relevant applications are filed, and approval in any single country may not meaningfully indicate that another country will approve the product.

*Commercialization*

All marketing activities associated with Gralise and Glumetza, as well as marketing activities related to any other products for which we obtain regulatory approval, will be subject to numerous federal and state laws governing the marketing and promotion of pharmaceutical products. The FDA regulates post-approval promotional labeling and advertising to ensure that they conform with statutory and regulatory requirements. In addition to FDA restrictions, the marketing of prescription drugs is subject to laws and regulations prohibiting fraud and abuse under government healthcare programs. For example, the federal healthcare program antikickback statute prohibits giving things of value to induce the prescribing or purchase of products that are reimbursed by federal healthcare programs, such as Medicare and Medicaid. In addition, federal false claims laws prohibit any person from knowingly presenting, or causing to be presented, a false claim for payment to the federal government. Under this law, the federal government in recent years has brought claims against drug manufacturers alleging that certain marketing activities caused false claims for prescription drugs to be submitted to federal programs. Many states have similar statutes or regulations, which apply to items and services reimbursed under Medicaid and other state programs, or, in some states, regardless of the payer. If we, or our collaborative partners, fail to comply with applicable FDA regulations or other laws or regulations relating to the marketing of our products, we could be subject to criminal prosecution, civil penalties, seizure of products, injunction, exclusion of our products from reimbursement under government programs, as well as other regulatory actions against our product candidates, our collaborative partners or us.

**EMPLOYEES**

As of March 7, 2012, we had 110 full-time employees. At December 31, 2011, we had 109 full-time employees. None of our employees are represented by a collective bargaining agreement, nor have we experienced any work stoppage. We believe that our relations with our employees are good.

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## ITEM 1A. RISK FACTORS

In addition to other information in this report, the following factors should be considered carefully in evaluating an investment in our securities. If any of the risks or uncertainties described in this Form 10-K actually occurs, our business, results of operations or financial condition could be materially adversely affected. The risks and uncertainties described in this Form 10-K are not the only ones facing us. Additional risks and uncertainties of which we are unaware or that we currently deem immaterial may also become important factors that may harm our business.

***If we are not able to successfully commercialize Gralise, our business will suffer.***

In October 2011, we began commercial sales of Gralise. Other than Ventiv, with whom we have contracted to provide sales force recruiting, training, deployment and operational support for this product, we do not currently have other partners assisting us with the commercialization of Gralise. We are a small organization with limited experience selling and marketing pharmaceutical products, and we have had limited time to build the capabilities necessary to commercialize the product. We may not be able to adequately or timely build, maintain or scale the necessary sales, marketing, manufacturing, managed markets or other capabilities on our own that are required to successfully commercialize Gralise, and we may not enter into arrangements with other collaborative partners or other third parties to perform those functions on terms that are acceptable to us, if at all. If we enter into a collaborative co-promotion or licensing arrangement related to Gralise, some or all of the revenues we receive will depend upon the efforts of one or more third parties, which may not be successful and over which we will have little or no control.

Ventiv and any other future third-party contractors and partners may not perform as required under their contracts with us or as expected. If our management of collaborative partners and third-party contractors is not effective or such partners or contractors do not perform as required or as expected, the commercial acceptance and success of Gralise may be limited and our business, financial condition and results of operations would be materially and adversely affected.

***If Santarus does not successfully commercialize Glumetza in the United States, our business will suffer.***

In August 2011, we entered into a commercialization agreement with Santarus pursuant to which Santarus assumed broad commercial, manufacturing and regulatory responsibility for the commercialization of Glumetza and we transferred the Glumetza NDA to Santarus. The commercialization agreement replaces the promotion agreement we entered into with Santarus in July 2008. Santarus will pay us royalties on net sales of Glumetza and will not pay any additional sales milestones that were required under the promotion agreement. Although we have retained rights to promote Glumetza to physicians not called on by us, we do not have any immediate plans to exercise our Glumetza co-promotion rights. As a result, the commercial success of Glumetza will depend almost entirely on Santarus' commercialization efforts. Other factors that may affect the success of our commercialization arrangement with Santarus include the following:

Santarus may acquire or develop alternative products;

Santarus may pursue higher-priority programs, or change the focus of its marketing programs;

Santarus may in the future choose to devote fewer resources to Glumetza;

Glumetza may fail to achieve greater market acceptance;

the outcome of our ongoing litigation against Sun seeking to prevent Sun from marketing a generic version of Glumetza in the United States, or the outcome of any legal or regulatory challenge to our settlement agreement with Lupin;

Santarus may experience financial difficulties; and

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Santarus may fail to comply with its obligations under our commercialization agreement.

Any of the preceding factors could affect Santarus' commitment to the commercialization agreement, which, in turn, could adversely affect the commercial success of Glumetza. Any failure by Santarus to successfully commercialize Glumetza would have a material adverse effect on our business, financial condition and results of operations.

***If generic manufacturers use litigation and regulatory means to obtain approval for generic versions of our products, our business will suffer.***

Under the Federal Food, Drug and Cosmetics Act (FDCA), the FDA can approve an Abbreviated New Drug Application (ANDA), for a generic version of a branded drug without the ANDA applicant undertaking the clinical testing necessary to obtain approval to market a new drug. In place of such clinical studies, an ANDA applicant usually needs only to submit data demonstrating that its product has the same active ingredient(s) and is bioequivalent to the branded product, in addition to any data necessary to establish that any difference in strength, dosage form, inactive ingredients, or delivery mechanism does not result in different safety or efficacy profiles, as compared to the reference drug.

The FDCA requires an applicant for a drug that relies, at least in part, on the patent of one of our branded drugs to notify us of their application and potential infringement of our patent rights. Upon receipt of this notice we have 45 days to bring a patent infringement suit in federal district court against the company seeking approval of a product covered by one of our patents. The discovery, trial and appeals process in such suits can take several years. If such a suit is commenced, the FDCA provides a 30-month stay on the FDA's approval of the competitor's application. Such litigation is often time-consuming and quite costly and may result in generic competition if the patents at issue are not upheld or if the generic competitor is found not to infringe such patents. If the litigation is resolved in favor of the applicant or the challenged patent expires during the 30-month stay period, the stay is lifted and the FDA may thereafter approve the application based on the standards for approval of ANDAs.

In June 2011, we filed a lawsuit in the United States District Court for the District of New Jersey against Sun Pharmaceutical Industries Inc., Sun Pharma Global FZE and Sun Pharmaceuticals Industries Ltd. (Sun), for infringement of the patents listed in the Orange Book for Glumetza. The lawsuit is in response to an ANDA filed by Sun with the FDA regarding Sun's intent to market generic versions of 500mg and 1000mg strengths of Glumetza prior to the expiration of the five listed U.S. patents (U.S. Patent Nos. 6,340,475; 6,488,962; 6,635,280; 6,723,340 and 7,780,987). We also are asserting U.S. Patent 7,736,667 in the lawsuit. We commenced the lawsuit within the 45 days required to automatically stay, or bar, the FDA from approving Sun's ANDA for 30 months or until a district court decision that is adverse to the asserted patents, whichever may occur earlier. The 30-month stay expires in November 2013. If the litigation is still ongoing after expiration of the applicable 30-month stay, the termination of the stay could result in the introduction of one or more products generic to Glumetza prior to resolution of the litigation. Any introduction of one or more products generic to Glumetza would harm our business, financial condition, results of operations and cash flows.

In February 2012, we and Santarus entered into a settlement and license agreement with Lupin to resolve patent litigation involving Glumetza we initiated in November 2009. The agreement grants Lupin the right to begin selling a generic version of Glumetza on February 1, 2016, or earlier under certain circumstances. The agreement is subject to review by the U.S. Department of Justice and the Federal Trade Commission, as well as entry by the U.S. District Court for the Northern District of California of an order dismissing the litigation. We cannot be certain that the settlement agreement will ultimately be approved. Any legal or regulatory challenge to the settlement agreement by the U.S. Department of Justice and/or the Federal Trade Commission could adversely impact our business and revenues.

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In March 2012, we filed a lawsuit in the United States District Court for the District of New Jersey against Actavis Elizabeth LLC (Actavis), Watson Laboratories (Watson) and Incepta Pharmaceuticals (Incepta) for infringement of six (6) U.S. patents listed in the Orange Book for the Gralise product. The lawsuit is in response to ANDAs filed by each of Actavis, Watson and Incepta with the FDA regarding the defendants' intent to market generic versions of 300mg and 600mg dosage strengths of Gralise prior to the expiration of the Orange Book patents, which includes U.S. Patent Nos.: 6,340,475, 6,488,962, 6,635,280, 6,723,340, 7,438,927 and 7,731,989. We commenced the lawsuit within the 45 days required to automatically stay, or bar, the FDA from approving the ANDAs for 30 months or until a district court decision that is adverse to the asserted patents, whichever may occur earlier. The 30-month stays expire in July 2014 and August 2014. If the litigation is still ongoing after expiration of the applicable 30-month stay, the termination of the stay could result in the introduction of one or more products generic to Gralise prior to resolution of the litigation. Any introduction of one or more products generic to Gralise would harm our business, financial condition and results of operations.

The filing of the ANDAs described above, or any other ANDA or similar application in respect to any of our products could have an adverse impact on our stock price. Moreover, if the patents covering our products were not upheld in litigation or if a generic competitor is found not to infringe these patents, the resulting generic competition would have a material adverse effect on our business, results of operations and financial condition.

***We depend on third parties that are single source suppliers to manufacture Gralise and our product candidates. If these suppliers are unable to manufacture and supply Gralise or our product candidates, our business will suffer.***

Patheon is our sole supplier for Gralise pursuant to a manufacturing and supply agreement we entered into with Patheon in September 2011 and our sole supplier of Serada. We do not have, and we do not intend to establish in the foreseeable future, internal commercial scale manufacturing capabilities. Rather, we intend to use the facilities of third parties to manufacture products for clinical trials and commercialization. Our dependence on third parties for the manufacture of our products and our product candidates adversely affect our ability to deliver such products on a timely or competitive basis, if at all. Any failure to obtain Gralise tablets from Patheon, active pharmaceutical ingredient from suppliers, or excipient suppliers, could adversely affect our business, results of operation and financial condition.

The manufacturing process for pharmaceutical products is highly regulated and regulators may shut down manufacturing facilities that they believe do not comply with regulations. We, our third-party manufacturers and our suppliers are subject to numerous regulations, including current FDA regulations governing manufacturing processes, stability testing, record keeping and quality standards. Similar regulations are in effect in other countries. Our third-party manufacturers and suppliers are independent entities who are subject to their own unique operational and financial risks which are out of our control. If we or any of these third-party manufacturers or suppliers fail to perform as required or fail to comply with the regulations of the FDA and other applicable governmental authorities, our ability to deliver our products on a timely basis or receive royalties or continue our clinical trials would be adversely affected. The manufacturing processes of our third party manufacturers and suppliers may also be found to violate the proprietary rights of others. To the extent these risks materialize and adversely affect their performance obligations to us, and we are unable to contract for a sufficient supply of required products on acceptable terms, or if we encounter delays and difficulties in our relationships with manufacturers or suppliers, our business, results of operation and financial condition would be adversely affected.

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***Our collaborative arrangements may give rise to disputes over commercial terms, contract interpretation and ownership of our intellectual property and may adversely affect the commercial success of our products.***

We currently have collaboration or license arrangements with Santarus, Covidien, Merck, Janssen, Boehringer Ingelheim, PharmaNova and Ironwood. In addition, we have in the past and may in the future enter into other collaborative arrangements, some of which have been based on less definitive agreements, such as memoranda of understanding, material transfer agreements, options or feasibility agreements. We may not execute definitive agreements formalizing these arrangements.

Collaborative relationships are generally complex and may give rise to disputes regarding the relative rights, obligations and revenues of the parties, including the ownership of intellectual property and associated rights and obligations, especially when the applicable collaborative provisions have not been fully negotiated and documented. Such disputes can delay collaborative research, development or commercialization of potential products, and can lead to lengthy, expensive litigation or arbitration. The terms of collaborative arrangements may also limit or preclude us from developing products or technologies developed pursuant to such collaborations. Additionally, the collaborators under these arrangements might breach the terms of their respective agreements or fail to prevent infringement of the licensed patents by third parties. Moreover, negotiating collaborative arrangements often takes considerably longer to conclude than the parties initially anticipate, which could cause us to enter into less favorable agreement terms that delay or defer recovery of our development costs and reduce the funding available to support key programs.

We may be unable to enter into future collaborative arrangements on acceptable terms, which could harm our ability to develop and commercialize our current and potential future products and technologies. Other factors relating to collaborations that may adversely affect the commercial success of our products include:

- any parallel development by a collaborative partner of competitive technologies or products;
- arrangements with collaborative partners that limit or preclude us from developing products or technologies;
- premature termination of a collaboration agreement; or
- failure by a collaborative partner to devote sufficient resources to the development and commercial sales of products using our current and potential future products and technologies.

Our collaborative arrangements do not necessarily restrict our collaborative partners from competing with us or restrict their ability to market or sell competitive products. Our current and any future collaborative partners may pursue existing or other development-stage products or alternative technologies in preference to those being developed in collaboration with us. Our collaborative partners may also terminate their collaborative relationships with us or otherwise decide not to proceed with development and commercialization of our products.

***If we do not obtain orphan drug exclusivity for Gralise in PHN, our business could suffer.***

The FDA has granted Gralise Orphan Drug designation for the management of PHN based on a plausible hypothesis that Gralise is "clinically superior" to immediate release gabapentin due to the incidence of adverse events observed in Gralise clinical trials relative to the incidence of adverse events reported in the package insert for immediate release gabapentin. Generally, an Orphan-designated drug approved for marketing is eligible for seven years of regulatory exclusivity for the orphan-designated indication. If the FDA grants Orphan Drug exclusivity for Gralise, the FDA may not approve another application to market the same drug for the same indication until January 2018, except in very limited circumstances. However, the FDA has indicated to us that Gralise is not currently eligible for Orphan

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Drug exclusivity because the hypothesis upon which the product's Orphan Drug designation was granted has not been proven.

We believe a showing of clinical superiority is not required under the statute and regulations related to Orphan Drugs in effect at the time of Gralise's Orphan Drug designation and approval. We also believe amendments to the FDA's Orphan Drug regulations proposed in October 2011 do not apply to our pending request to grant Orphan Drug exclusivity for Gralise. According to the FDA, the proposed amendments are intended to clarify certain provisions of the regulations and make minor improvements to address issues that have arisen since the regulations were issued. If adopted as proposed, it is possible the amendments will adversely affect our request for Orphan Drug exclusivity for Gralise.

The FDA may not grant Gralise orphan exclusivity in PHN. If we do not obtain orphan exclusivity for Gralise, the period of market exclusivity in the United States for Gralise may be reduced, which would adversely affect our business, results of operations and financial condition.

***Pharmaceutical marketing is subject to substantial regulation in the United States and any failure by us or our collaborative partners to comply with applicable statutes or regulations could adversely affect our business.***

All marketing activities associated with Gralise and Glumetza, as well as marketing activities related to any other products for which we obtain regulatory approval, will be subject to numerous federal and state laws governing the marketing and promotion of pharmaceutical products. The FDA regulates post-approval promotional labeling and advertising to ensure that they conform to statutory and regulatory requirements. In addition to FDA restrictions, the marketing of prescription drugs is subject to laws and regulations prohibiting fraud and abuse under government healthcare programs. For example, the federal healthcare program anti-kickback statute prohibits giving things of value to induce the prescribing or purchase of products that are reimbursed by federal healthcare programs, such as Medicare and Medicaid. In addition, federal false claims laws prohibit any person from knowingly presenting, or causing to be presented, a false claim for payment to the federal government. Under this law, the federal government in recent years has brought claims against drug manufacturers alleging that certain marketing activities caused false claims for prescription drugs to be submitted to federal programs. Many states have similar statutes or regulations, which apply to items and services reimbursed under Medicaid and other state programs, or, in some states, regardless of the payer. If we, or our collaborative partners, fail to comply with applicable FDA regulations or other laws or regulations relating to the marketing of our products, we could be subject to criminal prosecution, civil penalties, seizure of products, injunction, and exclusion of our products from reimbursement under government programs, as well as other regulatory actions against our product candidates, our collaborative partners or us.

***We may incur significant liability if it is determined that we are promoting or have in the past promoted the "off-label" use of drugs.***

Companies may not promote drugs for "off-label" uses that is, uses that are not described in the product's labeling and that differ from those approved by the FDA. Physicians may prescribe drug products for off-label uses, and such off-label uses are common across some medical specialties. Although the FDA and other regulatory agencies do not regulate a physician's choice of treatments, the FDCA and FDA regulations restrict communications on the subject of off-label uses of drug products by pharmaceutical companies. The Office of Inspector General of the Department of Health and Human Services (OIG), the FDA, and the Department of Justice (DOJ) all actively enforce laws and regulations prohibiting promotion of off-label uses and the promotion of products for which marketing clearance has not been obtained. A company that is found to have improperly promoted off-label uses may be subject to significant liability, including civil and administrative remedies as well as criminal sanctions.

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Notwithstanding the regulatory restrictions on off-label promotion, the OIG, the FDA, and DOJ allow companies to engage in truthful, non-misleading, and non-promotional speech concerning their products. If the OIG or the FDA takes the position that we are not in compliance with such requirements, and, if such non-compliance is proven, we may be subject to significant liability, including civil and administrative remedies, as well as criminal sanctions. In addition, management's attention could be diverted from our business operations and our reputation could be damaged.

***If we or our marketing partners are unable to obtain acceptable prices or adequate reimbursement for our products from third-party payers, our business will suffer.***

In both domestic and foreign markets, sales of our products and product candidates will depend in part on the availability of adequate reimbursement from third-party payers such as:

government health administration authorities;

private health insurers;

health maintenance organizations;

pharmacy benefit management companies; and

other healthcare-related organizations.

If reimbursement is not available for our products or product candidates, demand for these products may be limited. Further, any delay in receiving approval for reimbursement from third-party payers could have an adverse effect on our future revenues. Third-party payers are increasingly challenging the price and cost-effectiveness of medical products and services. Significant uncertainty exists as to the reimbursement status of newly approved healthcare products, including pharmaceuticals. Our products may not be considered cost effective, and adequate third-party reimbursement may be unavailable to enable us to maintain price levels sufficient to realize an acceptable return on our investment.

Federal and state governments in the United States and foreign governments continue to propose and pass new legislation designed to contain or reduce the cost of healthcare. Existing regulations affecting pricing may also change before many of our product candidates are approved for marketing. Cost control initiatives could decrease the price that we receive for our products and any product that we may develop.

***We may be unable to compete successfully in the pharmaceutical product and drug delivery technology industries.***

Other companies that have oral drug delivery technologies competitive with our Acuform technology include Elan Corporation, Bristol-Myers Squibb, TEVA Pharmaceutical Industries, Ltd., Johnson & Johnson, SkyePharma plc, Flamel Technologies S.A., Ranbaxy Laboratories, Ltd. and Intec Pharma, all of which develop oral tablet products designed to release the incorporated drugs over time. Each of these companies has patented technologies with attributes different from ours, and in some cases with different sites of delivery to the gastrointestinal tract.

Bristol-Myers Squibb is currently marketing a sustained release formulation of metformin, Glucophage XR, with which Glumetza competes. The limited license that Bristol-Myers Squibb obtained from us under our November 2002 settlement agreement extends to certain current and internally-developed future compounds, which may increase the likelihood that we will face competition from Bristol-Myers Squibb in the future on products in addition to Glumetza. Several other companies, including Barr Pharmaceuticals, Inc., Mylan Laboratories, Inc. and Teva Pharmaceutical Industries, Ltd. have received FDA approval for and are selling an extended-release metformin product. There may be other companies developing products competitive with Glumetza of which we are unaware.

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Gabapentin is currently marketed by Pfizer as Neurontin® for adjunctive therapy for epileptic seizures and for postherpetic pain. Pfizer's basic U.S. patents relating to Neurontin have expired, and numerous companies have received approval to market generic versions of the immediate release product. Pfizer has also developed Lyrica® (pregabalin), which has been approved for marketing in the United States for postherpetic pain, fibromyalgia, diabetic nerve pain and for adjunctive therapy for epileptic seizures. In April 2011, GlaxoSmithKline and Xenoport, Inc.'s Horizant™ (gabapentin enacarbil extended-release tablets) was approved and made commercially available in the United States for restless leg syndrome. There may be other companies developing products competitive with Gralise of which we are unaware.

Competition in pharmaceutical products and drug delivery systems is intense. We expect competition to increase. Competing technologies or products developed in the future may prove superior to the Acuform technology or products using the Acuform technology, either generally or in particular market segments. These developments could make the Acuform technology or products using the Acuform technology noncompetitive or obsolete.

Most of our principal competitors have substantially greater financial, sales, marketing, personnel and research and development resources than we do. In addition, many of our potential collaborative partners have devoted, and continue to devote, significant resources to the development of their own drug products, drug candidates and drug delivery systems and technologies.

***Our prior clinical trials evaluating Serada for menopausal hot flashes failed to meet all of their primary endpoints and we cannot be certain that this product will be approved for marketing. The development of drug candidates is inherently difficult and uncertain and we cannot be certain that any of our product candidates will be approved for marketing or, if approved, will achieve market acceptance.***

Each of our three Phase 3 trials evaluating Serada for menopausal hot flashes, including our Phase 3 trial known as Breeze 3, failed to meet all of their primary endpoints. Although we intend to meet with and discuss the results of the trials with the FDA, we cannot be certain that the FDA will determine the product candidate is sufficiently safe and effective to allow a New Drug Application to be submitted to the FDA. In the event the FDA allows us to file a New Drug Application for Serada based on the results of our three completed Phase 3 clinical trials, we cannot be certain that such New Drug Application will be approved.

Clinical development is a long, expensive and uncertain process and is subject to delays and failures. Our own product candidates and those of our collaborative partners are subject to the risk that any or all of them may be found to be ineffective or unsafe, or otherwise may fail to receive necessary regulatory clearances. Positive or encouraging results of prior clinical trial are not necessarily indicative of the results obtained in later clinical trials, as was the case with the Phase 3 trial for Gralise for the management of PHN that we completed in 2007, and with the Phase 3 trials evaluating Serada for menopausal hot flashes, the last of which we completed in October 2011. In addition, data obtained from pivotal clinical trials are susceptible to varying interpretations, which could delay, limit or prevent regulatory approval.

Many other factors could delay or result in termination of our clinical trials, including:

- negative or inconclusive results;
- patient noncompliance with the protocol;
- adverse medical events or side effects among patients during the clinical trials;
- FDA inspections of our clinical operations; and
- actual or perceived lack of efficacy or safety of the product candidate.

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We are unable to predict whether any of our product candidates will receive regulatory clearances or be successfully manufactured or marketed. Further, due to the extended testing and regulatory review process required before marketing clearance can be obtained, the time frame for commercializing a product is long and uncertain. Even if these other product candidates receive regulatory clearance, our products may not achieve or maintain market acceptance. Also, substantially all of our product candidates use the Acuform technology. If it is discovered that the Acuform technology could have adverse effects or other characteristics that indicate it is unlikely to be effective as a delivery system for drugs or therapeutics, our product development efforts and our business could be significantly harmed.

Even when or if our products obtain regulatory approval, successful commercialization requires:

market acceptance;

cost-effective commercial scale production; and

reimbursement under private or governmental health plans.

Any material delay or failure in the governmental approval process and/or the successful commercialization of our potential products could adversely impact our financial position and liquidity.

***We may be unable to protect our intellectual property and may be liable for infringing the intellectual property of others.***

Our success will depend in part on our ability to obtain and maintain patent protection for our products and technologies, and to preserve our trade secrets. Our policy is to seek to protect our proprietary rights, by, among other methods, filing patent applications in the United States and foreign jurisdictions to cover certain aspects of our technology. We hold issued United States patents, and have patent applications pending in the United States. In addition, we are preparing patent applications relating to our expanding technology for filing in the United States and abroad. We have also applied for patents in numerous foreign countries. Some of those countries have granted our applications and other applications are still pending. Our pending patent applications may lack priority over others' applications or may not result in the issuance of patents. Even if issued, our patents may not be sufficiently broad to provide protection against competitors with similar technologies and may be challenged, invalidated or circumvented, which could limit our ability to stop competitors from marketing related products or may not provide us with competitive advantages against competing products. We also rely on trade secrets and proprietary know-how, which are difficult to protect. We seek to protect such information, in part, through entering into confidentiality agreements with employees, consultants, collaborative partners and others before such persons or entities have access to our proprietary trade secrets and know-how. These confidentiality agreements may not be effective in certain cases, due to, among other things, the lack of an adequate remedy for breach of an agreement or a finding that an agreement is unenforceable. In addition, our trade secrets may otherwise become known or be independently developed by competitors.

Our ability to develop our technologies and to make commercial sales of products using our technologies also depends on not infringing others' patents or other intellectual property rights. We are not aware of any intellectual property claims against us. However, the pharmaceutical industry has experienced extensive litigation regarding patents and other intellectual property rights. Patents issued to third parties relating to sustained release drug formulations or particular pharmaceutical compounds could in the future be asserted against us, although we believe that we do not infringe any valid claim of any patents. If claims concerning any of our products were to arise and it was determined that these products infringe a third party's proprietary rights, we could be subject to substantial damages for past infringement or be forced to stop or delay our activities with respect to any infringing product, unless we can obtain a license, or we may have to redesign our product so that it does not infringe upon

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others' patent rights, which may not be possible or could require substantial funds or time. Such a license may not be available on acceptable terms, or at all. Even if we, our collaborators or our licensors were able to obtain a license, the rights may be nonexclusive, which could give our competitors access to the same intellectual property. In addition, any public announcements related to litigation or interference proceedings initiated or threatened against us, even if such claims are without merit, could cause our stock price to decline.

From time to time, we may become aware of activities by third parties that may infringe our patents. Infringement by others of our patents may reduce our market shares (if a related product is approved) and, consequently, our potential future revenues and adversely affect our patent rights if we do not take appropriate enforcement action. We may need to engage in litigation in the future to enforce any patents issued or licensed to us or to determine the scope and validity of third-party proprietary rights. Our issued or licensed patents may not be held valid by a court of competent jurisdiction. Whether or not the outcome of litigation is favorable to us, defending a lawsuit takes significant time, may be expensive and may divert management attention from other business concerns. We may also be required to participate in interference proceedings declared by the United States Patent and Trademark Office for the purpose of determining the priority of inventions in connection with our patent applications or other parties' patent applications. Adverse determinations in litigation or interference proceedings could require us to seek licenses which may not be available on commercially reasonable terms, or at all, or subject us to significant liabilities to third parties. If we need but cannot obtain a license, we may be prevented from marketing the affected product.

***If we are unable to obtain or maintain regulatory approval, we will be limited in our ability to commercialize our products, and our business will suffer.***

The regulatory process is expensive and time consuming. Even after investing significant time and expenditures on clinical trials, we may not obtain regulatory approval of our product candidates. Data obtained from clinical trials are susceptible to varying interpretations, which could delay, limit or prevent regulatory approval, and the FDA may not agree with our methods of clinical data analysis or our conclusions regarding safety and/or efficacy. Significant clinical trial delays could impair our ability to commercialize our products and could allow our competitors to bring products to market before we do. In addition, changes in regulatory policy for product approval during the period of product development and regulatory agency review of each submitted new application may cause delays or rejections. Even if we receive regulatory approval, this approval may entail limitations on the indicated uses for which we can market a product.

For example, the active ingredients in the products utilizing our Acuform delivery technology that are being developed pursuant to our collaboration with Covidien include acetaminophen in combination with opiates. In connection with concerns that consumers may inadvertently take more than the recommended daily dose of acetaminophen, potentially causing liver damage, an FDA advisory committee has recommended that prescription products containing acetaminophen in combination with prescription analgesics (including opiates) should include black box warnings and/or be removed from the market. The FDA is evaluating the recommendations and has indicated that such an evaluation will take some time. The FDA is not required to accept advisory committee recommendations. Covidien's ability or willingness to develop and market the products subject to our collaboration may be adversely affected by actions of the FDA in response to the advisory committee recommendations.

Further, with respect to our approved products, once regulatory approval is obtained, a marketed product and its manufacturer are subject to continual review. The discovery of previously unknown problems with a product or manufacturer may result in restrictions on the product, manufacturer or manufacturing facility, including withdrawal of the product from the market. Manufacturers of approved products are also subject to ongoing regulation and inspection, including compliance with FDA regulations governing current Good Manufacturing Practices (cGMP). The FDCA, the Controlled

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Substances Act and other federal and foreign statutes and regulations govern and influence the testing, manufacturing, packing, labeling, storing, record keeping, safety, approval, advertising, promotion, sale and distribution of our products. The failure to comply with these regulations can result in, among other things, warning letters, fines, injunctions, civil penalties, recall or seizure of products, total or partial suspension of production, non-renewal of marketing applications or criminal prosecution.

We are also required to report adverse events associated with our products to the FDA and other regulatory authorities. Unexpected or serious health or safety concerns could result in labeling changes, recalls, market withdrawals or other regulatory actions. Recalls may be issued at our discretion or at the discretion of the FDA or other empowered regulatory agencies. For example, in June 2010, we instituted a voluntary class 2 recall of 52 lots of our 500mg Glumetza product after chemical traces of 2,4,6-tribromoanisole (TBA) were found in the product bottle. We cannot be certain that the FDA will determine that we adequately addressed the matters that led to this recall or that the FDA will not seek to impose fines or sanctions against us as a result of this recall.

***We are subject to risks associated with NDAs submitted under Section 505(b)(2) of the Food, Drug and Cosmetic Act.***

The products we develop generally are or will be submitted for approval under Section 505(b)(2) of the FDCA which was enacted as part of the Drug Price Competition and Patent Term Restoration Act of 1984, otherwise known as the Hatch-Waxman Act. Section 505(b)(2) permits the submission 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 instance, the NDA for Gralise relies on the FDA's prior approval of Neurontin® (gabapentin), the immediate release formulation of gabapentin initially approved by the FDA. An NDA for Serada would also rely in part on the FDA's prior approval of Neurontin.

For NDAs submitted under Section 505(b)(2) of the FDCA, the patent certification and related provisions of the Hatch-Waxman Act apply. In accordance with the Hatch-Waxman Act, such NDAs may be required to includes certifications, known as "Paragraph IV certifications," that certify any patents listed in the FDA's Orange Book publication in respect to any product referenced in the 505(b)(2) application, are invalid, unenforceable, and/or will not be infringed by the manufacture, use, or sale of the product that is the subject of the 505(b)(2) application. Under the Hatch-Waxman Act, the holder of the NDA which the 505(b)(2) application references may file a patent infringement lawsuit after receiving notice of the Paragraph IV certification. Filing of a patent infringement lawsuit triggers a one-time automatic 30-month stay of the FDA's ability to approve the 505(b)(2) application. Accordingly, we may invest a significant amount of time and expense in the development of one or more products only to be subject to significant delay and patent litigation before such products may be commercialized, if at all. A Section 505(b)(2) application may also not be approved until any non-patent exclusivity, such as exclusivity for obtaining approval of a new chemical entity, listed in the Orange Book for the referenced product has expired. The FDA may also require us to perform one or more additional clinical studies or measurements to support the change from the approved product. The FDA may then approve the new formulation for all or only some of the indications sought by us. The FDA may also reject our future Section 505(b)(2) submissions and require us to file such submissions under Section 501(b)(1) of the FDCA, which could be considerably more expensive and time consuming. These factors, among others, may limit our ability to successfully commercialize our product candidates.

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***If a product liability claim against us is successful, our business will suffer.***

Our business involves exposure to potential product liability risks that are inherent in the development and production of pharmaceutical products. We have obtained product liability insurance for clinical trials currently underway and forecasted 2012 sales of our products, but:

- we may be unable to obtain product liability insurance for future trials;
- we may be unable to obtain product liability insurance for future products;
- we may be unable to maintain product liability insurance on acceptable terms;
- we may be unable to secure increased coverage as the commercialization of the Acuform technology proceeds; or
- our insurance may not provide adequate protection against potential liabilities.

Our inability to obtain adequate insurance coverage at an acceptable cost could prevent or inhibit the commercialization of our products. Defending a lawsuit could be costly and significantly divert management's attention from conducting our business. If third parties were to bring a successful product liability claim or series of claims against us for uninsured liabilities or in excess of insured liability limits, our business, financial condition and results of operations could be materially and adversely affected.

***We depend on clinical investigators and clinical sites to enroll patients in our clinical trials and other third parties to manage the trials and to perform related data collection and analysis, and, as a result, we may face costs and delays outside of our control.***

We rely on clinical investigators and clinical sites to enroll patients and other third parties to manage our trials and to perform related data collection and analysis. However, we may be unable to control the amount and timing of resources that the clinical sites that conduct the clinical testing may devote to our clinical trials. If our clinical investigators and clinical sites fail to enroll a sufficient number of patients in our clinical trials or fail to enroll them on our planned schedule, we will be unable to complete these trials or to complete them as planned, which could delay or prevent us from obtaining regulatory approvals for our product candidates.

Our agreements with clinical investigators and clinical sites for clinical testing and for trial management services place substantial responsibilities on these parties, which could result in delays in, or termination of, our clinical trials if these parties fail to perform as expected. For example, if any of our clinical trial sites fail to comply with FDA-approved good clinical practices, we may be unable to use the data gathered at those sites. If these clinical investigators, clinical sites or other third parties do not carry out their contractual duties or obligations or fail to meet expected deadlines, or if the quality or accuracy of the clinical data they obtain is compromised due to their failure to adhere to our clinical protocols or for other reasons, our clinical trials may be extended, delayed or terminated, and we may be unable to obtain regulatory approval for, or successfully commercialize, our product candidates.

***Our licensed patent covering the use of gabapentin to treat hot flashes associated with menopause is a method-of-use patent, which increases the risk that prescriptions for gabapentin to treat hot flashes in menopausal women could be written for, or filled with, generic gabapentin.***

We have an exclusive sublicense from PharmaNova, Inc. to a patent held by the University of Rochester to develop and commercialize in the United States a gabapentin product for the treatment of hot flashes associated with menopause. Because a method-of-use patent, such as the patent we have sublicensed from PharmaNova, covers only a specified use of a particular compound, not a particular composition of matter, we cannot prevent others from commercializing gabapentin for other indications for use. Accordingly, physicians can already prescribe another manufacturer's gabapentin to treat hot

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flashes in menopausal women, or pharmacists could in the future seek to fill future prescriptions for Serada, if any, with another manufacturer's gabapentin. Although any such "off-label" use could violate our licensed patent, effectively monitoring compliance with our licensed patent and enforcing our patent rights against individual physicians and pharmacies may be ineffective, impractical, difficult and costly.

In the event the FDA allows us to file and subsequently approves a New Drug Application for Serada based on the results of our three completed Phase 3 clinical trials and we initiate commercial sales of Serada, such competition would reduce any revenues generated by such sales.

***Our success is dependent in large part upon the continued services of our Chief Executive Officer and senior management with whom we do not have employment agreements.***

Our success is dependent in large part upon the continued services of our President and Chief Executive Officer, James A. Schoeneck, and other members of our executive management team, and on our ability to attract and retain key management and operating personnel. We do not have agreements with Mr. Schoeneck or any of our other executive officers that provide for their continued employment with us. We may have difficulty filling open senior scientific, financial and commercial positions. Management, scientific and operating personnel are in high demand in our industry and are often subject to competing offers. The loss of the services of one or more members of management or key employees or the inability to hire additional personnel as needed could result in delays in the research, development and commercialization of our products and potential product candidates.

***If we choose to acquire new and complementary businesses, products or technologies, we may be unable to complete these acquisitions or to successfully integrate them in a cost effective and non-disruptive manner.***

Our success depends on our ability to continually enhance and broaden our product offerings in response to changing customer demands, competitive pressures and technologies. One element of our business strategy is to actively seek to acquire products or companies, and to in-license or seek co-promotion rights to products that could be sold by our sales force. We have no current commitments with respect to any acquisition, in-licensing or co-promotion. We do not know if we would be able to successfully complete any acquisitions, or whether we would be able to successfully integrate any acquired business, product or technology or retain any key employees. Integrating any business, product or technology we acquire could be expensive and time consuming, disrupt our ongoing business and distract our management. If we were to be unable to integrate any acquired businesses, products or technologies effectively, our business would suffer. In addition, any amortization or charges resulting from the costs of acquisitions could adversely affect our operating results.

***Our operating results may fluctuate and affect our stock price.***

The following factors will affect our operating results and may result in a material adverse effect on our stock price:

- the degree of commercial success of Gralise and Glumetza;
- announcements and results regarding clinical trial results and plans for our drug candidates;
- filings and other regulatory actions related to our product candidates;
- developments concerning proprietary rights, including patents, infringement allegations and litigation matters;
- decisions by collaborative partners to proceed or not to proceed with subsequent phases of a collaboration or program;
- adverse events related to our products, including recalls;

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interruptions of manufacturing or supply, or other manufacture or supply difficulties;

the outcome of our patent infringement litigation against Sun for Glumetza;

the outcome of our patent infringement litigation against filers of abbreviated new drug applications for Gralise;

variations in revenues obtained from collaborative agreements, including milestone payments, royalties, license fees and other contract revenues;

adoption of new technologies by us or our competitors;

the introduction of new products by our competitors;

the status of our compliance with laws and regulations applicable to the commercialization of pharmaceutical products;

any limitations to access to physician prescription data, which may make our marketing efforts more effective;

manufacturing costs;

third-party reimbursement policies; and

the status of our compliance with the provisions of the Sarbanes-Oxley Act of 2002.

As a result of these factors, our stock price may continue to be volatile and investors may be unable to sell their shares at a price equal to, or above, the price paid. Additionally, any significant drops in our stock price, such as the ones we experienced following the announcement of our Serada Phase 3 trial results in October 2009 and October 2011, could give rise to shareholder lawsuits, which are costly and time consuming to defend against and which may adversely affect our ability to raise capital while the suits are pending, even if the suits are ultimately resolved in our favor.

***We expect to incur operating losses this year and may incur operating losses in the future.***

To date, we have recorded revenues from license fees, product sales, royalties, collaborative research and development arrangements and feasibility studies. For the three years ended 2011, 2010 and 2009 we recorded total revenues of $133.0 million, $80.8 million and $57.7 million, respectively. Collaborative milestones and settlement fees received from Abbott Products, Janssen and Merck resulted in our reaching profitability of $70.7 million and $3.9 million in 2011 and 2010, respectively. For the year ended December 31, 2009, we incurred a net loss of $22.0 million. We expect to incur operating losses in 2012, and we may incur operating losses in future years. Any such losses may have an adverse impact on our total assets, shareholders' equity and working capital.

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***Our existing resources may not be sufficient to fund our operations until such time as we may be able to consistently generate sufficient revenues to support our operations.***

Our existing capital resources may not be sufficient to fund our operations until such time as we may be able to generate sufficient revenues to consistently support our operations. We currently do not have any committed sources of capital. To the extent that our capital resources are insufficient to meet our future capital requirements, in order to continue our operations, we will have to raise additional funds through the sale of our equity securities, through debt financing, or from development and licensing arrangements. We may be unable to raise such additional capital on favorable terms, or at all. If we raise additional capital by selling our equity or convertible debt securities, the issuance of such securities could result in dilution of our shareholders' equity positions. If adequate funds are not available we may have to:

significantly curtail commercialization of our marketed products or other operations;

delay, postpone or terminate clinical trials; and/or

obtain funds through entering into collaboration agreements on unattractive terms.

***We have implemented certain anti-takeover provisions.***

Certain provisions of our articles of incorporation and the California General Corporation Law could discourage a third party from acquiring, or make it more difficult for a third party to acquire, control of our company without approval of our board of directors. These provisions could also limit the price that certain investors might be willing to pay in the future for shares of our common stock. Certain provisions allow the board of directors to authorize the issuance of preferred stock with rights superior to those of the common stock. We are also subject to the provisions of Section 1203 of the California General Corporation Law which requires a fairness opinion to be provided to our shareholders in connection with their consideration of any proposed "interested party" reorganization transaction.

We have adopted a shareholder rights plan, commonly known as a "poison pill". The provisions described above, our poison pill and provisions of the California General Corporation Law may discourage, delay or prevent a third party from acquiring us.

***Increased costs associated with corporate governance compliance may significantly impact our results of operations.***

Changing laws, regulations and standards relating to corporate governance, public disclosure and compliance practices, including the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ Global Market rules, are creating uncertainty for companies such as ours in understanding and complying with these laws, regulations and standards. As a result of this uncertainty and other factors, devoting the necessary resources to comply with evolving corporate governance and public disclosure standards has resulted in and may in the future result in increased general and administrative expenses and a diversion of management time and attention to compliance activities. We also expect these developments to increase our legal compliance and financial reporting costs. In addition, these developments may make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Moreover, we may be unable to comply with these new rules and regulations on a timely basis.

These developments could make it more difficult for us to attract and retain qualified members of our board of directors, or qualified executive officers. We are presently evaluating and monitoring regulatory developments and cannot estimate the timing or magnitude of additional costs we may incur

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as a result. In the event these costs are significant, our selling, general and administrative expenses are likely to increase.

***If we are unable to satisfy regulatory requirements relating to internal controls, our stock price could suffer.***

Section 404 of the Sarbanes-Oxley Act of 2002 requires companies to conduct a comprehensive evaluation of their internal control over financial reporting. At the end of each fiscal year, we must perform an evaluation of our internal control over financial reporting, include in our annual report the results of the evaluation, and have our external auditors publicly attest to such evaluation. If material weaknesses were found in our internal controls in the future, if we fail to complete future evaluations on time, or if our external auditors cannot attest to our future evaluations, we could fail to meet our regulatory reporting requirements and be subject to regulatory scrutiny and a loss of public confidence in our internal controls, which could have an adverse effect on our stock price.

***Business interruptions could limit our ability to operate our business.***

Our operations are vulnerable to damage or interruption from computer viruses, human error, natural disasters, telecommunications failures, intentional acts of vandalism and similar events. In particular, our corporate headquarters are located in the San Francisco Bay area, which has a history of seismic activity. We have not established a formal disaster recovery plan, and our back-up operations and our business interruption insurance may not be adequate to compensate us for losses that occur. A significant business interruption could result in losses or damages incurred by us and require us to cease or curtail our operations.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

We currently lease approximately 46,000 square feet of laboratory and office facilities located at 1330 and 1360 O'Brien Drive, Menlo Park, California.

In June 2011, the Company entered into amendments to its existing leases for the Company's premises located at 1330 and 1360 O'Brien Drive, Menlo Park, California. The lease amendments extend the term of the existing leases for twelve months, from February 1, 2012 through January 31, 2013. All material provisions of the leases remain the same, except that the Company may not extend either of the lease terms.

From July 2006 through January 2012, we leased 9,000 of square feet at 1430 O'Brien Drive. From March 2008 through June 2009, we subleased this space. The lease at 1430 O'Brien Drive was not extended and the lease ended in January 2012.

We believe we will either extend the leases on our existing facilities or that upon expiration of our existing leases sufficient space will be available on reasonable terms in the vicinity of our current facilities.

## ITEM 3. LEGAL PROCEEDINGS

***Depomed v. Sun Pharmaceutical (U.S. Generic Glumetza Litigation)***

In June 2011, a lawsuit was filed in the United States District Court for the District of New Jersey against Sun Pharmaceutical Industries Inc., Sun Pharma Global FZE and Sun Pharmaceuticals Industries Ltd. (Sun), for infringement of five (5) U.S. patents listed in the Orange Book for the Glumetza product. The lawsuit is in response to an Abbreviated New Drug Application (ANDA) filed

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by Sun with the FDA regarding Sun's intent to market generic versions of 500mg and 1000mg dosage strengths of Glumetza prior to the expiration of the Orange Book patents, which includes U.S. Patent Nos.: 6,340,475, 6,488,962, 6,635,280, 6,723,340 and 7,780,987. U.S. Patent No.7,736,667 is also being asserted against Sun in the lawsuit. The lawsuit commenced within the 45 days required to automatically stay, or bar, the FDA from approving Sun's ANDA for 30 months or until a district court decision that is adverse to the patents, whichever occurs earlier.

***Depomed v. Lupin (U.S. Generic Glumetza Litigation)***

In November 2009, a lawsuit was filed in the United States District Court for the Northern District of California against Lupin Limited and its wholly-owned subsidiary, Lupin Pharmaceutical, Inc. (Lupin), for infringement of four (4) U.S. patents listed in the Orange Book for the Glumetza product. The lawsuit was filed in response to an ANDA filed by Lupin with the FDA regarding Lupin's intent to market generic versions of 500mg and 1000mg dosage strengths of Glumetza prior to the expiration of the Orange Book, which includes U.S. Patent Nos.: 6,340,475; 6,488,962; 6,635,280; and 6,723,340. U.S. Patent No. 6,723,340 was subsequently removed from the litigation proceedings in an amended complaint. In February 2012, we and Santarus entered into a settlement and license agreement with Lupin to resolve the litigation. The agreement grants Lupin the right to begin selling a generic version of Glumetza on February 1, 2016, or earlier under certain circumstances. The agreement is subject to review by the U.S. Department of Justice and the Federal Trade Commission, as well as entry by the U.S. District Court for the Northern District of California of an order dismissing the litigation.

***Depomed vs. Gralise ANDA filers (U.S. Generic Gralise Litigation)***

In March 2012, we filed lawsuit in the United States District Court for the District of New Jersey against Actavis Elizabeth LLC (Actavis), Watson Laboratories (Watson) and Incepta Pharmaceuticals (Incepta) for infringement of six (6) U.S. patents listed in the Orange Book for our Gralise product. The lawsuit is in response to ANDAs filed by each of Actavis, Watson and Incepta with the FDA regarding the defendants' intent to market generic versions of 300mg and 600mg dosage strengths of Gralise prior to the expiration of the Orange Book patents, which includes U.S. Patent Nos.: 6,340,475, 6,488,962, 6,635,280, 6,723,340, 7,438,927 and 7,731,989. We commenced the lawsuit within the 45 days required to automatically stay, or bar, the FDA from approving the ANDAs for 30 months or until a district court decision that is adverse to the asserted patents, whichever may occur earlier. The 30-month stays expire in July 2014 and August 2014.

***General***

We may from time to time become party to actions, claims, suits, investigations or proceedings arising from the ordinary course of our business, including actions with respect to intellectual property claims, breach of contract claims, labor and employment claims, and other matters. Although actions, claims, suits, investigations and proceedings are inherently uncertain and their results cannot be predicted with certainty, other than the matters set forth above, we are not currently involved in any matters that we believe may have a material adverse effect on our business, financial position, results of operations or cash flow. However, regardless of the outcome, litigation can have an adverse impact on us because of associated cost and diversion of management time.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

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**EXECUTIVE AND OTHER OFFICERS OF THE REGISTRANT**

Our executive and other officers of the Company and their ages as of March 7, 2012 are as follows:

| Name | Age | Position |
|---|---|---|
| **Executive Officers:** | | |
| James A. Schoeneck | 54 | President and Chief Executive Officer |
| August J. Moretti | 61 | Chief Financial Officer |
| Matthew M. Gosling | 41 | Senior Vice President and General Counsel |
| Thadd M. Vargas | 46 | Senior Vice President, Business Development |
| Michael Sweeney, M.D. | 51 | Chief Medical Officer and VP, Research and Development |
| **Other Officers:** | | |
| Jeff Coon | 49 | Vice President, Human Resources |
| Steve Greco | 62 | Vice President, Sales |
| Kevin Weber | 53 | Vice President, Marketing |
| Gerd Kochendoerfer | 44 | Vice President, Pharmaceutical Development |

*James A. Schoeneck* has served as President and Chief Executive Officer since April 2011 and as a member of the board of directors since December 2007. From 2005 until joining Depomed, Mr. Schoeneck was Chief Executive Officer of BrainCells Inc., a private biopharmaceutical company. Prior to joining BrainCells, he served as Chief Executive Officer of ActivX BioSciences, a development stage biotechnology company. Mr. Schoeneck's broad pharmaceutical experience also includes three years as President and Chief Executive Officer of Prometheus Laboratories Inc. Prior to Prometheus, Mr. Schoeneck spent three years at Centocor, Inc., where he led the development of Centocor's commercial capabilities. Earlier in his career, he spent 13 years at Rhone-Poulenc Rorer, Inc. (now Sanofi-Aventis) serving in various sales and marketing positions of increasing responsibility. Mr. Schoeneck holds a B.S. degree in Education from Jacksonville State University.

*August J. Moretti* joined Depomed as Chief Financial Officer and Senior Vice President in January 2012. From 2004 to December 2011 he was Chief Financial Officer and Senior Vice President of Alexza Pharmaceuticals, Inc., a publicly held pharmaceutical company. From 2001 to 2004, Mr. Moretti was Chief Financial Officer of Alavita, Inc. (formerly Surromed, Inc.), a privately held biotechnology company. Prior to Alavita, he was a member of Heller Ehrman LLP, an international law firm. Mr. Moretti received a J.D. from Harvard Law School and a B.A. in economics from Princeton University.

*Matthew M. Gosling* has served as Senior Vice President and General Counsel since May 2011, after having served as Vice President and General Counsel since 2006. Before joining Depomed, Mr. Gosling was a member of Heller Ehrman LLP, an international law firm, where he served a nine-year tenure as a corporate transactional attorney. Mr. Gosling received his law degree from the University of Chicago and holds a B.A. degree from Trinity University, San Antonio, Texas.

*Thadd M. Vargas* has served as Senior Vice President of Business Development since December 2008, after having served as the Company's Vice President of Business Development since December 2002. Before joining the company, Mr. Vargas was Vice President of Finance at Worldres.com, Inc., Director of Finance at Kosan Biosciences, Inc. and Director of Business Development at Anergen, Inc. Prior to Anergen, Mr. Vargas was a member of Ernst & Young's life sciences audit practice. Mr. Vargas holds a B.A. degree in Business Economics from the University of California at Santa Barbara.

*Michael Sweeney, M.D.* has served as Chief Medical Officer and Vice President of Research and Development since May 2011, after having served as Vice President of Research and Development

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since December 2007. Before joining Depomed, Dr. Sweeney was Vice President of Medical Affairs at CV Therapeutics from August 2003 to September 2007. Prior to CV Therapeutics, Dr. Sweeney spent 11 years at Pfizer Pharmaceuticals in New York and the U.K. where he held a variety of senior-level medical and marketing positions, including Director of Marketing, Viagra Worldwide Team and Global Urology Medical Group Leader for Pfizer's urological products Viagra, Cardura and Detrol. Prior to Pfizer, he served as a senior clinical pharmacologist and a medical advisor at Zeneca PLC. Dr. Sweeney received his M.D. degree from Manchester University in the U.K. together with post graduate diplomas in Pharmaceutical Medicine and Pharmacoepidemiology, the latter from the University of London. He also is a Fellow of the Royal College of Physicians of Edinburgh.

*Jeff Coon* joined Depomed as Vice President, Human Resources in September 2011, after having worked for both large and small organizations including more than ten years in the biotech, pharmaceutical, and medical device industries. From 2009 to August 2011, He served as Human Resources Director at Satellite Communications. From 2008 to 2009, Mr. Coon served as the Vice President of Human Resources of Exelixis. From 2006 to 2008, He served as the Executive Director of Human Resources at PDL BioPharma. Prior to PDL BioPharma, Mr. Coon held senior HR roles with CD Holding and Johnson and Johnson. Mr. Coon holds a M.S. degree in Human Resources Management from Golden Gate University in San Francisco and B.A. degree from California State University Long Beach.

*Steve Greco* joined Depomed as Vice President of Sales in May 2011. He has 25 years of extensive experience building and leading successful pharmaceutical sales organizations. In 2001, Mr. Greco founded a pharmaceutical contract sales organization acquired by the Publicis Group the following year. Mr. Greco then served for five years as the President of Publicis Selling Solutions, the contract sales division of Publicis, where he worked with 25 organizations to launch 15 products and create new commercial divisions. Prior to Publicis, Mr. Greco spent 14 years in sales management at Bristol-Myers Squibb, most recently as Senior Vice President, Cardiovascular/Metabolic Sales. Since 2007, Mr. Greco has been the Chief Business Officer of Marine Polymer Technologies, a private company that commercializes cardiovascular medical devices. Mr. Greco holds a B.A. degree from Loyola University of Los Angeles.

*Kevin Weber* joined Depomed as Vice President of Marketing in July 2011. He has over 25 years of experience in pharmaceutical marketing and operations. Until 2007, Mr. Weber was at Medicis Pharmaceuticals for 8 years, most recently as Vice President, Division Head of Ucyclyd Pharmaceuticals, where he was responsible for the orphan drug division and instrumental in growing Medicis' sales to over $440 million in 2007 from $87 million in 1999. Since 2007, Mr. Weber was Senior Vice President, Global Operations and Strategy at Hyperion Therapeutics, a Biotech focused on orphan diseases and President of BioMark Partners, a strategic marketing consulting firm. Mr. Weber started his career at Rhone-Poulenc Rorer Pharmaceuticals in 1985 and spent 12 years in marketing and product management roles there, most recently as US Marketing Director Asthma. Mr. Weber holds a B.A. degree from Western Michigan University.

*Gerd Kochendoerfer* was named Vice President, Pharmaceutical Development in 2011 after having served since 2008 as Senior Director, Project Management, and taking on additional responsibilities in the areas of alliance management, analytical development and quality control. From 2005 to January 2008, Dr. Kochendoerfer served as Senior Director, Drug Development at FibroGen, Inc. Prior to FibroGen he served as Director of Research and Development of Gryphon Therapeutics. During this time, he led over a dozen drug development programs ranging from early-stage research through NDA approval, and multiple global drug development alliances. He has published over 25 papers in the peer-reviewed literature, and holds over half a dozen patents. Dr. Kochendoerfer received a Ph.D. Degree in Chemistry from the University of California at Berkeley.

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## PART II

### ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

**Market Information**

Our common stock trades on the NASDAQ Global Market (NASDAQ) under the symbol "DEPO". The following table sets forth, for the periods indicated, the intraday high and low prices of our common stock as reported by the NASDAQ from January 1, 2010 to December 31, 2011.

| | High | Low |
|---|---|---|
| **2010** | | |
| First Quarter | $ 3.63 | $ 2.32 |
| Second Quarter | $ 4.10 | $ 2.66 |
| Third Quarter | $ 4.65 | $ 2.55 |
| Fourth Quarter | $ 6.73 | $ 4.27 |
| **2011** | | |
| First Quarter | $ 10.40 | $ 5.40 |
| Second Quarter | $ 10.10 | $ 7.71 |
| Third Quarter | $ 8.80 | $ 4.53 |
| Fourth Quarter | $ 6.35 | $ 4.20 |

On March 7, 2012, the closing price of our common stock was $6.10. As of March 7, 2012, there were approximately 30 shareholders of record of our common stock, one of which is Cede & Co., a nominee for Depository Trust Company, or DTC. All of the shares of common stock held by brokerage firms, banks and other financial institutions as nominees for beneficial owners are deposited into participant accounts at DTC, and are therefore considered to be held of record by Cede & Co. as one shareholder.

**Dividends**

We have never declared or paid any cash dividends on our common stock. We currently intend to retain any future earnings to finance the growth and development of our business.

**Issuer Purchases of Securities**

We did not repurchase any of our equity securities during the fourth quarter of the year ended December 31, 2011.

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**Stock Price Performance Graph**

The following graph compares total shareholder returns of Depomed for the past five years to two indices: the NASDAQ Composite Index and the NASDAQ Pharmaceutical Index. The total return for Depomed's common stock and for each index assumes the reinvestment of all dividends, although cash dividends have never been declared on Depomed's common stock.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN***

Among Depomed, Inc., The NASDAQ Composite Index
And The NASDAQ Pharmaceutical Index

* $100 invested on 12/31/06 in stock or index, including reinvestment of dividends. Fiscal year ending December 31.

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## ITEM 6. SELECTED FINANCIAL DATA

The data set forth below is not necessarily indicative of the results of future operations and should be read in conjunction with the financial statements and the notes included elsewhere in this annual report on Form 10-K and also with "**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**."

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | **2011(1)** | **2010** | **2009** | **2008(2)** | **2007(3)** |
| **Statement of Operations Data (in thousands):** | | | | | |
| Total revenues | $ 132,973 | $ 80,764 | $ 57,728 | $ 34,842 | $ 65,582 |
| Total costs and expenses | 102,275 | 77,139 | 79,800 | 51,937 | 18,044 |
| Gain on litigation settlement | | | | 7,500 | |
| Gain on termination of Abbott agreement | 40,000 | | | | |
| Gain on termination of Esprit agreements | | | | | 5,000 |
| Gain on termination of King agreement | | | | | 29,584 |
| Income (loss) from operations | 70,698 | 3,625 | (22,072) | (17,095) | 47,538 |
| Net income (loss) before income taxes | 71,122 | 3,892 | (22,023) | (15,301) | 49,811 |
| Benefit from (provision for) income taxes | (396) | 4 | 15 | (1) | (592) |
| Net income (loss) | 70,726 | 3,896 | (22,008) | (15,302) | 49,219 |
| Deemed dividend on preferred stock | | | | (541) | (685) |
| Net income (loss) applicable to common stock shareholders | $ 70,726 | $ 3,896 | $ (22,008) | $ (15,843) | $ 48,534 |
| Basic net income (loss) per share applicable to common stock shareholders | $ 1.30 | $ 0.07 | $ (0.43) | $ (0.32) | $ 1.06 |
| Diluted net income (loss) per share applicable to common stock shareholders | $ 1.26 | $ 0.07 | $ (0.43) | $ (0.32) | $ 1.05 |
| Shares used in computing basic net income (loss) per share | 54,562,820 | 52,533,256 | 51,519,912 | 48,778,764 | 45,951,127 |
| Shares used in computing diluted net income (loss) per share | 56,089,796 | 53,463,749 | 51,519,912 | 48,778,764 | 46,353,207 |

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| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| **Balance Sheet Data** | | | | | |
| Cash, cash equivalents and marketable securities | $ 139,793 | $ 76,888 | $ 81,759 | $ 82,059 | $ 69,523 |
| Total assets | 164,372 | 87,031 | 91,581 | 95,084 | 80,645 |
| Deferred revenue, non-current portion | 17,932 | 30,926 | 41,306 | 33,209 | 20,763 |
| Long-term obligations, non-current portion | | | 2,170 | 5,775 | |
| Series A convertible preferred stock | | | | | 12,015 |
| Accumulated deficit | (97,580) | (168,306) | (172,202) | (150,194) | (134,892) |
| Total shareholders' equity (deficit) | 105,917 | 23,106 | 15,726 | 33,153 | 45,520 |

(1)

Total revenues, income from operations, net income before income taxes, net income, net income applicable to common stock shareholders and net income per share in 2011 include a one-time $48.0 million milestone received from Abbott Laboratories for the FDA approval of Gralise.

Total costs and expenses, income from operations, net income before income taxes, net income, net income applicable to common stock shareholders and net income per share in 2011 include a $40.0 million gain on termination of our agreement with Abbott related to Gralise.

(2)

Total costs and expenses, income from operations, net income before income taxes, net income, net income applicable to common stock shareholders and net income per share in 2008 include a $7.5 million gain on litigation related to our settlement with IVAX.

(3)

Total costs and expenses, income from operations, net income before income taxes, net income, net income applicable to common stock shareholders and net income per share in 2007 include (a) a $5.0 million gain on termination of our agreements with Esprit related to Proquin XR and (b) a $29.6 million gain on termination of our promotion agreement with King related to Glumetza.

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## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### OVERVIEW

Depomed is a specialty pharmaceutical company focused on neurology, pain and other diseases of the central nervous system. We also have a portfolio of royalty and milestone producing assets based on our proprietary drug delivery technologies. We have two products approved by the U.S. Food and Drug Administration (FDA) that are currently being marketed. Gralise (gabapentin) is our once-daily tablet for the management of postherpetic neuralgia that we launched and made commercially available in October 2011. Glumetza is our once-daily treatment for adults with type 2 diabetes that is commercialized in the United States by Santarus, Inc. (Santarus). We also have two product candidates under clinical development, DM-1992 for Parkinson's disease and Serada for menopausal hot flashes.

### SIGNIFICANT DEVELOPMENTS DURING 2011

There were a number of significant developments in our business in 2011, including the following:

In January 2011, the FDA approved Gralise for the treatment of postherpetic neuralgia. This approval triggered a $48 million milestone payment from a subsidiary of Abbott Laboratories that we received in February 2011.

In March 2011, we received all rights to Gralise from Abbott Laboratories along with a settlement payment of $40 million, and announced our intention to commercialize Gralise in the United States.

In March 2011, we entered into a License and Services Agreement with Boehringer Ingelheim, granting Boehringer Ingelheim a license to use our Acuform drug delivery technology for use in combination metformin products.

In April 2011, James A. Schoeneck was appointed as our President and Chief Executive Officer, following the resignation of Carl A. Pelzel, our former President and Chief Executive Officer.

In June 2011, we entered into a service agreement with Ventiv Commercial Services, LLC (Ventiv), to provide 164 full-time sales representatives dedicated to us to promote Gralise.

In July 2011, we entered into a research collaboration and license agreement with Ironwood Pharmaceuticals, Inc. granting Ironwood a license for worldwide rights to our Acuform drug delivery technology for an undisclosed Ironwood early stage development program.

In August 2011, we entered into a commercialization agreement with Santarus, superseding our Promotion Agreement with Santarus, pursuant to which Santarus assumed commercial, manufacturing and regulatory responsibility for the commercial activities of Glumetza and agreed to pay us a royalties on net sales of 26.5% in 2011, 29.5% in 2012, 32% in 2013 & 2014, and 34.5% in 2015 and thereafter.

In September 2011, we entered into a manufacturing and supply agreement with Patheon Puerto Rico, Inc. (Patheon) for the manufacture, package and supply of commercial quantities of Gralise.

In October 2011, we made Gralise commercially available, began distributing Gralise and began promoting Gralise to physicians through our contract sales organization.

In December 2011, August J. Moretti was appointed as Senior Vice President and Chief Financial Officer. Mr. Moretti commenced employment with the Company in January 2012.

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Total revenues for the year ended December 31, 2011 were $133.0 million compared to $80.8 million for the year ended December 31, 2010. Revenue for the year ended December 31, 2011 included a $48.0 million milestone from Abbott Products.

Operating expenses for the year ended December 31, 2011 were $56.7 million, compared to $69.0 million for the year ended December 31, 2010. Operating expenses for 2011 included a $40.0 million gain on termination of our agreement with Abbott related to Gralise, which reduced operating expenses for the year.

Cash, cash equivalents and marketable securities were $139.8 million as of December 31, 2011, compared to $76.9 million as of December 31, 2010.

As a result of these developments, our results of operations in 2012 will differ significantly from our reported results for 2011. For example, in 2011 we recognized $48 million in milestone revenue and a $40 million gain on settlement with regard to termination of our agreement with Abbott relating to Gralise. These were one-time payments and will not recur in 2012. In 2011, we reflect eight months of Glumetza product revenue, cost of sales and corresponding promotion expense to Santarus and four months of Glumetza royalty revenue from Santarus. As a result of the restructuring of our agreement with Santarus in August 2011, we will recognize royalty revenue from Santarus in 2012 but no product revenue or promotion expense for Glumetza. In 2011, we recognized $0.5 million of revenue from sales of Gralise and a partial year of corresponding sales and marketing expense. We expect to recognize a full year of Gralise sales in 2012 and to incur a full year of sales and marketing expense in 2012. Accordingly, we expect Gralise product sales and selling, general and administrative expense to be substantially higher in 2012 than in 2011.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

A detailed discussion of our significant accounting policies can be found in Note 1 of the Notes to Financial Statements, and the impact and risks associated with our accounting policies are discussed throughout this Annual Report on Form 10-K and in the footnotes to the financial statements. Critical accounting policies are those that require significant judgment and/or estimates by management at the time that financial statements are prepared such that materially different results might have been reported if other assumptions had been made. We consider certain accounting policies related to revenue recognition, accrued liabilities, and use of estimates to be critical policies. These estimates form the basis for making judgments about the carrying values of assets and liabilities. We base our estimates and judgments on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates.

We believe the following policies to be the most critical to an understanding of our financial condition and results of operations because they require us to make estimates, assumptions and judgments about matters that are inherently uncertain.

***Revenue Recognition***

We recognize revenue from the sale of our products, and from license fees, milestones and royalties earned on license agreements and collaborative arrangements. Revenue arrangements with multiple elements are divided into separate units of accounting if certain criteria are met, including whether the delivered element has stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered items. Revenue is recognized when there is persuasive evidence that an arrangement exists, delivery has occurred and title has passed, the price is fixed or determinable and we are reasonably assured of collecting the resulting receivable.

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*Product Sales*

*Gralise:* We sell Gralise to wholesalers and retail pharmacies and began shipping to customers in October 2011. We accept returns of unsalable product from customers within a return period of six months prior to, and twelve months following product expiration. Gralise tablets currently have a shelf-life of 24 months from date of manufacture. In October 2011, we offered certain launch incentives for customers to stock Gralise at pharmacies and wholesalers, which included discounts and extended payment terms. Given the limited history of prescriptions of Gralise and launch incentives associated with stocking Gralise, we currently cannot reliably estimate expected returns of the product at the time of shipment. Accordingly, we defer recognition of revenue on product shipments of Gralise until the right of return no longer exists, which occurs at the earlier of a) the time Gralise units are dispensed through patient prescriptions or b) expiration of the right of return. We estimate patient prescriptions dispensed using an analysis of third-party information, primarily third-party market research data and to a limited extent, information obtained from wholesalers with respect to inventory levels and inventory movement. As a result of this policy, we have a deferred revenue balance of $6.6 million at December 31, 2011 related to Gralise product shipments that have not been recognized as revenue, which is net of wholesaler fees, retail pharmacy discounts, launch discounts and prompt payment discounts. We recognized $0.5 million in product sales, which is net of wholesaler fees, retail pharmacy discounts, prompt payment discounts, patient support programs, and government chargebacks and rebates for the year ended December 31, 2011. If the Company underestimates or overestimates patient prescriptions dispensed for a given period, adjustments to revenue may be necessary in future periods. We will recognize revenue upon the earlier of prescription units dispensed or expiration of the right of return until we can reliably estimate product returns, at which time we will record a one-time increase in net revenue related to the recognition of revenue previously deferred.

*Glumetza:* We sold and recorded product sales on shipments of Glumetza® (metformin hydrochloride extended release tablets) to wholesalers and retail pharmacies through August 2011. The Company and Santarus entered into a commercialization agreement in August 2011, under which we transferred the rights to manufacture and distribute Glumetza in the United States to Santarus. Santarus commenced distributing Glumetza and began recording product sales in September 2011.

Until August 2011, we recognized revenue for Glumetza sales at the time title transferred to our customers, which occurred at the time product was delivered to our customers. Product distributed by us until August 2011 is subject to rights of return during the period commencing six months before and ending twelve months after product expiration. Revenue from sales of Glumetza were recorded net of estimated allowances for returns, wholesaler and retail pharmacy fees, prompt pay discounts, patient discount programs, government rebates and chargebacks and managed care rebates.

*Product Sales Allowances*

We recognize product sales allowances as a reduction of product sales in the same period the related revenue is recognized. Product sales allowances are based on amounts owed or to be claimed on the related sales. These estimates take into consideration the terms of our agreements with customers, historical product returns, rebates or discounts taken, estimated levels of inventory in the distribution channel, the shelf life of the product, and specific known market events, such as competitive pricing and new product introductions. If actual future results vary from our estimates, we may need to adjust these estimates, which could have an effect on product sales and earnings in the period of adjustment. Our product sales allowances include:

Product Returns We allow customers to return product for credit on returned product that is within six months before and up to one year after its product expiration date.

Wholesaler and Retail Pharmacy Discounts We offer contractually determined discounts to certain wholesale distributors and retail pharmacies that purchase directly from us. These

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discounts are either taken off-invoice at the time of shipment or paid to the customer on a quarterly basis one to two months after the quarter in which product was shipped to the customer.

Prompt Pay Discounts We offer cash discounts to our customers, generally 2% of the sales price, as an incentive for prompt payment. Based on our experience, the Company expects its customers to comply with the payment terms to earn the cash discount.

Patient Discount Programs We offer discount card programs in which patients receive certain discounts off their prescription at participating retail pharmacies. The discounts are reimbursed by the Company approximately one month after the prescription subject to the discount is filled.

Medicaid Rebates We participate in Medicaid rebate programs, which provide assistance to certain low-income patients based on each individual state's guidelines regarding eligibility and services. Under the Medicaid rebate programs, we pay a rebate to each participating state, generally two to three months after the quarter in which prescriptions subject to the rebate are filled.

Chargebacks We provide discounts to authorized users of the Federal Supply Schedule (FSS) of the General Services Administration under an FSS contract with the Department of Veterans Affairs. These federal entities purchase products from the wholesale distributors at a discounted price, and the wholesale distributors then charge back to us the difference between the current retail price and the price the federal entity paid for the product.

Managed Care Rebates We offer discounts under contracts with certain managed care providers who do not purchase directly from us. We generally pay managed care rebates one to two months after the quarter in which prescriptions subject to the rebate are filled.

Medicare Part D Coverage Gap Rebates We participate in the Medicare Part D Coverage Gap Discount Program under which we provide rebates on prescriptions that fall within the "donut hole" coverage gap. We generally pay Medicare Part D Coverage Gap rebates two to three months after the quarter in which prescriptions subject to the rebate are filled.

Launch Discounts We offered certain discounts in connection with the launch and commercially availability of Gralise in October 2011. These launch discounts include off-invoice discounts to wholesalers and stocking rebates to pharmacies for stocking Gralise that were paid in November 2011.

We believe our estimates related to gross-to-net sales adjustments for wholesaler and retail pharmacy fees and discounts, prompt payment discounts, patient discount programs, launch discounts, managed care rebates, and other government chargebacks for Gralise and Glumetza do not have a high degree of estimation complexity or uncertainty as the related amounts are settled within a relatively short period of time. We believe that our estimated product return allowances for Glumetza require a high degree of judgment and are subject to change based on our experience and certain quantitative and qualitative factors. We currently do not estimate returns for Gralise.

Beginning in the third quarter of 2008, we began recognizing Glumetza product sales at the time title transfers to our customer, and provide for an estimate of future product returns at that time. We monitor actual return history on individual product lot basis since product launch, which provides us with a basis to reasonably estimate future product returns, taking into consideration the shelf life of product, shipment and prescription trends, estimated distribution channel inventory levels, and consideration of the introduction of competitive products. The shelf life of the 500mg Glumetza is currently 48 months from the date of tablet manufacture. On product launch in August 2006 and through the second quarter of 2008, the shelf life of 500mg Glumetza product shipped was 36 months from the date of tablet manufacture. The shelf life of the 1000mg Glumetza is currently

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24 to 36 months from the date of tablet manufacture. In 2010, based on our review of actual product returns through the end of 2010, we increased our estimate for Glumetza product returns. This resulted in a decrease of product sales of approximately $1.1 million in 2010 related to sales made in prior periods.

Because of the shelf life of Glumetza product 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. As part of our commercialization agreement with Santarus, we are responsible for return allowances and credits with respect to Glumetza product we shipped (August 2011 and prior) up to a contractual amount equal to our return reserve estimates at August 31, 2011. If returns allowances and credits on product we shipped come in higher than the contractual amount, Santarus will be financially responsible for that difference. If returns allowances and credits on product we shipped come in lower than the contractual amount, we will pay Santarus 75% of that remaining balance.

Our product sales allowances and related accruals are evaluated each reporting period and adjusted when trends or significant events indicate that a change in estimate is appropriate. Such changes in estimate could affect our results of operations of financial position.

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A rollforward of our product sales allowances for the three years ended December 31, 2011 is as follows:

| (in thousands) | Contract Sales Discounts(1) | Product Returns(2) | Cash Discounts | Total |
|---|---|---|---|---|
| Balance at December 31, 2008 | $ 2,289 | $ 1,406 | $ 47 | $ 3,742 |
| Revenue Allowances: | | | | |
| Provision related to current period sales(2) | 7,645 | 2,177 | 936 | 10,758 |
| Provision related to sales made in prior years | | 526 | | 526 |
| Recorded to balance sheet(2) | 22 | | (1) | 21 |
| Payments and credits related to sales made in current period | (3,485) | (234) | (836) | (4,555) |
| Payments and credits related to sales made in prior periods | (2,075) | (511) | (47) | (2,633) |
| Balance at December 31, 2009 | 4,396 | 3,364 | 99 | 7,859 |
| Revenue Allowances: | | | | |
| Provision related to current period sales(2) | 6,510 | 5,720 | 1,169 | 13,399 |
| Provision related to sales made in prior years | (359) | 1,020 | | 661 |
| Recorded to balance sheet(2) | (37) | | (13) | (50) |
| Payments and credits related to sales made in current period | (3,848) | (1,846) | (1,043) | (6,737) |
| Payments and credits related to sales made in prior periods | (4,036) | (2,904) | (100) | (7,040) |
| Balance at December 31, 2010 | 2,626 | 5,354 | 112 | 8,092 |
| Revenue Allowances: | | | | |
| Provision related to current period sales(2) | 5,654 | 6,377 | 1,077 | 13,108 |
| Provision related to sales made in prior years | | (148) | | (148) |
| Recorded to balance sheet(2) | 392 | | 124 | 516 |
| Payments and credits related to sales made in current period | (3,421) | | (1,110) | (4,531) |
| Payments and credits related to sales made in prior periods | (2,625) | (1,741) | (113) | (4,479) |
| Balance at December 31, 2011 | $ 2,626 | $ 9,842 | $ 90 | $ 12,558 |

(1) Includes wholesaler fees and retail discounts, launch discounts, patient support programs, managed care rebates, and government chargebacks and rebates.

(2) Beginning in the third quarter of 2008, we began recognizing Glumetza product sales at the time title transfers to our customer, and began providing for an estimate of future product returns at that time. Through December 31, 2011, the Company was unable to reasonably estimate expected returns of Gralise at the time of shipment. Accordingly, the Company currently defers recognition of revenue on product shipments of Gralise, and deferred recognition of revenue prior to the third quarter of 2008 on product shipments of Glumetza, until the earlier of when units were dispensed through patient prescriptions or expiration of the right of return. Product sales allowances related to revenue that has been deferred are recorded on the balance sheet as a reduction of the related deferred revenue, and recognized within the income statement as a reduction of product sales in the same period the related revenue is recognized.

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*License and Collaborative Arrangements*

Revenue from license and collaborative arrangements, including license fees creditable against future royalty obligations (if any), of the licensee, is recognized when an arrangement is entered into if we have substantially completed our obligations under the terms of the arrangement and our remaining involvement is inconsequential and perfunctory. If we have significant continuing involvement under such an arrangement, license fees are deferred and recognized over the estimated performance period. License fee and collaborative payments received in excess of amounts earned are classified as deferred revenue until earned.

We recognize milestone payments upon the achievement of specified milestones if (1) the milestone is substantive in nature, and the achievement of the milestone was not reasonably assured at the inception of the agreement, (2) the achievement relates to past performance and (3) the fees are nonrefundable. Milestone payments received in excess of amounts earned are classified as deferred revenue until earned.

***Research and Development Expense and Accruals***

Research and development expenses include related salaries, clinical trial costs, consultant fees, supplies, manufacturing costs for research and development programs and allocations of corporate costs. All such costs are charged to research and development expense as incurred. These expenses result from our independent research and development efforts as well as efforts associated with collaborations. Our expense accruals for clinical trials are based on estimates of the services received from clinical trial centers and clinical research organizations. If possible, we obtain information regarding unbilled services directly from service providers. However, we may be required to estimate these services based on information available to our product development or administrative staff. If we underestimate or overestimate the activity associated with a study or service at a given point in time, adjustments to research and development expenses may be necessary in future periods. Historically, our estimated accrued liabilities have approximated actual expense incurred.

***Stock-Based Compensation***

The Company estimates the fair value of stock options and Employee Stock Purchase Plan (ESPP) shares using the Black-Scholes valuation model. The Black-Scholes model requires the input of highly subjective assumptions. The most significant assumptions are our estimates of the expected volatility and the expected term of the award.

*Risk-Free Interest Rate.* The risk-free interest rate is based on the implied yield available on U.S. Treasury zero-coupon issues with a remaining term equal to the expected term of the option.

*Expected Volatility.* The volatility assumption is based on the historical volatility of our common stock over the expected term of the options.

*Expected Life of Options.* Beginning on January 1, 2010, the Company uses historical option exercise data to estimate the expected life of the options. Prior to 2010, the Company's historical share option exercise experience did not provide a reasonable basis upon which to estimate expected term because of a lack of sufficient data points, and the Company estimated the expected term by using the weighted average terms of a peer group of companies that grant options with similar vesting provisions.

*Expected Dividend Yield.* The Company has never paid any dividends and does not intend to in the near future.

As required, we review our valuation assumptions at each grant date and, as a result, we are likely to change our valuation assumptions used to value employee stock-based awards granted in future

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periods. Employee and director stock-based compensation costs are to be recognized over the vesting period of the award, and we have elected to use the straight-line attribution method.

Forfeitures are to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We estimate forfeitures based on historical experience.

**RESULTS OF OPERATIONS**

***Revenues***

Total revenues are summarized in the following table (in thousands):

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| Product sales: | | | |
| Glumetza | $ 40,657 | $ 45,521 | $ 34,570 |
| Gralise | 508 | | |
| Proquin XR | 13 | 116 | 524 |
| Total product sales | 41,178 | 45,637 | 35,094 |
| Royalties: | | | |
| Glumetza | 9,997 | 306 | 244 |
| Teva | | | 1,289 |
| Total royalties | 9,997 | 306 | 1,533 |
| License and collaborative revenue: | | | |
| Gralise | 60,592 | 16,246 | 6,160 |
| Glumetza | 6,609 | 2,502 | 2,504 |
| Boehringer Ingelheim | 10,889 | | |
| Ironwood | 604 | | |
| Covidien | 500 | 4,465 | 2,332 |
| Janssen | 2,250 | 8.909 | |
| Proquin XR (EU) | 300 | 102 | 85 |
| Merck | | 2,500 | 10,000 |
| DM-1992 | 54 | 97 | 20 |
| Total license and collaborative revenue | 81,798 | 34,821 | 21,101 |
| Total revenues | $ 132,973 | $ 80,764 | $ 57,728 |

**Product sales**

*Glumetza*

The decrease in Glumetza product sales in 2011 as compared to 2010 was primarily due to Depomed distributing and recognizing product sales of Glumetza for eight months in 2011 as compared to the full year in 2010. This change resulted from the Santarus commercialization agreement entered into in August 2011. This decrease was offset by price increases and the resumption of shipments of the 500mg Glumetza in January 2011, following a voluntary recall of the 500mg Glumetza and a voluntary temporary suspension of 500mg Glumetza shipments in June 2010. The 1000mg Glumetza was not subject to the recall.

The increase in Glumetza product sales in 2010 from 2009 was primarily driven by increased penetration of the 1000mg Glumetza in the metformin prescription market resulting from the promotion efforts by our promotion partner, Santarus, conversion to the 1000mg Glumetza from the 500mg Glumetza resulting from the voluntary 500mg Glumetza recall, and price increases. This was

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offset by lower product sales of the 500mg Glumetza resulting from the voluntary 500mg Glumetza recall in 2010. Glumetza product sales in 2010 included returns of approximately $1.3 million related to credits for returns given to customers on returns of recalled 500mg Glumetza product, which had the effect of reducing product sales.

From October 2008 to August 2011, Glumetza was promoted by Santarus. From February 2008 through September 2008, we promoted Glumetza through a contract sales organization. As a result of the Santarus commercialization agreement entered into in August 2011, we will no longer be recognizing Glumetza product sales as we have transitioned the distribution and selling efforts related to Glumetza to Santarus. We will receive royalties based upon an agreed-upon percentage of Santarus' net sales of Glumetza and will record these as royalty revenue.

*Gralise*

In October 2011, we announced the commercial availability of Gralise and began distributing Gralise to wholesalers and retail pharmacies. We defer recognition of revenue on product shipments of Gralise until the right of return no longer exists, which occurs at the earlier of (a) the time Gralise units are dispensed through patient prescriptions or (b) expiration of the right of return. At December 31, 2011, we have a deferred revenue balance, which is classified as a liability on the balance sheet, of $6.6 million associated with the deferral of revenue on Gralise product shipments, which is net of estimated wholesaler fees, retail pharmacy discounts, stocking allowances and prompt payment discounts. We will recognize revenue upon the earlier of prescription units dispensed or expiration of the right of return until we can reliably estimate product returns, at which time we will record a one-time increase in net revenue related to the recognition of revenue previously deferred. We expect Gralise product sales to increase significantly in 2012 as compared to 2011 as 2011 only represented the first three months of selling Gralise.

**Royalties**

*Glumetza*

Glumetza royalties relate to royalties we received from Santarus based on net sales of Glumetza in the U.S., Valeant Pharmaceuticals International, Inc. (Valeant) based on net sales of Glumetza in Canada and LG based on net sales of LG's version of Glumetza, Novamet GR, in Korea. We began receiving royalties from Santarus in September 2011, from Valeant in the first quarter of 2006 and from LG in the first quarter of 2007.

Royalty revenue from Santarus in 2011 was $9.6 million and represented four months of Santarus distributing and recording product sales on shipments of Glumetza under the commercialization agreement. There were no royalty revenue amounts from Santarus in 2010 or 2009. We expect royalty revenue to increase in 2012 over 2011 as a result of a full year of royalties under our commercialization agreement with Santarus in 2012 as compared to 4 months in 2011.

*Teva*

In April 2008, we entered into a settlement and license agreement with Teva Pharmaceuticals USA, Inc. (Teva) associated with our patent infringement lawsuit against Teva affiliates IVAX Corporation and IVAX Pharmaceuticals, Inc. related to Teva's generic Glucophage XR tablets. In connection with the settlement and license agreement we were entitled to receive up to a total of $2.5 million in future royalties on Teva's generic Glucophage XR product in the United States. The $2.5 million cap in royalties was met in 2009.

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*Merck*

In February 2012, Merck received FDA approval to market Janumet XR in the United States, and we believe Merck will begin selling Janumet XR during the first quarter of 2012. We are entitled to receive very low single digit royalties on net product sales of JANUMET XR through the expiration date of the licensed patents, and expect to begin to recognize royalty revenue in 2012.

**License and Collaborative Revenue**

*Gralise*

In January 2011, Abbott Products received FDA approval of Gralise for the management of postherpetic neuralgia, which triggered a $48.0 million development milestone from Abbott to us, which we received in February 2011. Because the milestone was substantive in nature, achieved and based on past performance, the entire $48.0 million was recognized as license revenue in the first quarter of 2011.

Pursuant to the exclusive license agreement originally entered into in November 2008, Solvay paid us a $25.0 million upfront fee in February 2009. The upfront payment received was originally scheduled to be recognized as revenue ratably until January 2013, which represented the estimated length of time our development and supply obligations existed under the agreement. In February 2010, Solvay was acquired by Abbott Products and Abbott Products assumed responsibility for the license agreement. In connection with the termination of the license agreement with Abbott Products in 2011, we no longer have continuing obligations to Abbott Products. Accordingly, all remaining deferred revenue related to the $25.0 million upfront license fee previously received from Abbott Products was fully recognized as revenue in March 2011, resulting in immediate recognition of approximately $11.3 million of license revenue.

The increase in Gralise license and collaborative revenue in 2010 over 2009 relates to the $10.0 million milestone payment from Abbott Products in June 2010 on FDA acceptance of the NDA for Gralise for the treatment of postherpetic neuralgia. Because the non-refundable milestone was substantive in nature, achieved and based on past performance, the entire $10.0 million was recognized as license revenue in the second quarter of 2010.

*Glumetza*

In January 2011, we achieved the first sales milestone under the promotion agreement with Santarus related to net sales of Glumetza reaching $50.0 million for the 13 month period ending January 31, 2011, which triggered a milestone payment to us from Santarus of $3.0 million, which we received in March 2011. As the milestone was achieved and related to past performance the entire $3.0 million was recognized as milestone revenue in the first quarter of 2011.

Pursuant to the promotion agreement originally entered into in July 2008, Santarus paid us a $12.0 million upfront fee. The upfront payment received was originally being amortized as revenue ratably until October 2021, which represented the estimated length of time our obligations existed under the promotion agreement related to manufacturing Glumetza and paying Santarus promotion fees on gross margin of Glumetza. The commercialization agreement in August 2011 superseded the promotion agreement and removed our manufacturing and promotion fee obligations. The commercialization agreement includes obligations with respect to manufacturing and regulatory transition to Santarus and managing the patent infringement lawsuits against Sun and Lupin. These obligations are estimated to be completed in December 2013. Accordingly, on the effective date of the commercialization agreement, the amortization period related to remaining deferred revenue on the $12.0 million upfront fee has been adjusted, and the remaining deferred revenue will be recognized ratably until December 2013. We recognized approximately $2.0 million, $0.9 million and $0.9 million

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of revenue associated with this upfront license fee during the years ended December 31, 2011, 2010 and 2009, respectively. The remaining deferred revenue balance is $7.8 million at December 31, 2011.

Glumetza license revenue for the years ended December 31, 2011, 2010 and 2009 also consisted of license revenue recognized from the $25.0 million upfront license fee received from Biovail in July 2005, and the $12.0 million upfront fee received from Santarus in July 2008.

We are recognizing the $25.0 million upfront license fee payment from Biovail as revenue ratably until October 2021, which represents the estimated length of time our obligations exist under the arrangement related to royalties we are obligated to pay Biovail on net sales of Glumetza in the United States and for our obligation to use Biovail as our sole supplier of the 1000mg Glumetza. We recognized approximately $1.6 million associated with this upfront license fee during each of the years ended December 31, 2011, 2010 and 2009, respectively. The remaining deferred revenue balance is $15.7 million at December 31, 2011.

*Boehringer Ingelheim.* Under our license and services agreement with Boehringer Ingelheim entered into in March 2011, Boehringer Ingelheim paid us a $10.0 million upfront license fee which we received in April 2011, less applicable withholding taxes of approximately $1.5 million, for a net receipt of approximately $8.5 million. We received the remaining $1.5 million of taxes previously withheld directly from German tax authorities in June 2011.

The $10.0 million was amortized ratably through November 2011, which was the estimated length of time we were obligated to perform formulation work under the agreements. As such the entire amount was recognized as license revenue in 2011.

We also provided certain initial formulation work associated with the fixed dose combination products. Work performed by us under the service agreement was reimbursed by Boehringer Ingelheim on an agreed-upon FTE rate per hour plus out-of-pocket expenses. We recognized approximately $0.9 million of revenue associated with the reimbursement of formulation work under the service agreement during the year ended December 31, 2011.

*Ironwood Pharmaceuticals, Inc.* In July 2011, we entered into a collaboration and license agreement with Ironwood granting Ironwood a license for worldwide rights to the Company's Acuform drug delivery technology for an undisclosed Ironwood early stage development program. In connection with the research collaboration and license agreement, the Company received an upfront payment of $0.9 million which is being amortized ratably through June 2012, which is the estimated length of time Depomed is obligated to perform formulation work under the agreement. We recognized approximately $0.4 million of revenue associated with this upfront license fee for the year ended December 31, 2011. The remaining deferred revenue balance is $0.5 million at December 31, 2011.

Under the terms of the agreement, the Company will assist with initial product formulation and Ironwood will be responsible for all development and commercialization of the product. The initial formulation work performed by the Company under the agreement will be reimbursed by Ironwood on an agreed-upon FTE rate per hour plus out-of-pocket expenses. We recognized approximately $0.2 million of revenue associated with the reimbursement of formulation work under the agreement during the year ended December 31, 2011.

*Covidien* In November 2008, we entered into a license agreement with Covidien granting Covidien worldwide rights to utilize our Acuform technology for the exclusive development of four products containing acetaminophen in combination with opiates. In 2008, Covidien paid us a total of $5.5 million in upfront fees, representing a $4.0 million upfront license fee and a $1.5 million upfront payment for formulation work to be performed by Depomed under the agreement. The entire $5.5 million was initially accounted for as a single unit of accounting and being amortized ratably through November 2011, which was initially the estimated length of time Depomed was obligated to perform formulation work under the agreement.

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The development of each of the four products was to begin by November 2010. Depomed's formulation obligations related to the first and second products were completed in October 2009 and September 2010, respectively. Covidien did not elect to initiate development of the remaining two products under the agreement by November 2010, and under the agreement, Depomed was no longer required to perform formulation work on those two products. Accordingly, Depomed's formulation obligations were completed during the fourth quarter of 2010. As Depomed no longer has any substantive continuing performance obligations, all remaining deferred revenue related to the $5.5 million in upfront license fees previously received from Covidien was fully recognized as revenue in the fourth quarter of 2010. This resulted in a one-time increase in license revenue of $1.8 million during the fourth quarter of 2010.

Through December 31, 2011, we have also recognized a total of $2.0 million in milestone revenue under the agreement. In October 2009, the first formulation was completed by us and delivered to Covidien, which triggered a $0.5 million milestone payment from Covidien to us in October 2009. In September 2010, we recognized $0.5 million on completion and delivery of the second formulation under the agreement to Covidien, and an additional $0.5 million on the first formulation under the agreement entering clinical development. In November 2011, we recognized $0.5 million on the second formulation under the agreement entering clinical development. Because each of the non-refundable milestones were substantive in nature, based on past performance and achievement was not reasonably assured at the inception of the agreement, each of the milestones was recognized as revenue in its entirety upon achievement.

*Janssen* In August 2010, we entered into a non-exclusive license agreement with Janssen granting Janssen a license to certain patents related to the Company's Acuform drug delivery technology to be used in developing fixed dose combinations of canagliflozin and extended release metformin. Janssen paid us a $5.0 million upfront license fee associated with the license agreement. The $5.0 million was amortized ratably through March 2011, which was the estimated length of time we were obligated to perform formulation work under the agreements. We recognized approximately $1.9 million and $3.1 million of revenue associated with this upfront license fee during the years ended December 31, 2011 and 2010, respectively.

We also entered into a service agreement with Janssen under which we provide formulation work for Janssen and are reimbursed by Janssen on an agreed-upon FTE rate per hour plus out-of-pocket expenses. We recognized approximately $0.3 million and $0.8 million of revenue associated with the reimbursement of formulation work under the service agreement during the years ended 2011 and 2010, respectively.

In September 2010, we achieved the first development milestone under the agreement related to formulation work, which triggered a $5.0 milestone from Janssen to us. The non-refundable $5.0 million milestone was received in October 2010. As the milestone was substantive in nature, and the achievement of the milestone was not reasonably assured at the inception of the agreement, we recognized the $5.0 million milestone in its entirety as license revenue during the third quarter of 2010.

*Merck*

In October 2010, the Company received a $2.5 million development milestone from Merck under the license agreement related to the acceptance of the NDA application of Merck's combination product subject to the agreement. As the milestone was substantive in nature, and the achievement of the milestone was not reasonably assured at the inception of the agreement, we recognized the $2.5 million milestone in its entirety as license revenue during the fourth quarter of 2010.

Merck license revenue for the year ended December 31, 2009 relates to the $10.0 million upfront payment received from Merck in August 2009 under our non-exclusive license agreement granting Merck a license to certain patents related to the Company's metformin extended release technology to

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be used in developing fixed dose combinations of sitagliptin and extended release metformin. As the Company has no continuing obligations under the agreement, the $10.0 million upfront payment was fully recognized as license revenue on receipt in the third quarter of 2009.

*DM-1992*

*DM-1992* revenue in 2011, 2010 and 2009 represents grants received by the Michael J. Fox Foundation in relation to our DM-1992 product candidate for Parkinson's Disease.

***Cost of Sales***

Cost of sales consists of costs of the active pharmaceutical ingredient, contract manufacturing and packaging costs, inventory write-downs, product quality testing, internal employee costs related to the manufacturing process, distribution costs and shipping costs related to our product sales of Gralise, Glumetza and Proquin XR. Total costs of sales are summarized in the following table (in thousands):

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| Cost of sales | $ 5,544 | $ 8,097 | $ 5,257 |

Cost of sales decreased in 2011 as compared to 2010 mainly as a result of $2.3 million in inventory write-offs for unsalable inventory related to the 500mg Glumetza product recall in 2010. Additionally, the Company only sold Glumetza for eight months during 2011 as a result of the Santarus commercialization agreement. These decreases were partially offset by manufacturing and supply costs related to the Company's launch of Gralise in October 2011.

Cost of sales increased in 2010 as compared to 2009 mainly as a result of $2.3 million in inventory write-offs for unsalable inventory related to the 500mg Glumetza product recall in 2010. Cost of sales also increased in 2010 as a result of an increase in 1000mg Glumetza product sales partially offset by lower shipments of the 500mg Glumetza as a result of the 500mg Glumetza recall.

The costs of manufacturing associated with deferred revenue on Gralise and Proquin XR product shipments are recorded as deferred costs, which are included in inventory, until such time the deferred revenue is recognized.

***Research and Development Expense***

Our research and development expenses currently include salaries, clinical trial costs, consultant fees, supplies, manufacturing costs for research and development programs and allocations of corporate costs. The scope and magnitude of future research and development expenses cannot be predicted at this time for our product candidates in research and development, as it is not possible to determine the nature, timing and extent of clinical trials and studies, the FDA's requirements for a particular drug and the requirements and level of participation, if any, by potential partners. As potential products proceed through the development process, each step is typically more extensive, and therefore more expensive, than the previous step. Success in development therefore, generally results in increasing expenditures until actual product approval. Total research and development expense for each of the three years ended December 31, 2011 were as follows (in thousands):

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| Research and development expense | $ 15,187 | $ 20,111 | $ 34,298 |
| Dollar change from prior year | (4,924) | (14,187) | |
| Percentage change from prior year | (24)% | (41)% | |

The majority of our research and development expense was related to Serada and Gralise programs during 2009 and 2010. In 2011, the expense was primarily related to our Serada program. In

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September 2008, we started Breeze 1 and Breeze 2, our first two Phase 3 clinical trials for Serada for the treatment of menopausal hot flashes, which were completed in October 2009. Breeze 3, our third Phase 3 clinical trial started in August 2010 and was completed in October 2011.

In March 2008, we commenced our Phase 3 clinical trial for Gralise for postherpetic neuralgia, which was completed in October 2009.

The decrease in research and development expense in 2011 as compared to 2010 was primarily due to reductions in research and development expense for Gralise, which received FDA approval in the first quarter of 2011, partially offset by higher clinical research organization costs associated with our Breeze 3 Phase 3 clinical trial for Serada, which was completed in October 2011. We expect research and development expense in 2012 will be less than 2011.

The decrease in research and development expense in 2010 as compared to 2009 was primarily due to lower clinical research organization expenses related to the completion of the clinical Phase 3 program for Gralise and completion of Breeze 1 and Breeze 2 Phase 3 programs for Serada in October 2009.

We categorize our research and development expense by project. The table below shows research and development costs for our major clinical development programs, as well as other expenses associated with all other projects in our product pipeline.

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| Gralise | $ | $ 4,733 | $ 11,768 |
| Serada | 9,189 | 8,064 | 15,146 |
| Other projects | 5,998 | 7,314 | 7,384 |
| Total research and development expenses | $ 15,187 | $ 20,111 | $ 34,298 |

The following table summarizes our principal product development initiatives as of March 2012. In addition to the products listed in the table below, from time to time we may enter into feasibility studies with collaborative partners that, if successful, may be followed by definitive agreements to advance development of the product candidate.

| Program | Potential Indications | Development Status |
|---|---|---|
| Serada® | Menopausal hot flashes | Three Phase 3 studies completed (Breeze 1, Breeze 2 and Breeze 3). |
| DM-1992 | Parkinson's disease | Phase 2 study initiated in January 2012. |

We expect that the pharmaceutical products that we develop internally will take, on average, from four to eight years to research, develop and obtain FDA approval in the United States, assuming that we are successful. We generally must conduct preclinical testing on laboratory animals of new pharmaceutical products prior to commencement of clinical studies involving human beings. These studies evaluate the potential efficacy and safety of the product. We then submit the results of these studies to the FDA as part of an Investigational New Drug Application, or IND, which, if successful, allows the opportunity for clinical study of the potential new medicine.

Typically, human clinical evaluation involves a time-consuming and costly three-phase process:

In Phase 1, we conduct clinical trials with a small number of subjects to determine a drug's early safety profile and its blood concentration profile over time. A Phase 1 trial for our average potential product may take 6 to 12 months to plan and complete.

In Phase 2, we conduct limited clinical trials with groups of patients afflicted with a specific disease in order to determine preliminary efficacy, optimal dosages and further evidence of

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safety. A Phase 2 trial for our average potential product may take 9 to 18 months to plan and complete.

In Phase 3, we conduct large-scale, multi-center, comparative trials with patients afflicted with a target disease in order to provide enough data to statistically evaluate the efficacy and safety, as required by the FDA. A Phase 3 trial for our average potential product may take 1 to 3 years to plan and complete.

The most significant expenses associated with clinical development derive from Phase 3 trials as they tend to be the longest and largest studies conducted during the drug development process.

The successful development of pharmaceutical products is highly uncertain. The FDA closely monitors the progress of each phase of clinical testing. The FDA may, at its discretion, re-evaluate, alter, suspend or terminate testing based upon the data accumulated to that point and the FDA's assessment of the risk/benefit ratio to patients. The FDA may also require additional clinical trials after approval, which are known as Phase 4 trials. Various statutes and regulations also govern or influence the manufacturing, safety, labeling, storage and record keeping for each product. The lengthy process of seeking FDA approvals, and the subsequent compliance with applicable statutes and regulation, require the expenditure of substantial resources.

***Selling, General and Administrative Expense***

Selling, general and administrative expenses primarily consist of personnel, contract personnel, marketing and promotion expenses associated with our commercial products, personnel expenses to support our administrative and operating activities, facility costs and professional expenses, such as legal fees. Total selling, general and administrative expenses, as compared to the prior year, were as follows (in thousands):

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| Selling, general and administrative expense: | | | |
| Promotion fee expense | $ 27,339 | $ 31,419 | $ 23,589 |
| Other selling, general and administrative expense | 54,205 | 17,512 | 16,656 |
| Total selling, general and administrative expense | $ 81,544 | $ 48,931 | $ 40,245 |
| Dollar change from prior year | 32,613 | 8,686 | |
| Percentage change from prior year | 67% | 22% | |

The increase in other selling, general and administrative expense was primarily due to increased sales and marketing costs related to the launch of Gralise including launch marketing activities and costs associated with our contract sales organization. In March 2011, we received back from Abbott the rights to market Gralise and commenced pre-launch commercial activities to support the launch of Gralise. During 2011, we advanced our commercial infrastructure with the hiring of employees for our sales management and marketing organizations. In June 2011, we entered into a service agreement with Ventiv as our contract sales organization, pursuant to which Ventiv will provide 164 full-time sales representatives dedicated to promoting Gralise. The Ventiv sales representatives were hired and commenced training in September, and began promotion to physicians in October 2011. As such, 2011 reflected only a partial year of costs associated with our contract sales organization.

The decrease in promotion fee expense in 2011 as compared to 2010 was driven by a full year of Glumetza promotion fees for 2010 as compared to eight months in 2011, as a result of the Santarus commercialization agreement entered into in August 2011.

As a result of the Santarus commercialization agreement entered into in August 2011, we will no longer have promotion fee expense to Santarus going forward. However, we expect selling, general and administrative expense to increase as we expect to incur a full year of costs for our sales

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representatives, through our contract sales organization or by directly hiring sales representatives as full-time employees of the Company. Each month we are required to pay Ventiv, our contract sales organization, a monthly fixed fee of $1.8 million plus pass-through costs during the term of our service agreement with Ventiv. The service agreement with Ventiv will expire in October 2013, however, we may terminate the service agreement with Ventiv in October 2012, which represents the one year anniversary of the deployment date of the sales representatives. We also expect to incur a full year related sales and marketing costs for Gralise in 2012 as compared to a partial year in 2011.

The increase in selling, general and administrative expense in 2010 as compared to 2009 was primarily due to an increase in Glumetza promotion fees to Santarus which was driven by an increase in Glumetza product sales.

***Gain on Settlement with Abbott Products***

In March 2011, we entered into a settlement agreement with Abbott Products which provided for (i) the immediate termination of the parties' license agreement; (ii) the transition of Gralise back to us; and (iii) a $40.0 million payment from Abbott to us made in March 2011. The $40.0 million payment was recognized as a gain within operating income in the first quarter of 2011.

***Interest Income and Expense***

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| Interest and other income | $ 557 | $ 839 | $ 1,050 |
| Interest expense | (133) | (572) | (1,001) |
| Net interest income (expense) | $ 424 | $ 267 | $ 49 |

Interest and other income decreased in 2011 as compared to 2010 due to a receipt of approximately $0.5 million in two grants from the U.S. government under the Qualifying Therapeutic Discovery Project of the Patient Protection and Affordable Care Act of 2010 for our Serada for menopausal hot flashes and DM-1992 for Parkinson's disease programs in 2010, offset by higher interest income due to higher investment balances in 2011.

Interest and other income decreased in 2010 compared to 2009 due to lower interest income resulting from lower interest rates on investments. This decrease was partially offset by the receipt of approximately $0.5 million in two grants from the U.S. government under the Qualifying Therapeutic Discovery Project of the Patient Protection and Affordable Care Act of 2010.

Interest expense relates to interest on the credit facility we entered into in June 2008 with General Electric Capital Corporation and Oxford Finance Corporation. Interest expense decreased in 2011 as compared to 2010 because 2011 included only a partial year of interest as the credit facility was fully repaid by July 2011.

Interest expense decreased in 2010 as compared to 2009 as a result of a lower principal balance in 2010.

**LIQUIDITY AND CAPITAL RESOURCES**

| | As of December 31, | |
|---|---|---|
| | 2011 | 2010 |
| Cash, cash equivalents and marketable securities (in thousands) | $ 139,793 | $ 76,888 |

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In February 2011, we received a $48.0 million milestone from Abbott Products on FDA approval of Gralise for the management of postherpetic neuralgia. In March 2011, we received an additional $40.0 million on termination of our agreement with Abbott.

Since inception through December 31, 2011, we have financed our product development efforts and operations primarily from private and public sales of equity securities, upfront license, milestone and termination fees from collaborative and license partners, and product sales.

In December 2006, we entered into a common stock purchase agreement with Azimuth Opportunity, Ltd., pursuant to which Azimuth was committed to purchase, from time to time and at our sole discretion, up to the lesser of (a) $30.0 million of our common stock, or (b) 8,399,654 shares of common stock. In August 2008, the agreement was amended and the term of the agreement was extended until December 2010. The agreement ended in December 2010 and we did not sell any common stock to Azimuth under this common stock purchase agreement.

In June 2008, we entered into a credit facility with GECC and Oxford, to allow us capital flexibility as we funded our clinical trials. The credit facility was available in up to three tranches. The first tranche of $3.8 million was advanced to us upon the closing of the loan agreement. In July 2008, we received the second tranche of $5.6 million. The third tranche of $5.6 million was not drawn and it is no longer available to us, and GECC and Oxford waived the 2% unused line fee related to the third tranche.

We paid interest only on the first tranche for the first six months at an interest rate of 11.59%. Thereafter, we were required to pay the principal on the first tranche, plus interest at such rate, in 30 equal monthly installments. The second tranche was interest-only through December 31, 2008, with principal and interest payable thereafter in 30 equal monthly installments and has an interest rate of 11.59%. As of December 31, 2010, the outstanding balance on the credit facility was approximately $2.2 million at an interest rate of 11.59%. The credit facility was fully repaid in July 2011.

As of December 31, 2011, we have accumulated net losses of $97.6 million. We may incur operating losses in future years. We anticipate that our existing capital resources will permit us to meet our capital and operational requirements through at least the end of 2013. We base this expectation on our current operating plan, which may change as a result of many factors.

Our cash needs may also vary materially from our current expectations because of numerous factors, including:

- sales of our marketed products;
- expenditures related to our commercialization of Gralise, including our contractual obligations to Ventiv and other arrangements we make for the commercialization of Gralise;
- acquisitions or investment in complementary businesses, products or technologies.
- financial terms of definitive license agreements or other commercial agreements we enter into;
- results of research and development efforts;
- changes in the focus and direction of our business strategy and/or research and development programs;
- technological advances;
- results of clinical testing, requirements of the FDA and comparable foreign regulatory agencies; and
- expenditures related to our commercialization and development efforts, including arrangements we make for the commercialization of Serada, if the product is approved for marketing;

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We will need substantial funds of our own or from third parties to:

- conduct research and development programs;
- commercialize any products we market;
- conduct preclinical and clinical testing; and
- manufacture (or have manufactured) and market (or have marketed) our marketed products and product candidates.

Our existing capital resources may not be sufficient to fund our operations until such time as we may be able to generate sufficient revenues to support our operations. We currently do not have any other committed sources of capital. To the extent that our capital resources are insufficient to meet our future capital requirements, we will have to raise additional funds through the sale of our equity securities or from development and licensing arrangements to continue our development programs. We may be unable to raise such additional capital on favorable terms, or at all. If we raise additional capital by selling our equity or convertible debt securities, the issuance of such securities could result in dilution of our shareholders' equity positions. If adequate funds are not available we may have to:

- significantly curtail commercialization of our marketed products or other operations
- obtain funds through entering into collaboration agreements on unattractive terms; and/or
- delay, postpone or terminate clinical trials;

The inability to raise any additional capital required to fund our operations could have a material adverse effect on our company.

The following table summarizes our cash flow activities (in thousands):

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| Cash provided by (used in) operating activities | $ 57,651 | $ (2,381) | $ 1,838 |
| Cash provided by (used in) investing activities | (62,188) | 512 | 4,126 |
| Cash provided by (used in) financing activities | 6,055 | (2,427) | (1,270) |

Cash provided by operating activities in 2011 was primarily as a result of the $48.0 million milestone payment and $40.0 million termination fee received from Abbott Products during the first quarter of 2011, offset by cash used to commercially launch Gralise. Cash used in operating activities in 2010 was primarily due to our net income adjusted for movements in working capital, stock-based compensation and depreciation expense. Cash provided by operating activities in 2009 was primarily as a result of the $25.0 million upfront payment received from Abbott Products in 2009, offset by our net loss for the year.

Net cash used in investing activities during 2011 consisted of an increase in marketable securities resulting from a partial investment of the milestone payment and settlement fee received from Abbott during the first quarter of 2011. Cash provided by investing activities in 2010 and 2009 was approximately $0.5 million and $4.1 million respectively, and resulted primarily from net decreases in marketable securities to fund our operations.

Cash provided by financing activities during 2011 consisted of $8.3 million in cash proceeds from exercises of stock options and purchases of common stock under our employee stock purchase plan, offset by $2.2 million repayments of principal on our credit facility. Cash used in financing activities in 2010 primarily consisted of $3.8 million in principal payments on our credit facility offset by $1.4 million of cash proceeds from exercises of stock options and purchases of common stock under our employee stock purchase plan. Cash used in financing activities in 2009 primarily consisted of

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$3.3 million in principal payments on our credit facility offset by $2.0 million of cash proceeds from exercises of stock options and purchases of common stock under our employee stock purchase plan.

***Contractual Obligations***

As of December 31, 2011, our contractual obligations are shown in the following table (in thousands):

| | Less than 1 year | 1 - 3 years | 3 - 5 years | Total |
|---|---|---|---|---|
| Operating leases | $ 1,490 | $ 158 | | $ 1,648 |
| Related parties | 173 | | | 173 |
| Contract sales organization | 13,543 | | | 13,543 |
| Purchase commitments | 1,325 | | | 1,325 |
| | $ 16,531 | $ 158 | $ | $ 16,689 |

At December 31, 2011, we had non-cancelable purchase orders and minimum purchase obligations of approximately $1.3 million under our manufacturing agreement with Patheon for the manufacture of Gralise. The amounts disclosed only represent minimum purchase requirements. Actual purchases are expected to exceed these amounts.

Pursuant to the separation agreement and release entered into with Carl A. Pelzel, our former President and Chief Executive Officer, we are obligated to pay Mr. Pelzel $43,333 per month through April 2012.

In June 2011, we entered in to a service agreement with Ventiv, who will provide us with sales force recruiting, training, deployment and ongoing operational support to promote Gralise in the U.S. through 164 full-time sales representatives. Each month we are required to pay Ventiv a monthly fixed fee of $1.8 million during the term of the Ventiv Agreement. We may terminate the service agreement on the one year anniversary of the deployment date of the sales representatives. We have included an estimate of our expected contractual obligations to Ventiv based upon this fee and expected one year anniversary of deployment date of the sales representatives.

The contractual obligations reflected in this table exclude $3.0 million of contingent milestone payments we may be obligated to pay in the future under our sublicense agreement with PharmaNova related to the development of Serada. The payments relate to various milestones for the product candidate under the sublicense agreement, including submission to the FDA of an NDA, and FDA approval of an NDA. The above table also excludes any future royalty payments we may be required to pay on products we have licensed.

The contractual obligations reflected in the table above also exclude non-cancelable purchase orders and minimum purchase obligations of approximately $1.1 million under our supply agreement with Valeant for the supply of 1000mg Glumetza, which will be fully reimbursed by Santarus.

**OFF-BALANCE SHEET ARRANGEMENTS**

We do not have any off-balance sheet arrangements that are reasonably likely to have a current or future material effect on our financial condition, results of operations, liquidity, capital expenditures or capital resources.

**RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In September 2009, the Financial Accounting Standards Board (FASB) revised the authoritative guidance for revenue arrangements with multiple deliverables. The guidance addresses how to

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determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how the arrangement consideration should be allocated among the separate units of accounting. The guidance may be applied retrospectively or prospectively for new or materially modified arrangements. The Company elected to adopt this guidance prospectively, effective for the Company's fiscal year beginning January 1, 2011. Upon adoption, the guidance did not have a material impact on the Company's financial statements and is not expected to have a material impact on the Company's future operating results.

In June 2011, the FASB issued guidance amending the presentation requirements for comprehensive income. For public entities, this guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 with early adoption permitted. Upon adoption, the Company will have the option to report total comprehensive income, including components of net income and components of other comprehensive income, as a single continuous statement or in two separate but consecutive statements. The Company does not anticipate the adoption of this guidance will have a material impact on its financial statements.

In December 2011, the FASB issued a new accounting standard that requires an entity to disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position as well as instruments and transactions executed under a master netting or similar arrangement and was issued to enable users of financial statements to understand the effects or potential effects of those arrangements on its financial position. This standard is required to be applied retrospectively and is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. As this accounting standard only requires enhanced disclosure, the adoption of this standard is not expected to have an impact our financial position or results of operations.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

***Interest Rate Risk***

We consider all highly liquid investments with an original maturity (at date of purchase) of three months or less to be cash equivalents. At December 31, 2011, our marketable securities available for sale consisted of U.S. Treasury bills, U.S. government agency debt securities and U.S. corporate debt with maturity dates of less than two years. Our investments in U.S. corporate debt securities consist primarily of investments in investment grade corporate bonds and notes. Our investments in U.S. Treasury and government debt securities consist of low risk government agency bonds typically with a rating of A or higher. Our operating results have not been sensitive to changes in the general level of interest rates in the United States, particularly because most of our marketable securities are invested in short-term debt instruments.

As of December 31, 2011, the principal amounts, fair values and related weighted-average interest rates of our investments in debt securities classified as marketable securities available-for-sale were as follows:

| | Duration | | |
|---|---|---|---|
| | Less than 1 year | 1 to 2 years | Total |
| Principal amount | $ 62,090 | $ 53,672 | $ 115,762 |
| Fair value | $ 62,106 | $ 53,644 | $ 115,750 |
| Average interest rate | 0.34% | 0.45% | 0.39% |

***Foreign Currency Risk***

We have not had any significant transactions in foreign currencies, nor did we have any significant balances that were due or payable in foreign currencies at December 31, 2011. Accordingly, significant

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changes in foreign currency rates would not have a material impact on our financial position and results of operations.

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements required by this item are set forth beginning on page 77 of this report and are incorporated herein by reference.

## ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

## ITEM 9A. CONTROLS AND PROCEDURES

### (a) Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

At the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal accounting and financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on this evaluation, our principal executive officer and our iprincipal accounting and financial officer concluded that our disclosure controls and procedures were effective as of December 31, 2011 to ensure that information to be disclosed by us in this Annual Report on Form 10-K was recorded, processed summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and Form 10-K.

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 time periods 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 interim principal accounting and financial officer, as appropriate, to allow for timely decisions regarding required disclosure. There were no changes in our internal controls over financial reporting during the year ended December 31, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

We intend to review and evaluate the design and effectiveness of our disclosure controls and procedures on an ongoing basis and to correct any material deficiencies that we may discover. Our goal is to ensure that our management has timely access to material information that could affect our business. While we believe the present design of our disclosure controls and procedures is effective to achieve our goal, future events affecting our business may cause us to modify our disclosure controls and procedures. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

### (b) Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and interim principal accounting and financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control  Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control  Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2011. Ernst & Young LLP, our independent registered public accounting firm, has attested to and issued a report on the effectiveness of our internal control over financial reporting, which is included herein.

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders
Depomed, Inc.

We have audited Depomed, Inc.'s internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control  Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Depomed, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Depomed, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheets of Depomed, Inc. as of December 31, 2011 and 2010, and the related statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2011, and the financial statement schedule listed in the index at Item 15(a) and our report dated March 8, 2012 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Redwood City, California
March 8, 2012

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**ITEM 9B. OTHER INFORMATION**

None

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by this Item with respect to executive officers is set forth in Part I of this report and the information with respect to directors and corporate governance matters is incorporated by reference to the information set forth under the caption "Election of Directors" in the company's Proxy Statement for the 2011 Annual Meeting of Shareholders.

The section entitled "Compliance Under Section 16(a) of the Securities Exchange Act of 1934" appearing in the Proxy Statement for the 2011 Annual Meeting of Shareholders sets forth the information concerning compliance by officers, directors and 10% shareholders of the company with Section 16 of the Exchange Act of 1934 and is incorporated herein by reference.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by this Item is incorporated herein by reference to the information set forth under the caption "Executive Compensation" in the Proxy Statement for the 2012 Annual Meeting of Shareholders.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED SHAREHOLDER MATTERS**

The information required by this Item is incorporated herein by reference to the information set forth under the caption "Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters" in the Proxy Statement for the 2012 Annual Meeting of Shareholders.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by this Item is incorporated herein by reference to the information set forth under the captions "Directors" and "Certain Relationships and Related Transactions" in the Proxy Statement for the 2012 Annual Meeting of Shareholders.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by this Item is incorporated herein by reference to the information set forth under the caption "Principal Accountant Fees and Services" in the Proxy Statement for the 2012 Annual Meeting of Shareholders.

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## PART IV

### ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

**(a)**

**1. Financial Statements**

Report of Independent Registered Public Accounting Firm
Balance Sheets
Statements of Operations
Statements of Cash Flows
Statements of Shareholders' Equity
Notes to Financial Statements

**2. Financial Statement Schedules**

Schedule II is included on page 116 of this report. All other schedules are omitted because they are not required or the required information is included in the financial statements or notes thereto.

**3. Exhibits:**

| Exhibit | Footnote | Description of Document |
|---|---|---|
| 3.1 | (1) | Amended and Restated Articles of Incorporation |
| 3.2 | (2) | Certificate of Amendment to Amended and Restated Articles of Incorporation |
| 3.3 | (3) | Certificate of Determination of Series RP Preferred Stock of the company |
| 3.4 | (4) | Bylaws, as amended |
| 4.1 | (5) | Rights Agreement, dated as of April 21, 2005, between the company and Continental Stock Transfer and Trust Company as Rights Agent |
| 10.1 | (6) | 1995 Stock Option Plan, as amended |
| 10.2 | (7) | Form of Incentive Stock Option Agreement under 1995 Stock Option Plan |
| 10.3 | (7) | Form of Nonstatutory Stock Option Agreement under 1995 Stock Option Plan |
| 10.4 | (7) | Form of Exercise Notice under 1995 Stock Option Plan |
| 10.5 | (1) | Agreement re: Settlement of Lawsuit, Conveyance of Assets and Assumption of Liabilities dated August 28, 1995 by and among Depomed Systems, Inc., Dr. John W. Shell and M6 Pharmaceuticals, Inc. |
| 10.6 | (8) | Form of Indemnification Agreement between the Company and its directors and executive officers |
| 10.7 | (9) | Settlement and Release Agreement, dated as of November 22, 2002, between the Company and Bristol-Myers Squibb Company |
| 10.8 | (10) | Lease extension agreement dated April 30, 2003 between the Company and Menlo Business Park LLC |
| 10.9 | (10) | Lease agreement dated April 30, 2003 between the Company and Menlo Park Business Park LLC |
| 10.10 | | 2004 Equity Incentive Plan, as amended |

| | | |
|---|---|---|
| 10.11 | (12) | 2004 Employee Stock Purchase Plan, as amended |

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| Exhibit | Footnote | Description of Document |
|---|---|---|
| 10.12+ | (14) | Supply Agreement dated December 13, 2005 between the Company and Valeant Laboratories International SRL |
| 10.13+ | (14) | Manufacturing Transfer Agreement dated December 13, 2005 between the Company and Valeant Laboratories International SRL |
| 10.14 | (15) | Non-employee Director Compensation Policy, as amended |
| 10.15 | (16) | Bonus Plan of the Company, as amended |
| 10.16 | (17) | Form of Management Continuity Agreement between the Company and certain officers of the Company |
| 10.17 | (18) | Offer Letter, dated June 14, 2006, between the Company and Matthew Gosling |
| 10.18 | (8) | Lease Agreement dated July 28, 2006 between the Company and Menlo Business Park, LLC |
| 10.19 | (8) | Lease Extension Agreement dated July 28, 2006 between the Company and Menlo Business Park, LLC |
| 10.20 | (8) | Second Lease Extension Agreement dated July 28, 2006 between the Company and Menlo Business Park, LLC |
| 10.21+ | (7) | Sublicense Agreement dated October 13, 2006 between the Company and PharmaNova, Inc. |
| 10.22 | (11) | Amendment to Supply Agreement dated June 30, 2007 between the Company and Valeant Laboratories International SRL |
| 10.23 | (19) | Offer Letter, dated November 19, 2007, between the Company and Michael Sweeney, M.D. |
| 10.24 | (13) | Lease Extension Agreement dated March 18, 2008 between the Company and Menlo Business Park, LLC |
| 10.25 | (13) | Second Lease Extension Agreement dated March 18, 2008 between the Company and Menlo Business Park, LLC |
| 10.26 | (13) | Third Lease Extension Agreement dated March 18, 2008 between the Company and Menlo Business Park, LLC |
| 10.27 | (20) | Offer Letter dated April 3, 2011 between the Company and James A. Schoeneck |
| 10.28 | (20) | Separation Agreement and Release dated April 1, 2011, between the Company and Carl A. Pelzel |
| 10.29 | (20) | Management Continuity Agreement dated April 3, 2011, between the Company and James A. Schoeneck |
| 10.30 | (21) | Third Lease Extension Agreement dated June 20, 2011 between the Company and Menlo Business Park, LLC |
| 10.31 | (21) | Fourth Lease Extension Agreement dated June 20, 2011 between the Company and Menlo Business Park, LLC |
| 10.32+ | (21) | Service Agreement, dated June 20, 2011 between the Company and Ventiv Commercial Services, LLC |

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| Exhibit | Footnote | Description of Document |
|---|---|---|
| 10.33+ | (22) | Commercial Manufacturing Services Agreement dated June 1, 2011 between the Company and Patheon Puerto Rico, Inc. |
| 10.34+ | (22) | Commercialization Agreement dated August 22, 2011 between the Company and Santarus, Inc. |
| 10.35 | | Offer Letter dated December 13, 2011 between the Company and August J. Moretti |
| 23.1 | | Consent of Independent Registered Public Accounting Firm |
| 24.1 | | Power of Attorney (see signature page) |
| 31.1 | | Certification pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 of James A. Schoeneck |
| 31.2 | | Certification pursuant to Rule 13a-14(a) under the Securities Exchange Act of August J. Moretti |
| 32.1 | | Certification pursuant to 18 U.S.C. Section 1350 of James A. Schoeneck |
| 32.2 | | Certification pursuant to 18 U.S.C. Section 1350 of August J. Moretti |
| 101.INS | (23) | XBRL Instance Document |
| 101.SCH | (23) | XBRL Taxonomy Extension Schema Document |
| 101.CAL | (23) | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | (23) | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | (23) | XBRL Taxonomy Extension Labels Linkbase Document |
| 101.PRE | (23) | XBRL Taxonomy Extension Presentation Linkbase Document |

(1) Incorporated by reference to the Company's registration statement on Form SB-2 (File No. 333-25445)

(2) Incorporated by reference to the Company's Form 10-K filed on March 31, 2003

(3) Incorporated by reference to the Company's Form 10-Q filed on May 10, 2005

(4) Incorporated by reference to the Company's Form 8-K filed on April 19, 2005

(5) Incorporated by reference to the Company's Form 8-A filed on April 22, 2005

(6) Incorporated by reference to the Company's registration statement on Form S-8 (File No. 333-101796) filed on December 12, 2002

(7) Incorporated by reference to the Company's Form 10-K filed on March 16, 2007

(8) Incorporated by reference to the Company's Form 10-Q filed on November 9, 2006

(9)

Incorporated by reference to the Company's Form 8-K/A dated November 22, 2002 and filed on December 23, 2002

(10)

Incorporated by reference to the Company's Form 10-Q filed on August 14, 2003

(11)

Incorporated by reference to the Company's Form 10-Q filed on August 7, 2007

(12)

Incorporated by reference to the Company's registration statement on Form S-8 (File No. 333-167015) filed on May 21, 2010

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(13) Incorporated by reference to the Company's Form 10-Q filed on August 8, 2008

(14) Incorporated by reference to the Company's Form 10-K filed on March 16, 2006

(15) Incorporated by reference to the Company's Form 8-K filed on June 2, 2011

(16) Incorporated by reference to the Company's Form 8-K filed on April 12, 2006

(17) Incorporated by reference to the Company's Form 10-K filed on March 12, 2008

(18) Incorporated by reference to the Company's Form 8-K filed on June 30, 2006

(19) Incorporated by reference to the Company's Form 10-Q filed on May 7, 2008

(20) Incorporated by reference to the Company's Form 10-Q filed on May 6, 2011

(21) Incorporated by reference to the Company's Form 10-Q filed on August 2, 2011

(22) Incorporated by reference to the Company's Form 10-Q filed on November 7, 2011

(23) Pursuant to applicable securities laws and regulations, we are deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and are not subject to liability under any anti-fraud provisions of the federal securities laws as long as we have made a good faith attempt to comply with the submission requirements and promptly amend the interactive data files after becoming aware that the interactive data files fail to comply with the submission requirements. In accordance with Rule 406T of Regulation S-T, the information in these exhibits is furnished and deemed not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Exchange Act of 1934, and otherwise is not subject to liability under these sections and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.

\+ Confidential treatment granted

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the issuer, a corporation organized and existing under the laws of the State of California, has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, in the City of Menlo Park, State of California, on the 8th day of March 2012.

DEPOMED, INC.

By /s/ JAMES A. SCHOENECK

James A. Schoeneck
*President and Chief Executive Officer*

**POWER OF ATTORNEY**

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below hereby constitutes and appoints James A. Schoeneck and August J. Moretti, and each of them acting individually, as his true and lawful attorneys-in-fact and agents, each with full power of substitution, for him in any and all capacities, to sign any and all amendments to this report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, with full power of each to act alone, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully for all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or his or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

**Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed by the following persons in the capacities and on the dates indicated.**

| Signature | | |
|---|---|---|
| /s/ JAMES A. SCHOENECK<br>James A. Schoeneck | President and Chief Executive Officer (Principal Executive Officer) | March 8, 2012 |
| /s/ AUGUST J. MORETTI<br>August J. Moretti | Chief Financial Officer (Principal Financial Officer) | March 8, 2012 |
| /s/ PETER D. STAPLE<br>Peter D. Staple | Chairman of the Board of Directors | March 8, 2012 |
| /s/ G. STEVEN BURRILL<br>G. Steven Burrill | Director | March 8, 2012 |

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| Signature | | |
|---|---|---|
| /s/ KAREN A. DAWES<br>Karen A. Dawes | Director | March 8, 2012 |
| /s/ CRAIG R. SMITH, M.D.<br>Craig R. Smith, M.D. | Director | March 8, 2012 |
| /s/ JULIAN N. STERN<br>Julian N. Stern | Director and Secretary | March 8, 2012 |
| /s/ DAVID B. ZENOFF, D.B.A.<br>David B. Zenoff, D.B.A. | Director | March 8, 2012 |

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**DEPOMED, INC.**

**INDEX TO FINANCIAL STATEMENTS**

**DEPOMED, INC. FINANCIAL STATEMENTS**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders
Depomed, Inc.

We have audited the accompanying balance sheets of Depomed, Inc. as of December 31, 2011 and 2010, and the related statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2011. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Depomed, Inc. at December 31, 2011 and 2010, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Depomed, Inc.'s internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control  Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 8, 2012 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Redwood City, California
March 8, 2012

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**DEPOMED, INC.**

**BALANCE SHEETS**

**(in thousands, except share amounts)**

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 24,043 | $ 22,526 |
| Marketable securities | 62,106 | 47,825 |
| Accounts receivable | 4,420 | 6,094 |
| Receivables from collaborative partners | 8,135 | 253 |
| Inventories | 5,395 | 1,571 |
| Prepaid and other current assets | 5,390 | 1,330 |
| Total current assets | 109,489 | 79,599 |
| Marketable securities, long-term | 53,644 | 6,537 |
| Property and equipment, net | 1,070 | 698 |
| Other assets | 169 | 197 |
| | $ 164,372 | $ 87,031 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | 26,784 | 18,473 |
| Deferred product sales | 6,960 | 1,041 |
| Deferred license revenue | 6,032 | 10,665 |
| Other current liabilities | 64 | 635 |
| Current portion of long-term debt | | 2,170 |
| Total current liabilities | 39,840 | 32,984 |
| Deferred license revenue, non-current portion | 17,932 | 30,926 |
| Other long-term liabilities | 682 | 15 |
| Commitments | | |
| Shareholders' equity: | | |
| Preferred stock, no par value, 5,000,000 shares authorized; Series A convertible preferred stock, 25,000 shares designated, 18,158 shares issued and surrendered, and zero shares outstanding at December 31, 2011 and 2010 | | |
| Common stock, no par value, 100,000,000 shares authorized; 55,506,120 and 52,957,787 shares issued and outstanding at December 31, 2011 and 2010, respectively | 203,511 | 191,343 |
| Accumulated deficit | (97,580) | (168,306) |
| Accumulated other comprehensive gain (loss) | (13) | 69 |
| Total shareholders' equity | 105,918 | 23,106 |
| | $ 164,372 | $ 87,031 |

See accompanying notes to Financial Statements.

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**DEPOMED, INC.**

**STATEMENTS OF OPERATIONS**

**(in thousands, except share and per share amounts)**

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2011** | **2010** | **2009** |
| Revenues: | | | |
| Product sales | $ 41,178 | $ 45,637 | $ 35,094 |
| Royalties | 9,997 | 306 | 1,533 |
| License and collaborative revenue | 81,798 | 34,821 | 21,101 |
| Total revenues | 132,973 | 80,764 | 57,728 |
| Costs and expenses: | | | |
| Cost of sales | 5,544 | 8,097 | 5,257 |
| Research and development expense | 15,187 | 20,111 | 34,298 |
| Selling, general and administrative expense: | | | |
| Promotion fee expense | 27,339 | 31,419 | 23,589 |
| Other selling, general and administrative | 54,205 | 17,512 | 16,656 |
| Total selling, general and administrative expense | 81,544 | 48,931 | 40,245 |
| Gain on settlement agreement | (40,000) | | |
| Total costs and expenses | 62,275 | 77,139 | 79,800 |
| Income (loss) from operations | 70,698 | 3,625 | (22,072) |
| Other income (expenses): | | | |
| Interest and other income | 557 | 839 | 1,050 |
| Interest expense | (133) | (572) | (1,001) |
| Total other income (expenses) | 424 | 267 | 49 |
| Net income (loss) before income taxes | 71,122 | 3,892 | (22,023) |
| Benefit from (provision for) income taxes | (396) | 4 | 15 |
| Net income (loss) | $ 70,726 | $ 3,896 | $ (22,008) |
| Basic net income (loss) applicable to common stock shareholders per common share | $ 1.30 | $ 0.07 | $ (0.43) |
| Diluted net income (loss) applicable to common stock shareholders per common share | $ 1.26 | $ 0.07 | $ (0.43) |
| Shares used in computing basic net income (loss) per common share | 54,562,820 | 52,533,256 | 51,519,912 |
| Shares used in computing diluted net income (loss) per common share | 56,089,796 | 53,463,749 | 51,519,912 |

See accompanying notes to Financial Statements.

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**DEPOMED, INC.**

**STATEMENTS OF SHAREHOLDERS' EQUITY**

**(in thousands, except share amounts)**

| | Preferred Stock | | Common Stock | | | Accumulated Other Comprehensive | Shareholders' |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Accumulated Deficit | Income | Equity |
| Balances at Dec. 31, 2008 | | $ | 51,171,377 | $ 183,196 | $ (150,194) | $ 151 | $ 33,153 |
| Issuance of common stock upon exercise of options | | | 723,985 | 1,702 | | | 1,702 |
| Issuance of common stock under employee stock purchase plan | | | 274,996 | 340 | | | 340 |
| Issuance of common stock to employees | | | 30,000 | 54 | | | 54 |
| Stock-based compensation | | | | 2,603 | | | 2,603 |
| Comprehensive income (loss): | | | | | | | |
| Net income (loss) | | | | | (22,008) | | (22,008) |
| Unrealized gain (loss) on available-for-sale securities | | | | | | (118) | (118) |
| Comprehensive income (loss) | | | | | | | (22,126) |
| Balances at Dec. 31, 2009 | | | 52,200,358 | 187,895 | (172,202) | 33 | 15,726 |
| Issuance of common stock upon exercise of options | | | 458,962 | 1,034 | | | 1,034 |
| Issuance of common stock under employee stock purchase plan | | | 298,467 | 383 | | | 383 |
| Stock-based compensation | | | | 2,031 | | | 2,031 |
| Comprehensive income (loss): | | | | | | | |
| Net income (loss) | | | | | 3,896 | | 3,896 |
| Unrealized gain (loss) on available-for-sale securities | | | | | | 36 | 36 |
| Comprehensive income (loss) | | | | | | | 3,932 |
| Balances at Dec. 31, 2010 | | | 52,957,787 | 191,343 | (168,306) | 69 | 23,106 |
| Issuance of common stock upon exercise of options | | | 2,379,116 | 7,588 | | | 7,588 |
| Issuance of common stock under employee stock purchase plan | | | 169,217 | 711 | | | 711 |
| Stock-based compensation | | | | 3,869 | | | 3,869 |
| Comprehensive income (loss): | | | | | | | |
| Net income (loss) | | | | | 70,726 | | 70,726 |
| Unrealized gain (loss) on available-for-sale securities | | | | | | (82) | (82) |
| Comprehensive income (loss) | | | | | | | 70,644 |
| Balances at Dec. 31, 2011 | | $ | 55,506,120 | $ 203,511 | $ (97,580) | $ (13) | $ 105,918 |

See accompanying notes to Financial Statements.

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**DEPOMED, INC.**

**STATEMENTS OF CASH FLOWS**

**(in thousands)**

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2011** | **2010** | **2009** |
| **Operating Activities** | | | |
| Net income (loss) | $ 70,726 | $ 3,896 | $ (22,008) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 420 | 439 | 808 |
| Stock-based compensation | 3,869 | 2,031 | 2,656 |
| Changes in assets and liabilities: | | | |
| Accounts receivable | 1,673 | (1,316) | (2,313) |
| Receivables from collaborative partners | (7,881) | (98) | 1,054 |
| Inventories | (3,825) | 995 | 283 |
| Prepaid and other assets | (4,031) | (145) | 4,219 |
| Accounts payable and other accrued liabilities | 7,811 | 3,075 | 2,485 |
| Accrued compensation | 597 | 234 | (197) |
| Deferred revenue | (11,708) | (11,492) | 14,851 |
| Net cash provided by (used in) operating activities | 57,651 | (2,381) | 1,838 |
| **Investing Activities** | | | |
| Purchase of property and equipment | (698) | (179) | (629) |
| Purchases of marketable securities | (195,162) | (71,325) | (144,567) |
| Maturities of marketable securities | 58,495 | 64,531 | 96,396 |
| Sales of marketable securities | 75,177 | 7,485 | 52,926 |
| Net cash provided by (used in) investing activities | (62,188) | 512 | 4,126 |
| **Financing Activities** | | | |
| Principal payments on long-term debt | (2,244) | (3,843) | (3,312) |
| Proceeds from issuance of common stock | 8,298 | 1,417 | 2,042 |
| Net cash provided by (used in) financing activities | 6,054 | (2,426) | (1,270) |
| Net increase (decrease) in cash and cash equivalents | 1,517 | (4,295) | 4,694 |
| Cash and cash equivalents at beginning of year | 22,526 | 26,821 | 22,127 |
| Cash and cash equivalents at end of year | $ 24,043 | $ 22,526 | $ 26,821 |
| **Supplemental Disclosure of Cash Flow Information** | | | |
| Cash paid (received) during the period for: | | | |
| Interest | $ 133 | $ 512 | $ 935 |
| Taxes | $ (421) | $ (5) | $ (6) |

See accompanying notes to Financial Statements.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS**

**NOTE 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Organization***

Depomed, Inc. (Depomed or the Company) was incorporated in California in 1997 and is a specialty pharmaceutical company focused on neurology, pain and other diseases of the central nervous system. The Company has two products approved by the U.S. Food and Drug Administration (FDA) that are currently being marketed. Gralise (gabapentin) is the Company's once-daily tablet for the management of postherpetic neuralgia that was launched and made commercially available in October 2011. Glumetza is the Company's once-daily treatment for adults with type 2 diabetes that is commercialized in the United States by Santarus, Inc. (Santarus). The Company also has two product candidates under clinical development, DM-1992 for Parkinson's disease and Serada for menopausal hot flashes.

***Use of Estimates***

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

***Revenue Recognition***

The Company recognizes revenue from the sale of its products, royalties earned, and on payments received and services performed under collaborative arrangements. Revenue arrangements with multiple elements are divided into separate units of accounting if certain criteria are met, including whether the delivered element has stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered items. The consideration received is allocated among the separate units based on their respective fair values, and the applicable revenue recognition criteria are applied to each of the separate units.

Revenue is recognized when there is persuasive evidence that an arrangement exists, delivery has occurred and title has passed, the price is fixed or determinable and the Company is reasonably assured of collecting the resulting receivable.

Product Sales:

*Gralise:* The Company sells Gralise to wholesalers and retail pharmacies and began shipping to customers in October 2011. The Company accepts returns of unsalable product from customers within a return period of six months prior to, and twelve months following product expiration. Gralise tablets currently have a shelf-life of 24 months from date of manufacture. In October 2011, the Company offered certain launch incentives for customers to stock Gralise at pharmacies and wholesalers, which included discounts and extended payment terms. Given the limited history of prescriptions of Gralise and launch incentives associated with stocking Gralise, the Company currently cannot reliably estimate expected returns of the product at the time of shipment. Accordingly, the Company defers recognition of revenue on product shipments of Gralise until the right of return no longer exists, which occurs at the earlier of the time Gralise units are dispensed through patient prescriptions or expiration of the right of return. The Company estimates patient prescriptions dispensed using an analysis of third-party information, including third-party market research data and information obtained from wholesalers with respect to inventory

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

levels and inventory movement. As a result of this policy, the Company has a deferred revenue balance of $6.6 million at December 31, 2011 related to Gralise product shipments that have not been recognized as revenue, which is net of wholesaler fees, retail pharmacy discounts, launch discounts and prompt payment discounts. The Company has recognized $0.5 million in product sales, which is net of wholesaler fees, retail pharmacy discounts, prompt payment discounts, patient support programs, and government chargebacks and rebates for the year ended December 31, 2011. If the Company underestimates or overestimates patient prescriptions dispensed for a given period, adjustments to revenue may be necessary in future periods.

In addition, the costs of manufacturing Gralise associated with the deferred revenue are recorded as deferred costs, which are included in inventory, until such time the related deferred revenue is recognized.

*Glumetza:* The Company sold and recorded product sales on shipments of Glumetza® (metformin hydrochloride extended release tablets) to wholesalers and retail pharmacies through August 2011. The Company and Santarus entered into a commercialization agreement in August 2011, under which Depomed transferred the rights to manufacture and distribute Glumetza in the United States to Santarus. Santarus commenced selling Glumetza in September 2011 and began recording product sales. See Note 2 for further information on the Santarus commercialization agreement.

Product distributed by Depomed until August 2011 is subject to rights of return six months before product expiration and up to twelve months after product expiration. The Company recognized revenue for Glumetza sales at the time title transferred to its customers, which occurred at the time product was delivered to its customers. Revenue from sales of Glumetza were recorded net of estimated allowances for returns, wholesaler and retail pharmacy fees, prompt pay discounts, patient discount programs, government rebates and chargebacks and managed care rebates.

*Proquin XR:* The Company sold Proquin XR up until October 2010. Given the declining prescription demand for Proquin XR, the Company was not able to reliably estimate expected returns of the product at the time of shipment. Accordingly, the Company defers recognition of revenue on product shipments of Proquin XR until the right of return no longer exists, which occurs at the earlier of the time Proquin XR units are dispensed through patient prescriptions or expiration of the right of return. The Company estimates patient prescriptions dispensed using an analysis of third-party information, including third-party market research data and information obtained from wholesalers with respect to inventory levels and inventory movement. As a result of this policy, the Company has a deferred revenue balance of $0.4 million at December 31, 2011 related to Proquin XR product shipments that have not been recognized as revenue, which is net of wholesaler fees, retail pharmacy discounts and prompt payment discounts. In addition, the costs of manufacturing Proquin XR associated with the deferred revenue are recorded as deferred costs, which are included in inventory, until such time the related deferred revenue is recognized.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Product Sales Allowances The Company recognizes products sales allowances as a reduction of product sales in the same period the related revenue is recognized. Product sales allowances are based on amounts owed or to be claimed on the related sales. These estimates take into consideration the terms of the Company's agreements with customers, historical product returns, rebates or discounts taken, estimated levels of inventory in the distribution channel, the shelf life of the product, and specific known market events, such as competitive pricing and new product introductions. If actual future results vary, the Company may need to adjust these estimates, which could have an effect on earnings in the period of adjustment. The Company's product sales allowances include:

Product Returns The Company estimated product returns on sales of Glumetza that were originally distributed by the Company. The Company allows customers to return product that is within six months before and up to twelve months after its product expiration date. The shelf life of the 500mg Glumetza is currently 48 months from the date of tablet manufacture. On product launch in August 2006 and through the second quarter of 2008, the shelf life of 500mg Glumetza product shipped was 36 months from the date of tablet manufacture. The shelf life of the 1000mg Glumetza is 24 to 36 months from the date of tablet manufacture. The Company monitors actual return history on individual product lot basis since product launch, which provides it with a basis to reasonably estimate future product returns, taking into consideration the shelf life of product, shipment and prescription trends, estimated distribution channel inventory levels, and consideration of the introduction of competitive products.

Managed Care Rebates The Company offers rebates under contracts with certain managed care customers. The Company establishes an accrual equal to its estimates of future managed care rebates attributable to sales and recognizes the estimated rebates as a reduction of revenue in the same period the related revenue is recognized. The Company estimates its managed care rebates based on the terms of each agreement, estimated levels of inventory in the distribution channel, and historical and expected future utilization of product by the managed care organization.

Wholesaler and Retail Pharmacy Discounts The Company offers discounts to certain wholesale distributors and retail pharmacies based on contractually determined rates. The Company accrues the discount on shipment to the respective wholesale distributors and retail pharmacies and recognizes the discount as a reduction of revenue in the same period the related revenue is recognized.

Prompt Pay Discounts The Company offers cash discounts to its customers, generally 2% of the sales price, as an incentive for prompt payment. Based on the Company's experience, the Company expects its customers to comply with the payment terms to earn the cash discount. The Company accounts for cash discounts by reducing accounts receivable by the full amount and recognizes the discount as a reduction of revenue in the same period the related revenue is recognized.

Medicaid Rebates The Company participates in Medicaid rebate programs, which provide assistance to certain low-income patients based on each individual state's guidelines regarding eligibility and services. Under the Medicaid rebate programs, the Company pays a

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

rebate to each participating state, generally two to three months after the quarter in which prescriptions subject to the rebate are filled. The Company estimates and accrues Medicaid rebates based on product pricing, current rebates and changes in the level of discounts the Company offers that may affect the level of Medicaid discount, historical and estimated future percentages of product sold to Medicaid recipients and estimated levels of inventory in the distribution channel.

Chargebacks The Company provides discounts to authorized users of the Federal Supply Schedule (FSS) of the General Services Administration under an FSS contract negotiated by the Department of Veterans Affairs. These federal entities purchase products from wholesale distributors at a discounted price, and the wholesale distributors then charge back to the Company the difference between the current retail price and the price the federal entity paid for the product. The Company estimates and accrues chargebacks based on estimated wholesaler inventory levels, current contract prices and historical chargeback activity.

Medicare Part D Coverage Gap The Company participates in the Medicare Part D Coverage Gap Discount Program under which the Company provides rebates on prescriptions that fall within the "donut hole" coverage gap. The Company estimates and accrues rebates based on based on historical utilization and recognizes the rebate as a reduction of revenue in the same period the related revenue is recognized.

Patient Discount Programs The Company offers patient discount card programs in which patients receive certain discounts at participating retail pharmacies that are reimbursed by the Company. The Company estimates and accrues future redemptions based on historical redemption activity.

Royalties Royalties are recognized as earned in accordance with the contract terms when royalties from licensees can be reliably measured and collectability is reasonably assured.
Under the commercialization agreement between the Company and Santarus, the Company receives royalties on net sales of Glumetza distributed by Santarus in the United States. Santarus commenced distributing and recording product sales on shipments of Glumetza in September 2011. Royalties from Santarus are recognized in the period earned as the royalty amounts can reliably be estimated and collectability is reasonably assured. See Note 2 for further information on the Santarus commercialization agreement.

Royalties received under the Company's agreements with Valeant Pharmaceuticals International, Inc. (Valeant) and LG Life Sciences (LG) are recognized when the royalty payments are received as they cannot reliably be estimated.

License and Collaborative Arrangements Revenue from license and collaborative arrangements is recognized when the Company has substantially completed its obligations under the terms of the arrangement and the Company's remaining involvement is inconsequential and perfunctory. If the Company has significant continuing involvement under such an arrangement, license and collaborative fees are recognized over the estimated performance period. The Company recognizes milestone payments upon the achievement of specified milestones if (1) the milestone is substantive in nature and the achievement of the milestone was not reasonably assured at the

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

inception of the agreement; (2) consideration earned relates to past performance, and (3) the milestone payment is nonrefundable. A milestone is considered substantive if the consideration earned from the achievement of the milestone is consistent with the Company's performance required to achieve the milestone or consistent with the increase in value to the collaboration resulting from the Company's performance, the consideration earned relates solely to past performance, and the consideration earned is reasonable relative to all of the other deliverables and payments within the arrangement. License, milestones and collaborative fee payments received in excess of amounts earned are classified as deferred revenue until earned.

***Stock-Based Compensation***

Compensation expense for stock-based compensation is based on the single-option approach, includes an estimate for forfeitures and is recognized over the vesting term of the options using the straight-line method. Depomed estimates forfeitures based on historical experience.

Beginning on January 1, 2010, Depomed uses historical option exercise data to estimate the expected life of the options. Prior to 2010, because of a lack of sufficient data points, the Company did not believe its historical option exercise experience provided a reasonable basis upon which to estimate expected term, and the Company estimated the expected term by using the weighted average terms of a peer group of companies that grant options with similar vesting provisions. This change in estimate did not have a material effect on the Company's financial statements. See Note 11 of the Notes to Financial Statements for further discussion on stock-based compensation.

***Research and Development Expense and Accruals***

Research and development expenses include salaries, clinical trial costs, consultant fees, supplies, manufacturing costs for research and development programs and allocations of corporate costs. All such costs are charged to research and development expense as incurred. These expenses result from the Company's independent research and development efforts as well as efforts associated with collaborations. The Company reviews and accrues clinical trial expenses based on work performed, which relies on estimates of total costs incurred based on patient enrollment, completion of patient studies and other events. The Company follows this method since reasonably dependable estimates of the costs applicable to various stages of a research agreement or clinical trial can be made. Accrued clinical costs are subject to revisions as trials progress to completion. Revisions are charged to expense in the period in which the facts that give rise to the revision become known.

***Shipping and Handling Costs***

Shipping and handling costs incurred for inventory purchases and product shipments are recorded in cost of sales in the Statements of Operations.

***Advertising Costs***

Costs associated with advertising are expensed on first showing. Advertising expense for the years ended December 31, 2011, 2010 and 2009 were $2.1 million, $0.3 million and $0.7 million, respectively.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Comprehensive Income (Loss)***

Comprehensive income (loss) is comprised of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes certain changes in equity of the Company that are excluded from net income (loss). Unrealized gains and losses on the Company's available-for-sale securities are reported separately in shareholders' equity and included in accumulated other comprehensive income (loss). Comprehensive income (loss) for the years ended December 31, 2011, 2010 and 2009 has been reflected in the Statements of Shareholders' Equity.

***Cash, Cash Equivalents and Marketable Securities***

The Company considers all highly liquid investments with an original maturity (at date of purchase) of three months or less to be cash equivalents. Cash and cash equivalents consist of cash on deposit with banks, money market instruments and commercial paper. The Company places its cash, cash equivalents and marketable securities with high quality, U.S. government and financial institutions and, to date, has not experienced material losses on any of its balances. The Company records cash and cash equivalents at amortized cost, which approximates the fair value. All marketable securities are classified as available-for-sale since these instruments are readily marketable. These securities are carried at fair value, which is based on readily available market information, with unrealized gains and losses included in accumulated other comprehensive income (loss) within shareholders' equity. The Company uses the specific identification method to determine the amount of realized gains or losses on sales of marketable securities. We regularly review all of our investments for other-than-temporary declines in fair value. Our review includes the consideration of the cause of the impairment including the creditworthiness of the security issuers, the number of securities in an unrealized loss position, as well as the severity and duration of the unrealized losses. When we determine that the decline in fair value of an investment is below our accounting basis and this decline is other-than-temporary, we reduce the carrying value of the security we hold and record a loss in the amount of such decline. Realized gains or losses have been insignificant and are included in interest and other income in the Statements of Operations.

***Accounts Receivable***

Trade accounts receivable are recorded net of allowances for cash discounts for prompt payment. To date the Company has not recorded a bad debt allowance due to the fact that the majority of its product revenue comes from sales to a limited number of financially sound companies. The need for bad debt allowance is evaluated each reporting period based on our assessment of the credit worthiness of our customers.

Receivables from collaborative partners represent amounts due from Santarus per the commercialization agreement entered into in August 2011, as well as amounts due from Boehringer Ingelheim and Ironwood related to license agreements.

***Inventories***

Inventories are stated at the lower of cost or market with cost determined by specific manufactured lot. Inventories consist of costs of the active pharmaceutical ingredient, contract manufacturing and packaging costs. The Company writes-off the value of inventory for potentially

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

excess, dated or obsolete inventories based on an analysis of inventory on hand and on firm purchase commitments.

***Property and Equipment***

Property and equipment are stated at cost, less accumulated depreciation and amortization (See Note 6 of the Notes to Financial Statements). Depreciation is calculated using the straight-line method over the estimated useful lives of the respective assets, as follows:

| | |
|---|---|
| Furniture and office equipment | 3 - 5 years |
| Laboratory equipment | 3 - 5 years |
| Leasehold improvements | Shorter of estimated useful life or lease term |

***Impairment of Long-Lived Assets***

The Company identifies and records impairment losses, as circumstances dictate, on long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the discounted cash flows estimated to be generated by those assets are less than the carrying amounts of those assets. If the undiscounted future cash flows are less than the carrying amount of the asset, an impairment loss, measured as the excess of the carrying value of the asset over its estimated fair value, will be recognized. The cash flow estimates used in such calculations are based on management's best estimates, using appropriate and customary assumptions and projections at the time. No such impairments have been identified with respect to the Company's long-lived assets, which consist primarily of property and equipment.

***Net Income (Loss) Per Common Share***

Basic net income (loss) per share is calculated by dividing the net income (loss) by the weighted-average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by dividing the net income (loss) by the weighted-average number of common shares outstanding for the period, plus dilutive potential common shares for the period determined using the treasury-stock method. For purposes of this calculation, options to purchase stock and warrants are considered to be potential common shares and are only included in the calculation of diluted net income (loss) per share when their effect is dilutive. Basic and diluted earnings per share are calculated as follows:

| **(in thousands, except for per share amounts)** | **2011** | **2010** | **2009** |
|---|---|---|---|
| Numerator: | | | |
| Net income (loss) | $ 70,726 | $ 3,896 | $ (22,008) |
| Denominator for basic net income (loss) per share | 54,563 | 52,533 | 51,520 |
| Net effect of dilutive common stock equivalents | 1,527 | 931 | |
| Denominator for diluted net income (loss) per share: | 56,090 | 53,464 | 51,520 |
| Basic net income (loss) per share | $ 1.30 | $ 0.07 | $ (0.43) |
| Diluted net income (loss) per share | $ 1.26 | $ 0.07 | $ (0.43) |

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

For the years ended December 31, 2011, 2010 and 2009, 1.5 million, 2.8 million and 5.6 million common stock equivalents, respectively, were not included in dilutive shares because their effect is anti-dilutive.

***Income Taxes***

Deferred tax assets and liabilities are measured based on differences between the financial reporting and tax basis of assets and liabilities using enacted rates and laws that are expected to be in effect when the differences are expected to reverse. The Company records a valuation allowance for the full amount of deferred assets, which would otherwise be recorded for tax benefits relating to operating loss and tax credit carryforwards, as realization of such deferred tax assets cannot be determined to be more likely than not. See Note 15 of the Notes to the Financial Statements for further discussion on income taxes.

***Segment Information***

The Company operates in one operating segment and has operations solely in the United States. To date, all of the Company's revenues from product sales are related to sales of Glumetza, Gralise and Proquin XR in the United States. The Company has recognized license and royalty revenue from license agreements in the territories of the United States, Canada and Korea.

***Concentration of Risk***

The Company invests cash that is currently not being used for operational purposes in accordance with its investment policy in low risk debt securities of the U.S. Treasury, U.S. government sponsored agencies and very highly rated banks and corporations. The Company is exposed to credit risk in the event by default by the institutions holding the cash equivalents and available-for sale securities to the extent recorded on the balance sheet.

The Company is subject to credit risk from its accounts receivable related to product sales. The majority of the Company's trade accounts receivable arises from product sales in the United States. Three wholesale distributors represented 46%, 32% and 17% of product shipments for the year ended December 31, 2011. These three customers individually comprised 54%, 29% and 9%, respectively, of product sales related accounts receivable as of December 31, 2011. Three wholesale distributors represented 36%, 35% and 23% of product shipments for the year ended December 31, 2010. These three customers individually comprised 41%, 34% and 18%, respectively, of product sales related accounts receivable as of December 31, 2010. To date, the Company has not experienced any losses with respect to the collection of its accounts receivable and believes that all of its past due accounts receivable are collectible. Accounts receivable balances related to product sales were $4.4 million and $6.1 million for the years ended December 31, 2011 and 2010, respectively.

The Company relies on a single third-party contract manufacturer organization in Puerto Rico to manufacture Gralise. The Company also relies on two third-party suppliers for the supply of gabapentin, the active pharmaceutical ingredient in Gralise.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 2. LICENSE AND COLLABORATIVE ARRANGEMENTS**

***Santarus, Inc.***

*Promotion Agreement*

In July 2008, the Company entered into a promotion agreement with Santarus, Inc. (Santarus) granting Santarus exclusive rights to promote Glumetza in the United States. Santarus paid the Company a $12.0 million upfront fee, and based on the achievement of specified levels of annual Glumetza net product sales, was required to pay additional one-time sales milestones to the Company. Santarus began promotion of Glumetza in October 2008 and was responsible for promoting Glumetza to physicians, and was responsible for advertising and promotional marketing activities for Glumetza. Depomed was responsible for manufacturing, distribution, pharmacovigilance and regulatory affairs under the promotion agreement.

Beginning in October 2008, Depomed began paying Santarus a promotion fee equal to 80% of the gross margin earned from net sales of Glumetza product in the United States. The promotion fee was reduced to 75% of gross margin beginning in the fourth quarter of 2010. For the years ended December 31, 2011, 2010 and 2009, the Company recognized $27.3 million, $31.4 million and $23.6 million, respectively, in promotion fee expense to Santarus related to sales of Glumetza by Depomed under the promotion agreement. Promotion fee expense is classified within selling, general and administrative expense.

In January 2011, the Company achieved the first of the sales milestones related to net sales of Glumetza reaching $50.0 million for the 13 month period ending January 31, 2011. As the milestone was achieved and related to past performance the entire $3.0 million was recognized in its entirety as milestone revenue in the first quarter of 2011.

In August 2011, the Company and Santarus entered into commercialization agreement that superseded the promotion agreement.

*Commercialization Agreement*

The commercialization agreement with Santarus granted Santarus exclusive rights to manufacture and commercialize Glumetza in the United States. Under the commercialization agreement, the Company transitioned to Santarus responsibility for manufacturing, distribution, pharmacovigilance and regulatory affairs. The Company ceased shipments of Glumetza in August 2011 and Santarus began distributing and recording product sales on shipments of Glumetza beginning in September 2011. Santarus continued to be responsible for promoting Glumetza to physicians, as well as advertising and promotional marketing activities for Glumetza.

Santarus will be required to pay the Company royalties on net product sales of Glumetza in the United States of 26.5% in 2011; 29.5% in 2012; 32.0% in 2013 and 2014; and 34.5% in 2015 and beyond prior to generic entry of a Glumetza product. In the event of generic entry of a Glumetza product in the United States, the parties will equally share proceeds based on a gross margin split. Santarus has the exclusive right to commercialize authorized generic versions of the Glumetza products. Santarus will not pay additional sales milestones to the Company as was required under the prior promotion agreement.

In connection with its assumption of distribution and sales responsibility of Glumetza, Santarus purchased Depomed's existing inventory of Glumetza and bulk metformin hydrochloride at cost.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 2. LICENSE AND COLLABORATIVE ARRANGEMENTS (Continued)**

Depomed will be financially responsible for returns of Glumetza distributed by Depomed, up to the amount of the product returns reserve account for Glumetza product returns on the date immediately before Santarus begins distributing Glumetza. Depomed will be financially responsible for Glumetza rebates and chargebacks up to the amount of its reserve accounts for those items. Santarus will be responsible for all other Glumetza returns, rebates and chargebacks.

Pursuant to the terms of the commercialization agreement, Depomed has the option to co-promote Glumetza products to physicians other than those called on by Santarus, subject to certain limitations. Depomed will be entitled to receive a royalty equal to 70% of net sales attributable to prescriptions generated by its called on physicians over a pre-established baseline.

Under the commercialization agreement, Depomed agreed to manage the patent infringement lawsuits against Sun Pharmaceutical Industries, Inc. (Sun) and Lupin Limited (Lupin), subject to certain consent rights in favor of Santarus, including with regard to any proposed settlements. Santarus will reimburse Depomed for 70% of its non-settlement out-of-pocket costs, and Depomed will reimburse Santarus for 30% of its non-settlement out-of-pocket costs related to these two existing infringement cases.

The commercialization agreement will continue in effect for so long as Santarus commercializes branded Glumetza or authorized generic products, unless terminated sooner. Subject to 60 days prior written notice to Santarus, Depomed may terminate the agreement if Santarus fails to meet its obligations with respect to minimum promotion and expenditure obligations and fails to cure such breach within a specified time period. Either party may terminate the agreement if the other party fails to perform any material term of the agreement and fails to cure such breach, subject to prior written notice within a specified time period. In addition, either party may terminate the agreement if a force majeure event prevents the other party from carrying out its material obligations under the agreement for a period of at least six months. Finally, either party may terminate the agreement if the other party becomes insolvent, files or consents to the filing of a petition under any bankruptcy or insolvency law or has any such petition filed against it, and within a specified time period, such filing has not been dismissed. Santarus has a voluntary right to terminate the agreement upon 120 days' written notice.

During 2011, Depomed distributed Glumetza for the first eight months of the year, recognized Glumetza product sales on those respective sales and paid Santarus a promotion fee equal to 75% of Glumetza gross margin. In the final four months of the year, the distribution and sales responsibility transitioned to Santarus. Santarus sold Glumetza for the final four months of the year, recognized Glumetza product sales on those respective sales and paid Depomed a royalty equal to 26.5% of net sales.

Royalty revenue from Santarus for the year ended 2011 was $9.6 million and represented four months of Santarus distributing Glumetza under the commercialization agreement. There were no royalty revenue amounts from Santarus in the prior year.

The Company accounted for the transaction as a sale of a business as defined by FASB Accounting Standards Codification Topic 805, "*Business Combinations*". In connection with entering into the commercialization agreement with Santarus, no additional consideration was exchanged between the two parties. Accordingly, the Company did not record a gain or loss with respect to this transaction and related transfer of Glumetza manufacturing and distribution activities. As the Company will have significant continuing cash inflows with respect to receiving royalties on net sales of Glumetza by

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 2. LICENSE AND COLLABORATIVE ARRANGEMENTS (Continued)**

Santarus, the previously reported and future activities related to Glumetza will continue to be presented in income from continuing operations in the Company's income statement.

Pursuant to the promotion agreement originally entered into in July 2008, Santarus paid the Company a $12.0 million upfront fee. The upfront payment received was originally being amortized as revenue ratably until October 2021, which represented the estimated length of time the Company's obligations existed under the promotion agreement related to manufacturing Glumetza and paying Santarus promotion fees on gross margin of Glumetza. The commercialization agreement in August 2011 superseded the promotion agreement and removed the manufacturing and promotion fee obligations of the Company. The commercialization agreement includes obligations with respect to manufacturing and regulatory transition to Santarus and managing the ongoing patent infringement lawsuits against Sun and Lupin. These obligations are estimated to be completed in December 2013. Accordingly, on the effective date of the commercialization agreement, the amortization period related to remaining deferred revenue on the $12.0 million upfront fee has been adjusted, and the remaining deferred revenue will be recognized ratably until December 2013. The Company recognized approximately $2.0 million, $0.9 million and $0.9 million of license revenue associated with this upfront license fee for each of the years ended December 31, 2011, 2010 and 2009. The remaining deferred revenue balance related to this upfront payment is $7.8 million at December 31, 2011.

***Ventiv Commercial Services, LLC***

In June 2011, the Company entered into a service agreement with Ventiv Commercial Services, LLC (Ventiv), pursuant to which inVentiv Selling Solutions, Ventiv's outsourced sales business, will provide sales force recruiting, training, deployment and ongoing operational support to the Company to promote Gralise. The agreement provides for a sales force of 164 full-time sales representatives dedicated to the Company, all of whom are employees of Ventiv.

Under the terms of the agreement, the Company paid Ventiv an upfront implementation fee and will pay an agreed upon fixed monthly management fee of approximately $1.8 million, which is subject to adjustment based on actual staffing levels. During the term of the agreement, a portion of Ventiv's monthly management fee will be subject to payment by the Company only to the extent that specified performance objectives are met. The Company will also pay certain pass-through costs of Ventiv incurred in connection with the agreement, which primarily include bonuses, travel costs and certain administrative expenses. The Company incurred $9.7 million of expense related to Ventiv during 2011.

The agreement will expire on the second anniversary of the date on which sales representatives hired by Ventiv are deployed. The agreement is subject to early termination under certain circumstances and may be terminated by either party upon advance notice beginning in October 2012. The agreement provides for conversion of sales representatives from Ventiv employees to Depomed employees beginning in October 2012 at an agreed-upon cost per employee converted.

***Abbott Products Inc. (formerly Solvay Pharmaceuticals, Inc.)***

In November 2008, the Company entered into an exclusive license agreement with Solvay Pharmaceuticals, Inc. (Solvay) granting Solvay exclusive rights to develop and commercialize Gralise for pain indications in the United States, Canada and Mexico. In February 2010, Abbott Laboratories acquired the pharmaceutical business of Solvay and Abbott Products (Abbott Products), a subsidiary of Abbott Laboratories, became responsible for the Gralise license agreement with the Company.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 2. LICENSE AND COLLABORATIVE ARRANGEMENTS (Continued)**

In March 2010, Abbott Products submitted a New Drug Application (NDA) for Gralise to the U.S. Food and Drug Administration (FDA) for the management of postherpetic neuralgia. In May 2010, the FDA accepted the NDA filing for Gralise for postherpetic neuralgia, which triggered a $10.0 million milestone payment from Abbott Products which Depomed received in June 2010. As the nonrefundable milestone was substantive in nature, achievement of the milestone was not reasonably assured at the inception of the agreement and the milestone was related to past performance, the Company recognized the entire $10.0 million as revenue in the second quarter of 2010.

In January 2011, Abbott Products received FDA approval of Gralise for the management of postherpetic neuralgia, this triggered a $48.0 million development milestone from Abbott to the Company, which the Company received in February 2011. As the nonrefundable milestone was substantive in nature, achievement of the milestone was not reasonably assured at the inception of the agreement and the milestone was related to past performance, the Company recognized the entire $48.0 million as revenue in the first quarter of 2011.

In January 2011, Abbott Products notified the Company that Abbott Products did not intend to commercialize Gralise. In March 2011, the Company entered into a settlement agreement with Abbott Laboratories which provide for (i) the immediate termination of the Gralise license agreement, (ii) the transition of Gralise back to Depomed; and (iii) a $40.0 million payment to Depomed which the Company received in March 2011. The $40.0 million payment was recognized as a gain within operating income in the first quarter of 2011.

Pursuant to the license agreement originally entered into in November 2008, Solvay paid the Company a $25.0 million upfront fee in February 2009. The upfront payment received was originally being amortized as revenue ratably until January 2013, which represented the estimated length of time the Company's development and supply obligations existed under the agreement. In connection with the termination of the license agreement with Abbott Products, the Company no longer has continuing obligations to Abbott Products. Accordingly, all remaining deferred revenue related to the $25.0 million upfront license fee previously received from Abbott Products was fully recognized as revenue in March 2011, resulting in immediate recognition of approximately $11.3 million of license revenue. The Company recognized $12.6 million, $6.2 million and $6.2 million of license revenue related this upfront fee for each of the years ended December 31, 2011, 2010 and 2009, respectively.

***Boehringer Ingelheim International GMBH***

In March 2011, the Company entered into a license and service agreement with Boehringer Ingelheim International GMBH (Boehringer Ingelheim) granting Boehringer Ingelheim a license to certain patents related to the Company's Acuform drug delivery technology to be used in developing fixed dose combinations of extended release metformin and proprietary Boehringer Ingelheim compounds in development for type 2 diabetes. Under the terms of the agreement, Boehringer Ingelheim was also granted a right of reference to the New Drug Application covering the Company's Glumetza product and associated data for use in potential regulatory submission processes.

In connection with the license and service agreement, the Company received an upfront payment of $10.0 million less applicable withholding taxes of approximately $1.5 million, for a net receipt of approximately $8.5 million in April 2011. The Company received the remaining $1.5 million of taxes previously withheld directly from German tax authorities in June 2011.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 2. LICENSE AND COLLABORATIVE ARRANGEMENTS (Continued)**

The $10.0 million upfront was amortized ratably through November 2011, which was the estimated length of time Depomed was obligated to perform formulation work under the agreement. Accordingly, the Company recognized the entire $10.0 million upfront license fee during the year ended 2011.

Under the terms of the agreement, the Company may receive an additional $2.5 million upon delivery of experimental batches of prototype formulations that meet certain specification. The Company is also eligible to receive additional milestone payments based on regulatory filing and approval events, as well as royalties on worldwide net sales of products.

Depomed is responsible for providing certain initial formulation work associated with the fixed dose combination products. Work performed by the Company under the service agreement will be reimbursed by Boehringer Ingelheim on an agreed-upon FTE rate per hour plus out-of-pocket expenses. The Company recognized approximately $0.9 million of revenue associated with the reimbursement of formulation work under the service agreement during 2011.

***Ironwood Pharmaceuticals, Inc.***

In July 2011, the Company entered into a collaboration and license agreement with Ironwood Pharmaceuticals, Inc. (Ironwood) granting Ironwood a license for worldwide rights to the Company's Acuform drug delivery technology for an undisclosed Ironwood early stage development program.

In connection with the agreement, the Company received an upfront payment of $0.9 million which is being amortized ratably through June 2012, which is the estimated length of time Depomed is obligated to perform formulation work under the agreement. The Company recognized approximately $0.4 million of revenue associated with this upfront license fee during the year ended December 31, 2011. The remaining deferred revenue balance related to this upfront payment is $0.5 million at December 31, 2011.

Under the terms of the agreement, the Company will assist with initial product formulation and Ironwood will be responsible for all development and commercialization of the product. The initial formulation work performed by the Company under the agreement will be reimbursed by Ironwood on an agreed-upon FTE rate per hour plus out-of-pocket expenses. The Company recognized approximately $0.2 million of revenue associated with the reimbursement of formulation work under the agreement during 2011.

Under the terms of the agreement, the Company may receive additional payments pending achievement of certain development and regulatory milestones, as well as royalties on product sales.

***Janssen Pharmaceutica N.V.***

In August 2010, the Company entered into a non-exclusive license agreement with Janssen Pharmaceutica N.V. (Janssen), granting Janssen a license to certain patents related to the Company's Acuform drug delivery technology to be used in developing fixed dose combinations of canagliflozin and extended release metformin. Under the terms of the agreement, Janssen was also granted a right of reference to the New Drug Application covering the Company's Glumetza product in Janssen's regulatory filings covering fixed dose combinations of canagliflozin and extended release metformin. The parties also entered into a service agreement under which Depomed is responsible for providing formulation work associated with the fixed dose combination products.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 2. LICENSE AND COLLABORATIVE ARRANGEMENTS (Continued)**

In August 2010, Janssen paid the Company a $5.0 million upfront license fee associated with the license agreement. The $5.0 million upfront payment was amortized as revenue ratably through March 2011, which was the estimated length of time Depomed is obligated to perform formulation work under the agreements. The Company recognized approximately $1.9 million and $3.1 million of revenue associated with this upfront license fee during the years ended December 31, 2011 and 2010, respectively.

Also in August 2010, the Company received a refundable $1.0 million prepayment for formulation work to be performed under the service agreement. Work performed by the Company under the service agreement was reimbursed by Janssen on an agreed-upon FTE rate per hour plus out-of-pocket expenses. The $1.0 million prepayment was initially deferred and recognized as revenue as the Company performed the related formulation work under the service agreement. The Company recognized approximately $0.3 million and $0.8 million of revenue associated with the reimbursement of formulation work under the service agreement during the years ended December 31, 2011 and 2010, respectively. All formulation work under the agreement has been completed.

Under the license agreement, the Company is also eligible to receive additional development milestones. In September 2010, the Company achieved the first development milestone under the agreement related to formulation work, which triggered a $5.0 milestone from Janssen to the Company. The non-refundable $5.0 million milestone was received in October 2010. As the non-refundable milestone was substantive in nature, achievement was not reasonably assured at the inception of the agreement, and relates to past performance, the Company recognized the $5.0 million milestone in its entirety as revenue during the third quarter of 2010.

The agreement also provides for royalties to the Company on future net sales of Janssen's fixed dosed combinations of canagliflozin and extended release metformin.

***Merck & Co., Inc.***

In July 2009, the Company entered into a non-exclusive license agreement with Merck & Co., Inc. (Merck) granting Merck a license to certain patents related to the Company's metformin extended release technology to be used in developing fixed dose combinations of sitagliptin and extended release metformin.

Under terms of the agreement, Merck received a non-exclusive license as well as other rights to certain Depomed patents directed to metformin extended release technology. In exchange, the Company received a $10.0 million upfront fee in August 2009. As the Company has no continuing obligations under the agreement, the $10.0 million upfront payment was fully recognized as revenue on receipt in the third quarter of 2009.

Merck was also granted a right of reference to the New Drug Application covering the Company's Glumetza product in Merck's regulatory filings covering fixed dose combinations of sitagliptin and extended release metformin. In October 2010, the Company received a $2.5 million development milestone from Merck related to the acceptance of the NDA application of Merck's combination product under the agreement, Janumet® XR (sitagliptin and metformin hydrochloride extended-release tablets). As the milestone was substantive in nature, and the achievement of the milestone was not reasonably assured at the inception of the agreement, the Company recognized the $2.5 million milestone in its entirety as revenue during the fourth quarter of 2010.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 2. LICENSE AND COLLABORATIVE ARRANGEMENTS (Continued)**

In February 2012, Merck received FDA approval to market Janumet XR in the United States, the Company expects Merck to begin selling Janumet XR during the first quarter of 2012 . The Company is entitled to receive very low single digit royalties on net product sales of Janumet XR through the expiration date of the licensed patents.

***Covidien***

In November 2008, the Company entered into a license agreement with Mallinckrodt, Inc., a subsidiary of Covidien, Ltd. (Covidien) granting Covidien worldwide rights to utilize the Company's Acuform technology for the exclusive development of four products containing acetaminophen in combination with opiates. In 2008, Covidien paid the Company a total of $5.5 million in upfront fees, representing a $4.0 million upfront license fee and a $1.5 million non-refundable upfront payment for formulation work to be performed by Depomed under the agreement. Under the agreement, the Company may also receive certain developmental milestone payments, if achieved, and is also entitled to receive royalties on sales of the products.

The entire $5.5 million was accounted for as a single unit of accounting and being amortized ratably through November 2011, which was initially the estimated length of time Depomed was obligated to perform formulation work under the agreement. The development of each of the four products was to begin by November 2010. Covidien initiated development on two of the four products prior to November 2010, but also elected not to initiate development of the remaining two products under the agreement. The license rights to those two remaining products reverted back to Depomed. Depomed's formulation obligations related to the first and second products were completed in October 2009 and September 2010, respectively. Because Covidien did not elect to initiate development of the remaining two products by November 2010, Depomed's formulation obligations were completed during the fourth quarter of 2010. As Depomed no longer had any substantive continuing performance obligations, all remaining deferred revenue related to the $5.5 million in upfront license fees previously received from Covidien was fully recognized as revenue in the fourth quarter of 2010, which resulted in an immediate recognition of $1.8 million of previously deferred revenue. For the years ended December 31, 2011, 2010 and 2009, the Company recognized zero, $3.5 million and $1.8 million, respectively, of the upfront payments as license revenue.

Through December 31, 2011, the Company also recognized a total of $2.0 million in milestone revenue under the agreement. In October 2009, the first formulation was completed by Depomed and delivered to Covidien, which triggered a $0.5 million milestone payment from Covidien to Depomed in October 2009. In September 2010, the Company recognized $0.5 million on completion and delivery of the second formulation under the agreement to Covidien, and an additional $0.5 million on the first formulation under the agreement entering clinical development. In November 2011, the Company recognized $0.5 million on the second formulation under the agreement entering clinical development. Because each of the non-refundable milestones were substantive in nature, based on past performance and achievement was not reasonably assured at the inception of the agreement, each of the milestones were recognized as revenue in its entirety upon achievement.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 2. LICENSE AND COLLABORATIVE ARRANGEMENTS (Continued)**

*Patheon Puerto Rico, Inc.*

In September 2011, the Company entered into a manufacturing agreement with Patheon Puerto Rico, Inc. (Patheon), pursuant to which Patheon will manufacture, package and supply commercial quantities of Gralise.

Under the agreement, the Company will provide rolling forecasts to Patheon of its requirements for the product, a portion of which will be considered a firm purchase order. At December 31, 2011, the Company had non-cancelable purchase orders and minimum purchase obligations of approximately $1.3 million under the manufacturing agreement with Patheon for the manufacture of Gralise. The Company may obtain a portion of its product requirements from a second manufacturing source. The Company will be responsible for providing Patheon with the active pharmaceutical ingredient in Gralise.

The agreement will expire on May 31, 2016, subject to early termination under certain circumstances.

***Valeant Pharmaceuticals International, Inc. (Formerly Biovail Laboratories, Inc.)***

In May 2002, the Company entered into a development and license agreement granting Valeant Laboratories Incorporated (Valeant) an exclusive license in the United States and Canada to manufacture and market Glumetza. Under the terms of the agreement, the Company was responsible for completing the clinical development program in support of the 500mg Glumetza. In July 2005, Valeant received FDA approval to market Glumetza in the United States. In accordance with the license agreement, Valeant paid a $25.0 million license fee payment to the Company.

In April 2004, the Company and Valeant amended the Glumetza license agreement. Under the amended agreement, the Company would receive royalties on sales of Valeant's 1000mg metformin HCl tablet in the United States and Canada in exchange for allowing Valeant to use the Company's clinical data for its Metformin GR, a 500mg metformin HCl tablet, to support and accelerate regulatory submissions for Valeant's 1000mg tablet and to establish equivalence between the two dosage forms. In May 2005, Valeant received a Notice of Compliance for the 500mg and 1000mg strengths of Glumetza from the Therapeutic Products Directorate of Canada to market the products in Canada.

In October 2005, the Company delivered a notice of breach to Valeant and subsequently filed suit in respect of its license agreement with Valeant, related to the failure of Valeant to make the first commercial sale of the 500mg strength Glumetza within 120 days of approval in each of Canada and the United States as required in the license agreement. In December 2005, the Company settled its dispute with Valeant and entered into an amended license agreement whereby the Company granted to Valeant an exclusive license in Canada to manufacture and market the 500mg formulation of Glumetza and the Company established its right to manufacture and market the 500mg Glumetza in the United States and internationally with the exception of Canada. The Company will recognize the $25.0 million license fee payment as revenue ratably until October 2021, which represents the estimated length of time the Company's obligations exist under the arrangement related to royalties it is obligated to pay Valeant on net sales of the 500mg Glumetza in the United States and to use Valeant as the sole supplier of the 1000mg Glumetza. The Company recognized $1.6 million of license revenue related to the amortization of this upfront fee for each of the years ended December 31, 2011, 2010 and 2009.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 2. LICENSE AND COLLABORATIVE ARRANGEMENTS (Continued)**

The remaining deferred revenue balance related to the $25.0 million upfront payment was $15.7 million as of December 31, 2011.

Under the agreement, Valeant is obligated to pay the Company royalties of six percent on Canadian net sales of the 500mg Glumetza and one percent on Canadian net sales of the 1000mg Glumetza. The Company recognized royalty revenue under the agreement of $0.4 million, $0.3 million, and $0.2 million for the years ended December 31, 2011, 2010 and 2009, respectively.

The Company is obligated to pay Valeant royalties of one percent on net sales of the 500mg Glumetza in the United States. The Company recognized royalty expense under the agreement of $0.2 million, $0.1 million and $0.3 million for the years ended December 31, 2011, 2010 and 2009, respectively.

***PharmaNova, Inc.***

In October 2006, Depomed entered into a sublicense agreement with PharmaNova, Inc. Pursuant to the agreement, PharmaNova has granted the Company an exclusive sublicense, under a United States patent held by the University of Rochester, to develop and commercialize a product in the United States containing the compound gabapentin as its active pharmaceutical ingredient which is indicated for the treatment of hot flashes associated with menopause in women.

The Company paid PharmaNova an upfront license fee of $0.5 million and paid an additional $0.5 million upon dosing of the first patient in the Company's Phase 3 trials for the product in 2008. The Company is required to pay PharmaNova $1.0 million upon submission to the FDA of a New Drug Application for the product, and $2.0 million upon FDA approval of an NDA. The agreement also provides for royalty payments to PharmaNova on net sales of the product, and for milestone payments upon achievement of annual net sales in excess of certain thresholds. The Company also paid PharmaNova consultancy fees of $0.3 million over a ten month period beginning in November 2006.

***Settlement with TEVA Pharmaceuticals USA, Inc.***

In April 2008, the Company entered into a settlement and license agreement with Teva related to the patent infringement lawsuit filed by the Company against Teva affiliates IVAX Corporation and IVAX Pharmaceuticals, Inc. The settlement agreement provided for a one-time payment to the Company of $7.5 million, which the Company received in April 2008, and for a non-exclusive license in favor of Teva (including IVAX) to continue to market its generic Glucophage XR product in the United States.

The Company also received ongoing royalty payments from Teva on sales by Teva (including IVAX) of generic Glucophage XR in the United States, which was calculated as a percentage of sales, as reported by a third-party market research company. The royalty was subject to a $2.5 million aggregate cap, which was met during the third quarter of 2009. For the year ended December 31 2009, the Company recognized $1.3 million in royalty revenue related to this arrangement. A cumulative total of $2.5 million in royalties have been recognized to date under the settlement, with no royalties remaining under the aggregate cap.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 3. CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES**

Securities classified as available-for-sale as of December 31, 2011 and 2010 are summarized below (in thousands). Estimated fair value is based on quoted market prices for these investments.

| December 31, 2011 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Cash and cash equivalents: | | | | |
| Cash | $ 5,629 | $ | $ | $ 5,629 |
| Money market funds | 12,467 | | | 12,467 |
| U.S. corporate debt securities | 5,947 | | | 5,947 |
| Total cash and cash equivalents | $ 24,043 | $ | $ | $ 24,043 |
| Available-for-sale securities: | | | | |
| Total maturing within 1 year and included in marketable securities: | | | | |
| U.S. corporate debt securities | 49,717 | 10 | (9) | 49.718 |
| U.S. government agency debt securities | 5,503 | 2 | | 5,505 |
| U.S. Treasury securities | 6,870 | 13 | | 6,883 |
| Total maturing between 1 and 2 years and included in marketable securities: | | | | |
| U.S. corporate debt securities | 17,767 | 7 | (62) | 17,712 |
| U.S. government agency debt securities | 35,906 | 30 | (4) | 35,932 |
| Total available-for-sale securities | $ 115,763 | $ 62 | $ (75) | $ 115,750 |
| Total cash, cash equivalents and marketable securities | $ 139,806 | $ 62 | $ (75) | $ 139,793 |

| December 31, 2010 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Cash and cash equivalents: | | | | |
| Cash | $ 3,913 | $ | $ | $ 3,913 |
| Money market funds | 17,613 | | | 17,613 |
| U.S. Treasury securities | 1,000 | | | 1,000 |
| Total cash and cash equivalents | $ 22,526 | $ | $ | $ 22,526 |
| Available-for-sale securities: | | | | |
| Total maturing within 1 year and included in marketable securities: | | | | |
| U.S. corporate debt securities | 12,099 | 4 | (2) | 12,101 |
| U.S. government agency debt securities | 25,667 | 21 | | 25,688 |
| U.S. Treasury securities | 10,015 | 21 | | 10,036 |
| Total maturing between 1 and 2 years and included in marketable securities: | | | | |
| U.S. corporate debt securities | | | | |
| U.S. government agency debt securities | | | | |
| U.S. Treasury securities | 6,512 | 25 | | 6,537 |
| Total available-for-sale securities | $ 54,293 | $ 71 | $ (2) | $ 54,362 |
| Total cash, cash equivalents and marketable securities | $ 76,819 | $ 71 | $ (2) | $ 76,888 |

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 3. CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES (Continued)**

At December 31, 2011, the Company had eighteen securities in an unrealized loss position.

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2011 (in thousands):

| | Less than 12 months | | 12 months or greater | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. corporate debt securities | $ 22,118 | $ (71) | | | $ 22,118 | $ (71) |
| U.S. government agency debt securities | 14,530 | (4) | | | 14,530 | (4) |
| Total available-for-sale | $ 36,648 | $ (75) | $ | $ | $ 36,648 | $ (75) |

The gross unrealized losses above were caused by interest rate increases. No significant facts or circumstances have arisen to indicate that there has been any deterioration in the creditworthiness of the issuers of the securities held by the Company. Based on the Company's review of these securities, including the assessment of the duration and severity of the related unrealized losses and the Company's ability and intent to hold the investments until maturity, there were no other-than-temporary impairments for these securities as of December 31, 2011.

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs.

Level 1: Quoted prices in active markets for identical assets or liabilities.

Level 2: Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 3. CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES (Continued)**

The following table represents the Company's fair value hierarchy for its financial assets measured at fair value on a recurring basis as of December 31, 2011 (in thousands):

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Money market funds | $ 12,467 | $ | $ | $ 12,467 |
| U.S. corporate debt securities | | 73,378 | | 73,378 |
| U.S. government agency debt securities | | 41,437 | | 41,437 |
| U.S. Treasury securities | | 6,882 | | 6,882 |
| Total | $ 12,467 | $ 121,697 | $ | $ 134,164 |

The following table represents the Company's fair value hierarchy for its financial assets measured at fair value on a recurring basis as of December 31, 2010 (in thousands):

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Money market funds | $ 17,613 | $ | $ | $ 17,613 |
| U.S. corporate debt securities | | 12,101 | | 12,101 |
| U.S. government agency debt securities | | 25,688 | | 25,688 |
| U.S. Treasury securities | | 17,573 | | 17,573 |
| Total | $ 17,613 | $ 55,362 | $ | $ 72,975 |

There are no financial liabilities measured at fair value on a recurring basis as of December 31, 2011 and December 31, 2010.

**NOTE 4. 500mg GLUMETZA RECALL**

In June 2010, the Company conducted a voluntary class 2 recall of fifty-two lots of 500mg Glumetza tablets from wholesalers due to the presence of trace amounts of a chemical called 2,4,6-tribromoanisole (TBA) in bottles containing 500mg Glumetza tablets. As a result, the Company temporarily suspended product shipments of 500mg Glumetza in June 2010 and resumed product shipments in January 2011. For the year ended December 31, 2010, the Company took a return reserve of approximately $1.3 million related to estimated credit for returns to be given to its customers on returns of recalled product, which had the effect of reducing net product sales for the respective period. The Company also incurred $2.3 million of inventory write-offs during the year ended December 31, 2010, related to non-salable inventory resulting from the recall at the Company's third-party distribution and manufacturing facilities, which were recorded in cost of goods sold.

The 1000mg Glumetza was not subject to the recall.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 5. INVENTORIES**

Inventories relate to the manufacturing costs of the Company's Gralise product at December 31, 2011 and Glumetza product at December 31, 2010. In August 2011, the Company sold its Glumetza inventory, at cost, to Santarus as part of the commercialization agreement. See Note 2 for further information with regards to the Santarus commercialization agreement. Inventories are stated at the lower of cost or market and consist of the following (in thousands):

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Raw materials | $ 1,244 | $ 74 |
| Work-in-process | 643 | 202 |
| Finished goods | 2,831 | 1,254 |
| Deferred costs | 677 | 41 |
| Total | $ 5,395 | $ 1,571 |

Deferred costs represent the costs of Gralise and Proquin XR product shipped for which recognition of revenue has been deferred. See Note 4 of the Notes to Financial Statements for further discussion on inventory write-offs related to the Company's 500mg Glumetza recall in 2010.

**NOTE 6. PROPERTY AND EQUIPMENT**

Property and equipment consists of the following (in thousands):

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Furniture and office equipment | $ 957 | $ 821 |
| Laboratory equipment | 5,127 | 4,730 |
| Leasehold improvements | 3,280 | 3,164 |
| Construction in Progress | 56 | 111 |
| | 9,420 | 8,826 |
| Less accumulated depreciation | (8,350) | (8,128) |
| Property and equipment, net | $ 1,070 | $ 698 |

There was no property and equipment included under capitalized leases as of December 31, 2011 or December 31, 2010. Depreciation expense was $0.3 million, $0.4 million and $0.6 million for the years ended December 31, 2011, 2010 and 2009, respectively.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 7. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES**

Accounts payable and accrued liabilities consist of the following (in thousands):

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Accounts payable | $ 2,417 | $ 1,655 |
| Accrued compensation | 3,235 | 2,638 |
| Accrued clinical trial costs | 31 | 307 |
| Accrued rebates and sales discounts | 2,626 | 2,625 |
| Allowance for product returns | 9,843 | 5,355 |
| Accrued promotion fee | | 2,490 |
| Accrued contract sales organization fees | 3,365 | |
| Other accrued liabilities | 5,267 | 3,403 |
| Total accounts payable and accrued liabilities | $ 26,784 | $ 18,473 |

**NOTE 8. DEFERRED REVENUE**

Deferred revenue consists of the following (in thousands):

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Deferred revenue, current portion: | | |
| Deferred product sales | $ 6,960 | $ 1,041 |
| Deferred license revenue, current portion: | | |
| Valeant | 1,598 | 1,598 |
| Santarus | 3,952 | 905 |
| Ironwood | 482 | |
| Abbott Products | | 6,245 |
| Janssen | | 1,917 |
| Deferred license revenue, current portion | 6,032 | 10,665 |
| Deferred revenue, current portion | $ 12,992 | $ 11,706 |
| Deferred license revenue, non-current portion: | | |
| Valeant | 14,100 | 15,697 |
| Santarus | 3,832 | 8,882 |
| Abbott Products | | 6,347 |
| Deferred license revenue, non-current portion | 17,932 | 30,926 |
| Total deferred revenue | $ 30,924 | $ 42,632 |

Deferred product sales as of December 31, 2011 relate to Gralise and Proquin XR product shipments that have not been recognized as revenue in accordance with the Company's revenue recognition policy. Deferred product sales as of December 31, 2010 relate to Proquin XR product shipments that have not been recognized as revenue in accordance with the Company's revenue recognition policy.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 8. DEFERRED REVENUE (Continued)**

Deferred license revenue relates to upfront payments received by the Company under license and collaborative agreements with its partners. At December 31, 2011 and 2010, deferred license revenue consisted primarily of upfront license fee payments received from Santarus, Abbott Products, and Valeant.

In December 2004, the Company received a $25.0 million license fee payment under its agreements with Valeant. The $25.0 million license fee is being recognized as revenue ratably until October 2021, which represents the estimated length of time our obligations exist under the arrangement related to royalties we are obligated to pay Valeant on net sales of Glumetza in the United States and for our obligation and our licensee's (Santarus) obligation to use Valeant as the sole supplier of the 1000mg Glumetza.

In July 2008, the Company received a $12.0 million upfront payment under its promotion agreement with Santarus. The upfront payment received was originally being amortized as revenue ratably until October 2021, which represented the estimated length of time the Company's obligations existed under the promotion agreement related to manufacturing Glumetza and paying Santarus promotion fees on gross margin of Glumetza. The commercialization agreement in August 2011 superseded the promotion agreement and removed the manufacturing and promotion fee obligations of the Company. The commercialization agreement includes obligations with respect to manufacturing and regulatory transition to Santarus and managing the ongoing patent infringement lawsuits against Sun and Lupin. These obligations are estimated to be completed in December 2013. Accordingly, on the effective date of the commercialization agreement, the amortization period related to remaining deferred revenue on the $12.0 million upfront fee has been adjusted, and the remaining deferred revenue will be recognized ratably until December 2013.

In February 2009, the Company received a $25.0 million upfront payment under its exclusive license agreement with Abbott Products. The upfront payment received was originally being amortized as revenue ratably until January 2013, which represented the estimated length of time the Company's development and supply obligations existed under the agreement. In connection with the termination of the license agreement with Abbott Products, the Company no longer has continuing obligations to Abbott Products. Accordingly, all remaining deferred revenue related to the $25.0 million upfront license fee previously received from Abbott Products was fully recognized as revenue in March 2011.

In August 2010, Janssen paid the Company a $5.0 million upfront license fee associated with the license agreement. The $5.0 million was amortized ratably through March 2011, which was the estimated length of time we were obligated to perform formulation work under the agreements.

In July 2011, Ironwood paid the Company a $0.9 million upfront license fee associated with the collaboration and license agreement. The $0.9 million is being amortized ratably through June 2012, which is the estimated length of time Depomed is obligated to perform formulation work under the agreement.

**NOTE 9. LONG-TERM DEBT**

In June 2008, the Company entered into a loan and security agreement with General Electric Capital Corporation, as agent (GECC), and Oxford Finance Corporation (Oxford) that provided the Company with a $15.0 million credit facility. The credit facility was available in up to three tranches. The first tranche of $3.8 million was advanced to the Company upon the closing of the loan agreement.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 9. LONG-TERM DEBT (Continued)**

The second tranche of $5.6 million was advanced to the Company in July 2008. The third tranche of $5.6 million was not drawn and is no longer available to the Company, and GECC and Oxford waived the 2% unused line fee related to the unused portion of the credit facility.

The Company paid interest on the first tranche for the first six months at an interest rate of 11.59%. Thereafter we were required to pay principal on the first tranche, plus interest at such rate, in 30 equal monthly installments. The second tranche was interest-only through December 31, 2008, with principal and interest payable thereafter in 30 equal monthly installments with an interest rate of 11.59%. Interest expense, which includes amortization of the debt issuance costs was $0.1 million, $0.6 million and $1.0 million for the years ended December 31, 2011, 2010 and 2009, respectively. The credit facility was fully repaid in July 2011.

**NOTE 10. COMMITMENTS AND CONTINGENCIES**

***Leases***

In June 2011, the Company entered into amendments to its existing leases for the Company's premises located at 1330 and 1360 O'Brien Drive, Menlo Park, California, consisting of approximately 46,000 rentable square feet. The lease amendments extend the term of the existing leases for twelve months, from February 1, 2012 through January 31, 2013. All material provisions of the leases remain the same, except that the Company may not extend either of the lease terms. The lease for the Company's premises located at 1430 O'Brien Drive, consisting of approximately 9,000 rentable square feet, was not amended by the lease amendments and terminated on January 31, 2012.

Rent expense was $1.5 million for each of the years ended December 31, 2011 and 2010, and $1.4 million for the year ended December 31, 2009.

As of December 31, 2011 future minimum payments under operating leases for facilities and equipment were as follows (in thousands):

| | |
|---|---|
| 2012 | 1,490 |
| 2013 | 158 |
| Total | $ 1,648 |

***Manufacturing Agreements***

The Company has entered into a manufacturing arrangement with Patheon Puerto Rico (Patheon) pursuant to which Patheon will manufacture commercial quantities of Gralise for the Company. As of December 31, 2011 the Company has non-cancelable purchase orders and minimum purchase obligations to Patheon totaling approximately $1.3 million under this arrangement.

**NOTE 11. STOCK-BASED COMPENSATION**

The Company uses the Black-Scholes option valuation model to determine the fair value of stock options and employee stock purchase plan (ESPP) shares. The determination of the fair value of stock-based payment awards on the date of grant using an option valuation model is affected by the Company's stock price as well as assumptions which include the Company's expected term of the

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 11. STOCK-BASED COMPENSATION (Continued)**

award, the expected stock price volatility, risk-free interest rate and expected dividends over the expected term of the award.

As described in Note 1 of the Notes to Financial Statements, beginning on January 1, 2010, Depomed uses historical option exercise data to estimate the expected life of the options. Prior to 2010, because of a lack of sufficient data points, the Company did not believe its historical option exercise experience provided a reasonable basis upon which to estimate expected term, and the Company estimated the expected term by using the weighted average terms of a peer group of companies that grant options with similar vesting provisions. This change in estimate did not have a material effect on the Company's financial statements. The Company estimates the volatility of its common stock price by using the historical volatility over the expected term of the options. The Company bases the risk-free interest rate on U.S. Treasury zero-coupon issues with terms similar to the expected term of the options as of the date of grant. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model.

The Company used the following assumptions to calculate the fair value of option grants for the years ended December 31, 2011, 2010 and 2009:

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| **Employee and Director Stock Options** | | | |
| Risk-free interest rate | 0.77 - 1.99% | 1.51 - 2.62% | 1.64 - 2.82% |
| Dividend yield | None | None | None |
| Expected option term (in years) | 4.54 - 4.84 | 5.19 - 5.44 | 5.10 |
| Expected stock price volatility | 73.9 - 76.4% | 69.2 - 72.1% | 65.3 - 71.1% |

The Company used the following assumptions to calculate the fair value of purchase rights granted under the ESPP for the years ended December 31, 2011, 2010 and 2011:

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| **Employee Stock Purchase Plan** | | | |
| Risk-free interest rate | 0.05 - 0.44% | 0.20 - 0.78% | 0.15 - 0.97% |
| Dividend yield | None | None | None |
| Expected option term (in years) | 0.5 - 2.0 | 0.5 - 2.0 | 0.5 - 2.0 |
| Expected stock price volatility | 60.1 - 76.6% | 55.7 - 90.9% | 86.5 - 107.8% |

The following table presents stock-based compensation expense recognized for stock options, stock awards and the ESPP in the Company's Statements of Operations (in thousands):

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| Cost of sales | $ 68 | $ 19 | $ 23 |
| Research and development expense | 668 | 568 | 885 |
| Selling, general and administrative expense | 3,133 | 1,444 | 1,748 |
| Total | $ 3,869 | $ 2,031 | $ 2,656 |

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 11. STOCK-BASED COMPENSATION (Continued)**

For the year ended December 31, 2011, the Company recognized approximately $0.4 million in stock-compensation expense associated with the accelerated vesting of stock options in connection with a separation agreement and release with Carl A. Pelzel, the Company's former President and Chief Executive Officer. See Note 13 for further information with regards to the separation agreement and release.

The weighted-average grant date fair value of options granted during the years ended December 31, 2011, 2010 and 2009 were $4.38, $2.05 and $1.26, respectively. The weighted-average grant date fair value of purchase rights granted under the ESPP during the years ended December 31, 2011, 2010 and 2009 were $2.67, $2.00 and $1.39, respectively. The total intrinsic value of options exercised during the years ended December 31, 2011, 2010 and 2009 were $12.2 million, $0.8 million and $1.1 million, respectively. The total fair value of options that vested during the years ended December 31, 2011, 2010 and 2009 was $2.4 million, $1.7 million and $2.1 million, respectively. At December 31, 2011, Depomed had $7.3 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option plans that will be recognized over an average vesting period of 2.5 years. Cash received from stock option exercises was $7.6 million, $1.0 million and $1.7 million for the years ended December 31, 2011, 2010 and 2009, respectively.

***1995 Stock Option Plan***

The Company's 1995 Stock Option Plan (the 1995 Plan) was adopted by the Board of Directors and approved by the shareholders in September 1995, and has been subsequently amended. The 1995 Plan provided for the grant to employees of the Company, including officers, of incentive stock options, and for the grant of nonstatutory stock options to employees, directors and consultants of the Company. The number of shares authorized under the 1995 Plan is 4,700,000 shares, of which zero are available for future issuance at December 31, 2011. In May 2004, the 1995 Plan was terminated with respect to grants of new stock options and all options which expire or are forfeited will be retired from the pool.

Generally, the exercise price of all incentive stock options and nonstatutory stock options granted under the 1995 Plan must be at least 100% and 85%, respectively, of the fair value of the common stock of the Company on the grant date. The term of incentive and nonstatutory stock options may not exceed 10 years from the date of grant. An option shall be exercisable on or after each vesting date in accordance with the terms set forth in the option agreement. The right to exercise an option generally vests over four years at the rate of at least 25% by the end of the first year and then ratably in monthly installments over the remaining vesting period of the option.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 11. STOCK-BASED COMPENSATION (Continued)**

The following table summarizes the activity for the three years ended December 31, 2011 under the 1995 Plan:

| | Shares | Weighted-Average Exercise Price |
|---|---|---|
| Options outstanding at December 31, 2008 | 1,396,887 | $ 3.80 |
| Options exercised | (418,397) | 2.33 |
| Options forfeited | | |
| Options expired | (193,790) | 5.07 |
| Options outstanding at December 31, 2009 | 784,700 | $ 4.28 |
| Options exercised | (105,871) | 2.01 |
| Options forfeited | | |
| Options expired | (337,229) | 4.43 |
| Options outstanding at December 31, 2010 | 341,600 | $ 4.83 |
| Options exercised | (215,850) | 4.68 |
| Options forfeited | | |
| Options expired | (10,800) | 5.31 |
| Options outstanding at December 31, 2011 | 114,950 | $ 5.05 |
| Options exercisable and expected to become exercisable at December 31, 2011 | 114,950 | $ 5.05 |
| Options exercisable at December 31, 2011 | 114,950 | $ 5.05 |

| | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|
| Options outstanding at December 31, 2011 | 1.60 | $ 122 |
| Options exercisable and expected to become exercisable at December 31, 2011 | 1.60 | $ 122 |
| Options exercisable at December 31, 2011 | 1.60 | $ 122 |

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 11. STOCK-BASED COMPENSATION (Continued)**

Information regarding the stock options outstanding at December 31, 2011 under the 1995 Plan is summarized below:

| Range of Exercise Prices | Number Outstanding | Weighted-Average Remaining Contractual Term (Years) | Weighted-Average Exercise Price (Outstanding) | Number Exercisable | Weighted-Average Exercise Price (Exercisable) |
|---|---|---|---|---|---|
| $1.71 - $1.95 | 25,800 | 0.96 | $ 1.85 | 25,800 | $ 1.85 |
| $2.90 - $4.25 | 20,250 | 1.16 | 3.37 | 20,250 | 3.37 |
| $6.50 | 15,000 | 1.89 | 6.50 | 15,000 | 6.50 |
| $6.76 | 48,900 | 1.96 | 6.76 | 48,900 | 6.76 |
| $7.32 | 5,000 | 2.21 | 7.32 | 5,000 | 7.32 |
| | 114,950 | 1.60 | $ 5.05 | 114,950 | $ 5.05 |

***2004 Equity Incentive Plan***

The Company's 2004 Equity Incentive Plan (the 2004 Plan) was adopted by the Board of Directors and approved by the shareholders in May 2004. The 2004 Plan provides for the grant to employees of the Company, including officers, of incentive stock options, and for the grant of nonstatutory stock options to employees, directors and consultants of the Company. The number of shares authorized under the 2004 Plan is 9,250,000 shares, of which 1,364,088 were available for future issuance at December 31, 2011.

Generally, the exercise price of all incentive stock options and nonstatutory stock options granted under the 2004 Plan must be at least 100% and 85%, respectively, of the fair value of the common stock of the Company on the grant date. The term of incentive and nonstatutory stock options may not exceed 10 years from the date of grant. An option shall be exercisable on or after each vesting date in accordance with the terms set forth in the option agreement. The right to exercise an option generally vests over four years at the rate of at least 25% by the end of the first year and then ratably in monthly installments over the remaining vesting period of the option.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 11. STOCK-BASED COMPENSATION (Continued)**

The following tables summarize the activity for the three years ended December 31, 2011 under the 2004 Plan:

| | Shares | Weighted-Average Exercise Price |
|---|---|---|
| Options outstanding at December 31, 2008 | 4,182,155 | $ 3.65 |
| Options granted | 1,267,000 | 2.21 |
| Options exercised | (305,588) | 2.38 |
| Options forfeited | (341,762) | 3.48 |
| Options expired | (5,194) | 5.30 |
| Options outstanding at December 31, 2009 | 4,796,611 | $ 3.32 |
| Options granted | 1,159,500 | 3.37 |
| Options exercised | (353,091) | 2.32 |
| Options forfeited | (639,687) | 2.60 |
| Options expired | (22,988) | 5.51 |
| Options outstanding at December 31, 2010 | 4,940,345 | $ 3.21 |
| Options granted | 2,762,181 | 7.35 |
| Options exercised | (2,163,266) | 3.04 |
| Options forfeited | (639,043) | 4.51 |
| Options expired | | |
| Options outstanding at December 31, 2011 | 4,900,217 | $ 5.44 |
| Options exercisable and expected to become exercisable at December 31, 2011 | 4,261,152 | $ 5.20 |
| Options exercisable at December 31, 2011 | 2,055,457 | $ 4.03 |

| | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|
| Options outstanding at December 31, 2011 | 7.91 | $ 4,525 |
| Options exercisable and expected to become exercisable at December 31, 2011 | 7.70 | $ 4,426 |
| Options exercisable at December 31, 2011 | 6.28 | $ 3,179 |

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 11. STOCK-BASED COMPENSATION (Continued)**

Information regarding the stock options outstanding at December 31, 2011 under the 2004 Plan is summarized below:

| Range of Exercise Prices | Number Outstanding | Weighted-Average Remaining Contractual Term (Years) | Weighted-Average Exercise Price (Outstanding) | Number Exercisable | Weighted-Average Exercise Price (Exercisable) |
|---|---|---|---|---|---|
| $1.49 - $3.09 | 1,176,953 | 7.17 | $ 2.42 | 694,266 | $ 2.24 |
| $3.27 - $5.08 | 1,000,833 | 6.27 | 3.90 | 796,562 | 3.75 |
| $5.56 - $6.29 | 1,026,200 | 8.32 | 5.92 | 363,483 | 6.03 |
| $7.12 - $8.54 | 1,441,231 | 9.08 | 8.09 | 193,854 | 7.71 |
| $8.55 - $9.02 | 255,000 | 9.39 | 8.58 | 7,292 | 8.55 |
| | 4,900,217 | 7.91 | $ 5.44 | 2,055,457 | $ 4.03 |

**NOTE 12. SHAREHOLDERS' EQUITY**

***Employee Stock Purchase Plan***

In May 2004, the ESPP was approved by the shareholders. The ESPP is qualified under Section 423 of the Internal Revenue Code. The ESPP is designed to allow eligible employees to purchase shares of the Company's common stock through periodic payroll deductions. The price of the common stock purchased under the ESPP must be equal to at least 85% of the lower of the fair market value of the common stock on the commencement date of each offering period or the specified purchase date. The number of shares authorized for issuance under the ESPP as of December 31, 2011 was 1,500,000, of which 139,043 shares were available for future issuance.

In 2011, the Company sold 169,217 shares of its common stock under the ESPP. The shares were purchased at a weighted average purchase price of $4.20 with proceeds of approximately $0.7 million. In 2010, the Company sold 298,467 shares of its common stock under the ESPP. The shares were purchased at a weighted average purchase price of $1.28 with proceeds of approximately $0.4 million.

***Option Exercises***

Employees and consultants exercised options to purchase 2,379,116 shares of the Company's common stock with net proceeds to the Company of approximately $7.6 million during the year ended December 31, 2011. Employees and consultants exercised options to purchase 458,962 shares of the Company's common stock with net proceeds to the Company of approximately $1.0 million during the year ended December 31, 2010.

***Shareholder Rights Plan***

On April 21, 2005, the Company adopted a shareholder rights plan, (the Rights Plan). Under the Rights Plan, the Company distributed one preferred share purchase right for each share of common stock outstanding at the close of business on May 5, 2005. If a person or group acquires 20% or more of the Company's common stock in a transaction not pre-approved by the Company's Board of Directors, each right will entitle its holder, other than the acquirer, to buy additional shares of the Company's common stock at 50% of its market value, as defined in the Rights Plan. In addition, if an

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 12. SHAREHOLDERS' EQUITY (Continued)**

unapproved party acquires more than 20% of the Company's common stock, and the Company is later acquired by the unapproved party or in a transaction in which all shareholders are not treated alike, shareholders with unexercised rights, other than the unapproved party, will be entitled to receive upon exercise of the rights, common stock of the merger party or asset buyer with a value of twice the exercise price of the rights. Each right also becomes exercisable for one one-thousandth of a share of the Company's Series RP preferred stock at the right's then current exercise price ten days after an unapproved third party makes, or announces an intention to make, a tender offer or exchange offer that, if completed, would result in the unapproved party acquiring 20% or more of the Company's common stock. The Board of Directors may redeem the rights for a nominal amount before an event that causes the rights to become exercisable. The rights will expire on April 21, 2015.

***Equity Line of Credit***

In December 2006, the Company entered into a common stock purchase agreement with Azimuth Opportunity, Ltd., pursuant to which Azimuth is committed to purchase at a specified discount, up to the lesser of (a) $30,000,000 of the Company's common stock, or (b) 8,399,654 shares of common stock, which was equal to the number of shares that is one less than 20% of the issued and outstanding shares of the Company's common stock as of December 11, 2006. The term of the original agreement was 24 months. In August 2008, the agreement was amended and the agreement was extended an additional 24 months until December 2010. The agreement expired on December 31, 2010 and the Company did not sell any shares under the agreement.

**NOTE 13. RELATED PARTY TRANSACTIONS**

***Carl A. Pelzel***

In April 2011, the Company entered into a separation agreement and release with Carl A. Pelzel, the Company's former President and Chief Executive Officer. Pursuant to the separation agreement, Mr. Pelzel is being paid $520,000, which is equivalent to one year of his base salary. Payments are being made over one year, and will be reduced dollar-for-dollar by any compensation Mr. Pelzel receives in connection with employment (or full-time consulting) by another employer (or third party). The Company is also paying Mr. Pelzel's health and dental insurance COBRA premiums for up to 18 months following his separation from the Company. The separation agreement further provides for three months' accelerated vesting of Mr. Pelzel's options to purchase the Company's common stock, and a release of claims in favor of the Company. The Company incurred a one-time severance charge of approximately $1.0 million in the second quarter of 2011 with respect to this separation agreement, consisting of approximately $0.4 million in stock-based compensation related to the accelerated vesting of Mr. Pelzel's awards and approximately $0.6 million of severance expense related to future payments and health care benefits.

**NOTE 14. QUALIFYING THERAPEUTIC DISCOVERY PROJECT**

In November 2010, the Company was awarded a total of $489,000 in two grants by the U.S. government under the Qualifying Therapeutic Discovery Project of the Patient Protection and Affordable Care Act of 2010 for the Company's Serada for menopausal hot flashes and DM-1992 for Parkinson's disease programs. The amounts were recorded in Interest and Other Income in the Statements of Operations.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 15. INCOME TAXES**

The Benefit from (provision for) income taxes consists of the following (in thousands):

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Current: | | | |
| Federal | $ 466 | $ 10 | $ 18 |
| State | (858) | (1) | 2 |
| Foreign | (4) | (5) | (5) |
| | (396) | 4 | 15 |
| Deferred: | | | |
| Federal | | | |
| State | | | |
| Foreign | | | |
| Total provision for income taxes | $ (396) | $ 4 | $ 15 |

A reconciliation of income taxes at the statutory federal income tax rate to the actual tax rate included in the statements of operations is as follows (in thousands):

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Tax at federal statutory rate | $ (24,893) | $ (1,323) | $ 7,488 |
| State tax, net of federal benefit | (558) | (1) | 2 |
| Foreign tax | (4) | (5) | (5) |
| Net operating losses | 25,510 | 1,812 | (6,774) |
| Federal AMT | 466 | | |
| Other | (917) | (479) | (696) |
| | $ (396) | $ 4 | $ 15 |

The Company's tax provision for the year ended December 31, 2011 is due to state taxes and foreign taxes withheld on royalty revenue related to the Company's agreement with LG by the Republic of Korea, offset by federal refundable credits.

The Company's tax benefits for the years ended December 31, 2010 and 2009 is due to Federal and state refundable credits offset by foreign taxes withheld on royalty revenue related to the Company's agreement with LG by the Republic of Korea.

As of December 31, 2011, the Company had net operating loss carryforwards for federal income tax purposes of approximately $27.0 million, which expire in the years 2021 through 2030 and federal research and development tax credits of approximately $6.4 million which expire in the years 2012 through 2030. Net operating loss carryforwards for state income tax purposes were approximately $77.0 million, which expire in the years 2017 through 2030 and state research and development tax credits were approximately $1.6 million which have no expiration date. The Company has federal alternative minimum tax credit carryforwards of approximately $10,000 that have no expiration date.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 15. INCOME TAXES (Continued)**

Additionally, the Company has foreign tax credit carryforwards of approximately $0.2 million, which begin to expire in 2014.

Utilization of the Company's net operating loss and credit carryforwards may be subject to a substantial annual limitation due to ownership change limitations provided by the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses and credits before utilization.

Deferred income taxes reflect the net tax effects of net operating loss and tax credit carryovers and temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets are as follows (in thousands):

| | Year Ended December 31, | |
|---|---|---|
| **Deferred Tax Assets:** | **2011** | **2010** |
| Net operating loss carryforwards | $ 9,700 | $ 31,600 |
| Tax carryforwards | 4,700 | 7,100 |
| In-process research and development | 1,500 | 1,900 |
| Capitalized research expenses | 200 | 400 |
| Deferred revenue | 12,000 | 16,200 |
| Other, net | 6,600 | 5,100 |
| Total deferred tax assets | 34,700 | 62,300 |
| Valuation allowance for deferred tax assets | (34,700) | (62,300) |
| Deferred tax assets, net | $ | $ |

Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Accordingly, the net deferred tax assets have been fully offset by a valuation allowance. The valuation allowance decreased by $27.6 million, $2.1 million and increased by $9.1 million during the years ended December 31, 2011, 2010 and 2009 respectively.

At December 31, 2011, the portion of the federal and state net operating loss carryforwards related to stock option deductions is approximately $10.3 million, which is not included in the Company's gross or net deferred tax assets.

The Company files income tax returns in the United States federal jurisdiction and in various states, and the tax returns filed for the years 1995 through 2011 have not been examined and the applicable statutes of limitation have not expire with respect to those returns. Because of net operating loss and research credit carryovers, substantially all of the Company's tax years remain open to examination.

Interest and penalties, if any, related to unrecognized tax benefits, would be recognized as income tax expense by the Company. As of the date of adoption of authoritative guidance for *Accounting for Uncertainty in Income Taxes*, the Company did not have any accrued interest or penalties associated with any unrecognized tax benefits.

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 15. INCOME TAXES (Continued)**

The following table summarizes the activity related to our unrecognized tax benefits for the 2 years ended December 31, 2011 (in thousands):

| | |
|---|---|
| Unrecognized tax benefits January 1, 2010 | $ 3,226 |
| Gross increases prior year tax positions | 166 |
| Gross increases current year tax positions | |
| Settlements with taxing authorities | |
| Expiration of statute of limitations | |
| Unrecognized tax benefits December 31, 2010 | $ 3,392 |
| Gross increases current year tax positions | 181 |
| Settlements with taxing authorities | |
| Expiration of statute of limitations | |
| Unrecognized tax benefits December 31, 2011 | $ 3,573 |

Though our unrecognized tax benefits may change during the next year for items that arise in the ordinary course of business, we do not expect any such change to be significant.

**NOTE 16. SUMMARIZED QUARTERLY DATA (UNAUDITED)**

The following tables set forth certain Statements of Operations data for each of the eight quarters beginning with the quarter ended March 31, 2010 through the quarter ended December 31, 2011 (in thousands). This quarterly information is unaudited, but has been prepared on the same basis as the annual financial statements and, in the opinion of management, reflects all adjustments, consisting only of normal recurring adjustments necessary for a fair representation of the information for the periods presented. Operating results for any quarter are not necessarily indicative of results for any future period.

| | 2011 Quarter Ended | | | |
|---|---|---|---|---|
| | March 31 | June 30 | September 30 | December 31 |
| Product sales | $ 15,311 | $ 16,153 | $ 9,205 | $ 508 |
| Total revenues | 83,101 | 21,218 | 16,522 | 12,132 |
| Gross margin on product sales | 13,676 | 14,013 | 8,055 | (111) |
| Income (loss) from operations | 98,809 | (5,996) | (9,310) | (12,807) |
| Net income (loss) | 98,817 | (5,679) | (8,576) | (13,836) |
| Basic net income (loss) per share | $ 1.85 | $ (0.11) | $ (0.15) | $ (0.25) |
| Diluted net income (loss) per share | $ 1.77 | $ (0.11) | $ (0.15) | $ (0.25) |

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**DEPOMED, INC.**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**NOTE 16. SUMMARIZED QUARTERLY DATA (UNAUDITED) (Continued)**

| | 2010 Quarter Ended | | | |
|---|---|---|---|---|
| | March 31 | June 30 | September 30 | December 31 |
| Product sales | $ 12,601 | $ 11,657 | $ 9,829 | $ 11,550 |
| Total revenues | 15,360 | 24,419 | 20,127 | 20,858 |
| Gross margin on product sales | 11,120 | 8,676 | 7,330 | 10,414 |
| Income (loss) from operations | (3,737) | 4,228 | 1,922 | 1,212 |
| Net income (loss) | (3,827) | 4,126 | 1,891 | 1,706 |
| Basic net income (loss) per share | $ (0.07) | $ 0.08 | $ 0.04 | $ 0.03 |
| Diluted net income (loss) per share | $ (0.07) | $ 0.08 | $ 0.04 | $ 0.03 |

**NOTE 17. SUBSEQUENT EVENTS**

***Merck***

In February 2012, Merck received FDA approval to market Janumet XR in the United States, and the Company expects Merck to begin selling Janumet XR during the first quarter of 2012. The Company is entitled to receive very low single digit royalties on net product sales of Janumet XR through the expiration date of the licensed patents.

***Lupin***

In February 2012, the Company and its Glumetza licensee, Santarus, entered into a settlement agreement with Lupin Ltd. and its subsidiary, Lupin Pharmaceuticals, Inc., to resolve pending patent litigation involving Glumetza.

The settlement agreement grants Lupin the right to begin selling a generic version of Glumetza on February 1, 2016, or earlier under certain circumstances. The settlement agreement is subject to review by the U.S. Department of Justice and the Federal Trade Commission, as well as entry by the U.S. District Court for the Northern District of California of an order dismissing the litigation.

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**SCHEDULE II: VALUATION AND QUALIFYING ACCOUNTS**

**(in thousands)**

| Description | Balance at Beginning of Year | Additions Charged as a Reduction to Revenue(1) | Additions Change in Deferred Revenue(1) | Deductions(2) | Balance at End of Year |
|---|---|---|---|---|---|
| Sales & return allowances, discounts, chargebacks and rebates: | | | | | |
| Year ended December 31, 2011 | $ 8,092 | $ 12,960 | $ 516 | $ (9,009) | $ 12,559 |
| Year ended December 31, 2010 | $ 7,859 | $ 14,060 | $ (50) | $ (13,777) | $ 8,092 |
| Year ended December 31, 2009 | $ 3,742 | $ 11,284 | $ 21 | $ (7,188) | $ 7,859 |

(1) Additions to sales discounts and allowances are recorded as a reduction of deferred revenue until such time revenue is recognized.

(2) Deductions to sales discounts and allowances relate to discounts or allowances actually taken or paid.