

DURECT CORP  
Form 10-K  
March 13, 2008  
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UNITED STATES  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2007

OR

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

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

Commission file number: 000-31615

**DURECT CORPORATION**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of

94-3297098  
(I.R.S. Employer

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incorporation or organization)

Identification No.)

2 Results Way

Cupertino, CA 95014

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (408) 777-1417

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

None

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

Common Stock, \$0.0001 par value

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ☐ NO ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 of the Act. YES ☐ NO ☒

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

Indicate by check mark 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. ☒

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

Large accelerated filer ☐ Accelerated filer ☒ Smaller reporting company ☐ Non-accelerated filer ☐  
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES ☐ NO ☒

The aggregate market value of the voting stock held by non-affiliates of the registrant was approximately \$248,606,755 as of June 30, 2007 based upon the closing sale price on the Nasdaq Global Market reported for such date. Shares of Common Stock held by each officer and director and by each person who may be deemed to be an affiliate have been excluded. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

There were 74,112,239 shares of the registrant's Common Stock issued and outstanding as of February 29, 2008.

## DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates information by reference from the definitive Proxy Statement for the 2008 annual meeting of stockholders, which is expected to be filed not later than 120 days after the Registrant's fiscal year ended December 31, 2007.



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**FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007**  
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Overview**

We are an emerging specialty pharmaceutical company focused on the development of pharmaceutical products based on our proprietary drug delivery technology platforms. We are developing pharmaceutical systems that will deliver the right drug to the right place in the right amount at the right time to treat chronic or episodic diseases and conditions. By integrating chemistry and engineering advancements, we can achieve what drugs or devices alone cannot. Our pharmaceutical systems enable optimized therapy for a given disease or patient population by controlling the rate and duration of drug administration as well as, for certain applications, placement of the drug at the intended site of action. Our proprietary drug delivery technology platforms include:

**SABER Delivery System** a patented and versatile depot injectable useful for delivery of small molecules and biologics that can be formulated for systemic or local administration. The advantages of SABER may include reduced side effects, longer duration and smaller injection volume. Our first application is for controlled delivery of bupivacaine for post-operative pain relief (POSIDUR<sup>®</sup>), for which we have licensed commercialization rights in Europe and other select countries to Nycomed Danmark APS (Nycomed) while retaining commercialization rights in the United States, Canada, Asia and other countries. In 2007, we successfully completed a 122 patient Phase IIb clinical trial of POSIDUR for treatment of post-operative pain in patients undergoing inguinal hernia repair. We have held an end-of-Phase II meeting with the U.S. Food & Drug Administration (FDA) and are in dialogue with the FDA regarding our anticipated POSIDUR Phase III program.

**ORADUR Delivery System** an oral sustained release gel-cap technology. We believe that ORADUR can transform short-acting oral capsule forms into oral sustained release technology products with the added benefit of being less prone to abuse. Our first application is Remoxy<sup>®</sup>, a novel long-acting, abuse deterrent oral formulation of the opioid oxycodone, for which we have licensed worldwide rights to Pain Therapeutics, Inc. (Pain Therapeutics), which has in turn sublicensed the commercialization rights to King Pharmaceuticals, Inc. (King). In December 2007, it was announced that the pivotal Phase III trial for Remoxy successfully met its primary endpoint ( $p < 0.01$ ) that was prospectively defined by the FDA during the Special Protocol Assessment process. Pain Therapeutics has stated that they expect to file a New Drug Application (NDA) for Remoxy in the second quarter of 2008.

**TRANSDUR Delivery System** a proprietary transdermal patch technology. The advantages of TRANSDUR may include, depending on the application, less potential for abuse, longer use per patch and smaller patch size. Our first application is for a transdermal sufentanil patch (TRANSDUR-Sufentanil) which we have licensed to Endo Pharmaceuticals for the U.S. and Canada. TRANSDUR-Sufentanil is currently in Phase II clinical trials. Our second application of TRANSDUR is for a transdermal bupivacaine patch (ELADUR<sup>®</sup>), for which we own all worldwide rights. ELADUR successfully completed a Phase IIa clinical trial in the fourth quarter of 2007.

**DURIN Biodegradable Implant** a proprietary biodegradable drug-loaded implant that is absorbed into the body. DURIN enables parenteral (injectable) delivery over a period of weeks or months of both large and small molecules using our proprietary polymers. The advantages of DURIN may include small size, longer duration and constant rate of delivery. Our first application is Memryte<sup>®</sup>, a novel long-acting potential therapy for the treatment of Alzheimer's disease using leuprolide, for which we have licensed worldwide rights to Voyager Pharmaceutical Corporation (Voyager). Voyager has conducted clinical studies for Memryte but future development is pending Voyager's ability to obtain additional financing and is not assured.

*NOTE: POSIDUR<sup>®</sup>, SABER<sup>®</sup>, TRANSDUR<sup>®</sup>, ORADUR<sup>®</sup>, ELADUR<sup>®</sup>, DURIN<sup>®</sup>, CHRONOGESIC<sup>®</sup>, MICRODUR<sup>®</sup>, ALZET<sup>®</sup> and LACTEL<sup>®</sup> are trademarks of DURECT Corporation. Other trademarks referred to belong to their respective owners.*



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**DUROS® System** an osmotic implant technology licensed to us for specified fields from ALZA Corporation, a Johnson & Johnson Company (ALZA). DUROS is a miniature drug-dispensing subcutaneous pump which can be as small as a matchstick that can be used for therapies requiring systemic or site-specific administration of drug. The advantages of DUROS may include precise constant drug delivery of potent molecules. Our first application is CHRONOGESIC®, designed to deliver sufentanil for a period of three months for treatment of chronic pain, which we have licensed to Endo Pharmaceuticals for the U.S. and Canada. CHRONOGESIC completed a pilot Phase III clinical trial. Clinical trials have been suspended pending system redesign.

**MICRODUR** Biodegradable Microparticulates a patented biodegradable microparticulate depot injectable. Sustained release from a few days to many months can be achieved through suitable choice of polymers and processing.

Our pharmaceutical systems combine engineering with proprietary small molecule pharmaceutical and biotechnology drug formulation to yield proprietary delivery technologies and products. Through this combination, we are able to control the rate and duration of drug administration, as well as, when desired, target the delivery of the drug to its intended site of action, allowing our pharmaceutical systems to meet the special challenges associated with treating medical conditions over an extended period of time. Our pharmaceutical systems can enable new drug therapies or optimize existing therapies based on a broad range of compounds, including small molecule pharmaceuticals as well as biologics such as proteins, peptides and genes.

Our pharmaceutical systems are suitable for providing long-term drug therapy because they store highly concentrated, stabilized drugs in a small volume and can protect the drug from degradation by the body. This, in combination with our ability to continuously deliver precise and accurate doses of a drug, allows us to extend the therapeutic value of a wide variety of drugs, including those which would otherwise be ineffective, too unstable, too potent or cause adverse side effects. In some cases, delivering the drug directly to the intended site of action can improve efficacy while minimizing unwanted side effects elsewhere in the body, which often limit the long-term use of many drugs. Our pharmaceutical systems can thus provide better therapy for chronic diseases or conditions, or for certain acute conditions where longer drug dosing is required or advantageous, by replacing multiple injection therapy or oral dosing, improving drug efficacy, reducing side effects and ensuring dosing compliance. Our pharmaceutical systems can improve patients' quality of life by eliminating more repetitive treatments, reducing dependence on caregivers and allowing patients to lead more independent lives.

In addition to developing our own proprietary products, we also collaborate with pharmaceutical and biotechnology companies to develop and commercialize proprietary and enhanced pharmaceutical products based on our technologies.

**Product Research and Development Programs**

Our development efforts are focused on the application of our pharmaceutical systems technologies to potential products in a variety of chronic and episodic disease areas including pain, central nervous system, or CNS, disorders, cardiovascular disease and other chronic diseases. Our ongoing product research and development efforts in these areas are set forth in the following table:

| <b>Disease/Indication</b> | <b>Product Candidate</b>                                       | <b>Collaborator</b>                                                                                                        | <b>Technology Platform</b> | <b>Stage</b> |
|---------------------------|----------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------|----------------------------|--------------|
| Post Operative Pain       | POSIDUR<br>(Controlled release<br>injection of<br>bupivacaine) | Nycomed (Europe and<br>other select territories);<br>DURECT retains rights in<br>U.S., Canada, Asia and<br>other countries | SABER                      | Phase II     |

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| <b>Disease/Indication</b>                                      | <b>Product Candidate</b>                                  | <b>Collaborator</b>                                                             | <b>Technology Platform</b> | <b>Stage</b>                                                  |
|----------------------------------------------------------------|-----------------------------------------------------------|---------------------------------------------------------------------------------|----------------------------|---------------------------------------------------------------|
| Chronic Pain                                                   | TRANSDUR-Sufentanil<br>(Transdermal sufentanil)           | Endo (U.S. & Canada); DURECT retains rights in Europe, Asia and other countries | TRANSDUR                   | Phase II                                                      |
| Neuropathic Pain associated with Post-Herpetic Neuralgia (PHN) | ELADUR (Transdermal bupivacaine)                          | DURECT retains worldwide rights                                                 | TRANSDUR                   | Phase II                                                      |
| Chronic Pain                                                   | Remoxy (Oral controlled release oxycodone)                | King/Pain Therapeutics (worldwide)                                              | ORADUR                     | NDA Preparation                                               |
| Pain                                                           | Oral controlled release opioid (active agent undisclosed) | King/Pain Therapeutics (worldwide)                                              | ORADUR                     | Phase I                                                       |
| Alzheimer's Disease                                            | Memryte (Controlled Release Leuprolide Implant)           | Voyager (worldwide)                                                             | DURIN                      | Further development pending financing / partnering by Voyager |
| Chronic Pain                                                   | CHRONOGESIC (Systemic sufentanil)                         | Endo (U.S. & Canada); DURECT retains rights in Europe, Asia and other countries | DUROS                      | System redesign                                               |
| Central Nervous System Disorders                               | Various                                                   | DURECT retains worldwide rights                                                 | SABER/DUROS/DURIN          | Preclinical/Research Stage                                    |
| Cardiovascular Disorders                                       | Various                                                   | DURECT retains worldwide rights                                                 | SABER/DUROS/DURIN          | Preclinical/Research Stage                                    |

*Local Post-Operative Pain*

**Market Opportunity.** According to data published by the Center for Disease Control and Prevention, there are approximately 72 million ambulatory and inpatient procedures performed in the United States. Epidemiological studies indicate that up to 100% of surgical patients experience postoperative pain, with 50-75% reporting inadequate pain relief. The current standard of care for post-surgical pain includes oral opiate and non-opiate analgesics, transdermal opiate patches and muscle relaxants. While oral analgesics can effectively control post-surgical pain, they commonly cause side effects including drowsiness, constipation, cognitive impairment. Effective pain management can be compromised if patients fail to adhere to recommended dosing regimens because they are sleeping or disoriented. Post-surgical pain can be treated effectively with local anesthetics; however, the usefulness of current conventional medications is limited by their short duration of action.

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*Development Strategy.* We are developing POSIDUR, a sustained-release formulation of bupivacaine, using our SABER delivery system for the treatment of post-surgical pain. Bupivacaine is a local anesthetic agent currently used in the hospital for anesthesia and analgesia and for which the patent covering the chemical entity has expired. The physician would administer POSIDUR at the time of surgery to the surgical site. This formulation is designed to provide sustained regional analgesia from a single dose. We believe that by delivering effective amounts of a potent analgesic to the location from which the pain originates, adequate pain control can be achieved with minimal exposure to the remainder of the body, thus minimizing side effects. POSIDUR is intended to provide local analgesia for up to 3 days, which we believe coincides with the time period of greatest need for post-surgical pain control in most patients. In November 2006, we entered into a collaboration agreement with Nycomed Danmark, APS. Under the terms of the agreement, we licensed to Nycomed the exclusive commercialization rights to POSIDUR for the European Union (E.U.) and select other countries. Nycomed paid us an upfront license fee of \$14.0 million in 2006 and an \$8.0 million milestone payment in 2007 triggered by achievement of a clinical development milestone, with future potential additional milestone payments of up to \$180.0 million upon achievement of defined development, regulatory and sales milestones. We will jointly direct and equally fund with Nycomed a development program for POSIDUR intended to secure regulatory approval in both the U.S. and the E.U. In addition, we will manufacture and supply the product to Nycomed for commercial sale in the territory licensed to Nycomed. Nycomed will pay us blended royalties on sales in the defined territory of 15-40% depending on annual sales, as well as a manufacturing markup. We retain full commercial rights to POSIDUR in the U.S., Canada, Asia and certain other countries.

*Clinical Program.* In 2007, we successfully completed a 122 patient Phase IIb clinical trial of POSIDUR for treatment of post-operative pain in patients undergoing inguinal hernia repair. In the Phase IIb trial, POSIDUR at a dose of 5 mL demonstrated statistically significant reductions in pain and in total consumption of supplemental opioid analgesic medications versus placebo. These successful results triggered an \$8.0 million milestone payment by Nycomed to us under our agreement with Nycomed.

*Phase IIb Inguinal Hernia Trial**Design*

The POSIDUR Phase IIb clinical trial was designed to evaluate the tolerability, activity, dose response and pharmacokinetics of POSIDUR in patients undergoing open inguinal hernia repair. The study was conducted in Australia and New Zealand as a multi-center, randomized, double blind, placebo-controlled study in 122 patients. Study patients were randomized into three treatment groups: patients that were treated with POSIDUR 2.5 mL (n=43), POSIDUR 5 mL (n=47) and placebo (n=32). The co-primary efficacy endpoints for the study were Mean Pain Intensity on Movement area under the curve (AUC), a measure of pain over a period of 1-72 hours post-surgery, and the proportion of patients requiring supplemental opioid analgesic medication during the study. Secondary efficacy endpoints included Mean Pain Intensity on Movement AUC over the period 1-48 hours post-surgery, mean total consumption of supplemental opioid analgesic medication, and time to first use of supplemental opioid analgesic medication. The threshold for statistical significance was considered to be at the  $p < 0.05$  level.

*Results**Pain Control*

In relation to the co-primary endpoint of pain reduction as measured by Mean Pain Intensity on Movement AUC 1-72 hours post-surgery, the patient group treated with POSIDUR 5 mL reported thirty-one percent (31%) less pain versus placebo ( $p=0.0033$ ). A secondary endpoint measure reported a thirty-five percent (35%) reduction of pain as measured by Mean Pain Intensity on Movement AUC for the period 1-48 hours post-surgery between the POSIDUR 5 mL treatment group versus placebo ( $p=0.0007$ ).

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### *Consumption of Supplemental Opioid Analgesic Medication*

Fifty-three percent (53%) of the study patients in the POSIDUR 5 mL group took supplemental opioid analgesic medications versus seventy-two percent (72%) of the placebo patients ( $p=0.0909$ ). Although this positive trend for this co-primary endpoint in favor of the POSIDUR 5 mL group was not statistically significant, both secondary endpoints measuring opioid analgesic medication consumption were met at a statistically significant level. During the periods of 1-24 hours, 24-48 hours and 48-72 hours after surgery, placebo patients consumed approximately 3.5 ( $p=0.0009$ ), 2.9 ( $p=0.0190$ ) and 3.6 ( $p=0.0172$ ) times more supplemental opioid analgesic medications (mean total daily consumption of opioid analgesic medication in morphine equivalents), respectively, than the POSIDUR 5 mL treatment group. In addition, the median time to first use of supplemental opioid analgesic medication after surgery for the placebo patients was 2.7 hours versus >72 hours for the POSIDUR 5 mL treatment group ( $p=0.0197$ ).

### *Dose Finding*

POSIDUR administered at the dose of 5 mL showed statistically significant activity relative to placebo whereas POSIDUR administered at 2.5 mL showed a positive trend relative to placebo on certain parameters but the results were not statistically significant.

### *Safety*

The patient groups treated with POSIDUR 5 mL and POSIDUR 2.5 mL showed comparable safety profiles as the patient groups treated with placebo, and the drug administration appeared well tolerated. The side effects commonly observed with opioid medication use were less frequent in the POSIDUR 5 mL and 2.5 mL treatment groups compared to placebo.

### *Other Exploratory Phase II studies*

In addition to the Phase IIb study described above, we have also been conducting smaller exploratory Phase II studies in hernia, shoulder arthroscopy and appendectomy surgeries to evaluate different application techniques, clinical design and conduct as well as other investigational factors. These trials have been conducted in multiple cohorts, generally consisting of approximately 6 to 21 patients in each treatment group. Hernia and shoulder studies have been completed while an appendectomy study is on-going. In all the exploratory studies, patient groups treated with POSIDUR 5 mL and POSIDUR 2.5 mL showed comparable safety profiles as the patient groups treated with placebo, and the drug administration appeared well tolerated. Some treatment groups from the hernia and shoulder exploratory studies utilizing POSIDUR have shown positive activity as measured by reduction of pain or consumption of supplemental opioid analgesic medication versus placebo, while other treatment groups have not. We are continuing to evaluate these studies to understand the different results observed, and intend to apply our learnings in the design of our Phase III program.

We have held an end-of-Phase II meeting with the FDA and are in dialogue with the FDA regarding our anticipated POSIDUR Phase III program.

### *Chronic Pain (Systemic)*

**Market Opportunity.** Chronic pain, defined as lasting six months or longer, is usually the result of an ongoing condition or significant problem associated with chronic diseases, including cancer, various neurological and skeletal disorders and other ailments such as severe arthritis or a debilitating back injury. As the condition gets worse, the pain often gets worse. Also, long-lasting pain can affect the nervous system to the point where pain persists even if the condition that originally caused the pain is stabilized or improved. This is one reason patients often need stronger pain medication even if their underlying condition has been treated. Chronic pain affects as many as 50 million Americans annually. Worldwide opioid sales continue to grow and achieved projected annual sales in 2006 of over \$8.5 billion. Of this amount, OxyContin®, a brand name oral oxycodone-based painkiller and generic oral oxycodone products together accounted for approximately \$1.2 billion in sales,

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and Duragesic®, a leading transdermal fentanyl product, together with generic fentanyl patches accounted for approximately \$1.2 billion in sales.

*Development Strategy.* We are developing several products for the chronic pain market:

ORADUR-based oral sustained release, abuse deterrent opioid products, including Remoxy, licensed to Pain Therapeutics, which has in turn sublicensed the commercialization rights of these products to King;

TRANSDUR-Sufentanil, our proprietary transdermal patch licensed to Endo Pharmaceuticals (Endo) in the U.S. and Canada that is intended to provide sufentanil for a period of up to seven days from a single application;

CHRONOGESIC, a subcutaneous, implantable DUROS-based system licensed to Endo Pharmaceuticals in the U.S. and Canada that delivers sufentanil systemically at a constant rate for three months.

### *ORADUR-Opioid Products In Development*

#### *Remoxy (ORADUR-Oxycodone)*

Remoxy is an oral, long-acting oxycodone gelatin capsule under development with Pain Therapeutics, to which we have licensed exclusive, worldwide, development and commercialization rights under a development and license agreement entered into in December 2002. Subsequently, Pain Therapeutics has sublicensed the commercialization rights of Remoxy to King. Remoxy is formulated with our ORADUR technology and incorporates several abuse-deterrent properties with the convenience of twice-a-day dosing. Oxycodone is also the active drug ingredient in OxyContin®, a brand name oral painkiller, which together with generic oxycodone oral products, achieved annual sales of over \$1.2 billion in 2006. We will receive payments if certain development and regulatory milestones are achieved. We also receive reimbursement for our research and development efforts on Remoxy and a manufacturing profit on our supply of key product excipients for use in Remoxy. In addition, if Remoxy is commercialized, we will receive royalties for Remoxy of between 6.0% to 11.5% of net sales depending on the sales volumes.

*Clinical Program.* In December 2007, Pain Therapeutics and King Pharmaceuticals announced that the pivotal Phase III trial for Remoxy successfully met its primary endpoint ( $p < 0.01$ ) that was prospectively defined by the FDA during the Special Protocol Assessment process. In addition, the study achieved statistically significant results in secondary endpoints such as Quality of Analgesia ( $p < 0.01$ ) and Global Assessment ( $p < 0.01$ ). Pain Therapeutics has stated that they expect to file the NDA for Remoxy in the second quarter of 2008.

### *Additional ORADUR-Opioid Products in Development*

During 2006 and 2007, we also worked with King and Pain Therapeutics on the development of additional ORADUR abuse-resistant opioid drug candidates. In August 2006, King and Pain Therapeutics announced the initiation of a Phase I clinical trial for one of these drug candidates, and that the IND application for this drug candidate had been accepted by the FDA. In November 2006, Pain Therapeutics announced positive results from that Phase I clinical trial.

#### *TRANSDUR-Sufentanil Patch*

Our transdermal sufentanil patch (TRANSDUR-Sufentanil) under development is based on our proprietary TRANSDUR transdermal technology and is intended to provide continuous delivery of sufentanil for up to seven days from a single application, as compared to the three days of relief provided by currently available opioid patches. Sufentanil is a highly potent opioid that is currently used in hospitals as an analgesic for which the patent covering the chemical entity has expired. We anticipate that the small size of our sufentanil patch (potentially as small as 1/5th the size of currently marketed transdermal fentanyl patches for a therapeutically equivalent dose) and longer duration of delivery may offer improved convenience and compliance for patients. Worldwide sales for Duragesic®, a leading transdermal fentanyl product, along with generic fentanyl patches exceeded \$1.2 billion in 2006.

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In March 2005, we entered into an agreement with Endo granting Endo exclusive rights to develop, market and commercialize TRANSDUR-Sufentanil in the U.S. and Canada. We have received an initial payment of \$10.0 million, and we will receive up to \$35.0 million in additional milestone payments if specified development and commercialization milestones are achieved. If commercialized, we will also receive royalties based on the sale of TRANSDUR-Sufentanil in the U.S. and Canada. We have retained limited co-promotion rights to TRANSDUR-Sufentanil in the U.S. and Canada and full commercialization rights in the rest of the world. We continued to perform development activities for Endo with respect to TRANSDUR-Sufentanil throughout 2007.

*Clinical Program.* In 2005, we successfully completed the first clinical trial of the Phase II program for TRANSDUR-Sufentanil using patches manufactured by us to evaluate the transition of chronic pain patients from the Duragesic® fentanyl patch to TRANSDUR-Sufentanil. Endo, our licensee for the U.S. and Canadian markets, has entered into an agreement with a contract manufacturer, 3M Company (3M), related to manufacturing process development and scale-up for TRANSDUR-Sufentanil. Endo is conducting Phase II studies with TRANSDUR-Sufentanil designed to evaluate the conversion of chronic pain patients treated with oral opioid products to TRANSDUR-Sufentanil.

### *Local Pain*

*Market Opportunity.* Neuropathic pain is pain resulting from a disturbance of the central nervous system (brain and spinal cord) or peripheral nervous system (nerves outside the brain and spinal cord). There are a variety of conditions and diseases that produce neuropathic pain, including trauma and diseases such as multiple sclerosis and stroke. One form of neuropathic pain is a debilitating complication of herpes zoster referred to as Post-Herpetic Neuralgia (PHN or post-shingles pain), which is usually defined as the presence of pain at the site of eruption that lasts more than a month after the onset of zoster eruption. Within the affected skin supplied by the nerve root, patients have a variety of sensory abnormalities in addition to neuropathic pain. Pain can persist for months and occasionally years. The prevalence of PHN (including PHN lasting more than one year) is estimated to be approximately 144,000 people in the U.S.

*Development Strategy.* We are developing a transdermal bupivacaine patch (ELADUR) based on our proprietary TRANSDUR transdermal technology intended to provide continuous delivery of bupivacaine for up to three days from a single application, as compared to a wearing time limited to 12 hours with currently available lidocaine patches. We anticipate that ELADUR will have several potential differentiating attributes compared with currently marketed lidocaine patches, including extended duration of action and better wearability. We retain the worldwide commercialization rights to ELADUR.

*Clinical Program.* In 2007, we successfully completed a 60 patient Phase IIa clinical trial for ELADUR. In this study of patients suffering from PHN, ELADUR showed improved pain control versus placebo during the 3-day continuous treatment period. In addition, ELADUR appeared well tolerated overall, and patients treated with ELADUR and placebo exhibited similar safety profiles. We are currently conducting manufacturing scale-up and processing studies to secure additional Phase II and Phase III supplies, and are developing our clinical and regulatory strategy.

### *Alzheimer's Disease*

*Market Opportunity.* Alzheimer's disease is a progressive, degenerative and ultimately terminal brain disorder that gradually destroys a person's memory and ability to learn, reason, make judgments, communicate and carry out daily activities. There is currently no treatment that stops or materially slows the progression of Alzheimer's disease. It is estimated that Alzheimer's patients and their families spend more than \$200,000 on health care per patient and employers lose approximately \$60 billion per year on lost productivity as adult caregivers are forced to leave their jobs either permanently or temporarily to care for a family member with the disease. As a result, it is one of the world's largest unmet medical needs. The global market for currently available Alzheimer's disease drugs is growing rapidly and has been estimated to be over \$3.5 billion in 2006. It is estimated that over five million Americans suffer from Alzheimer's disease and this number could more than triple by mid-century.

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*Development Strategy.* In July 2002, we entered into a development and commercialization agreement with Voyager under which we granted Voyager the exclusive, worldwide rights to develop and commercialize a product, Memryte, using the DURIN implant system to deliver the peptide leuprolide acetate to treat Alzheimer's disease based on Voyager's patented method of treatment. Under the agreement, as amended, we will receive milestone payments from Voyager if specified development milestones are achieved, and, if the product candidate is commercialized, royalties of between 10% to 14% of net sales depending on the sales volumes. In addition, we will receive 10% of any upfront, milestone and other fees received by Voyager in the event that the product candidate is sublicensed to a third party.

*Clinical Program.* In October 2005, Voyager initiated a Phase III clinical trial for Memryte, which was truncated by Voyager in order to get an earlier look at potential efficacy. In the second quarter of 2007, Voyager informed its shareholders that it has observed positive outcome trends among women, but no positive effect among men in Voyager's truncated Phase III clinical trial. Based on these results, Voyager has stated that it intends to focus its efforts on developing Memryte for the treatment of Alzheimer's disease in women and on seeking a potential collaborative partner for the program. There can be no assurance that Voyager or any other party will continue development of Memryte.

### ***CHRONOGESIC***

Our CHRONOGESIC drug candidate, based on the DUROS technology, is intended for patients with chronic pain that is stable and opioid responsive and results from a variety of causes. CHRONOGESIC consists of a small osmotic pump, about the size of a matchstick, which is implanted under the skin of a patient in a simple out-patient procedure. Once implanted, CHRONOGESIC is designed to deliver sufentanil for period of up to three months from a single application. If approved for marketing and sale, CHRONOGESIC will provide an alternative to current therapies for the treatment of chronic pain such as pills and patches, as well as providing the potential advantages of physician controlled dosing, improved patient compliance and convenience and reduced potential for opioid abuse. CHRONOGESIC is being developed for the U.S. and Canadian markets in collaboration with Endo Pharmaceuticals, to which we have granted exclusive commercialization rights pursuant to a development, commercialization and supply license agreement entered into effective November 2002. We will receive from Endo milestone payments if specified development milestones are achieved, and, if commercialized, we will receive royalties based on sales of CHRONOGESIC in the U.S. and Canada.

*Clinical Program.* We have completed an initial Phase I clinical trial, a Phase II clinical trial, a pilot Phase III clinical trial and a pharmacokinetic trial for CHRONOGESIC. We are presently working to redesign the delivery system to address performance problems. We have stopped all clinical testing of CHRONOGESIC and will not resume clinical testing until the system design is completed.

### ***Biologics Programs***

The proteins and genes identified by the biotechnology industry are large, complex, intricate molecules, and many are unsuitable as drugs. If these molecules are given orally, they are often digested before they can have an effect; if given by injection, they may be destroyed by the body's natural processes before they can reach their intended sites of action. The body's natural elimination processes require frequent, high dose injections that may result in unwanted side effects. As a result, the development of biotechnology molecules for the treatment of human diseases has been limited, and advanced drug delivery systems such as we possess are required to realize the full potential of many of these protein and peptide drugs. We have active programs underway to apply our drug delivery systems to various biotechnology drugs and drug candidates, and have entered into a number of feasibility studies with biotechnology and pharmaceutical companies to test their products in our systems.

### ***Research Programs in other Therapeutic Categories***

We have underway a number of research programs covering medical diseases and conditions other than pain. Such programs include various diseases and disorders of the central nervous system (CNS), including schizophrenia and attention deficit/hyperactivity disorder. Another area of focus includes cardiovascular disease,

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including congestive heart failure. In conducting our research programs and determining which particular efforts to prioritize for formal development, we employ a rigorous opportunity assessment process that takes into account the unmet medical need, commercial opportunity, technical feasibility, clinical viability, intellectual property considerations, and the development path including costs to achieve various critical milestones.

## **Industry Background**

### *Chronic Diseases and Conditions*

Although the pharmaceutical, biotechnology and medical device industries have played key roles in increasing life expectancy and improving health, many chronic, debilitating diseases continue to be inadequately addressed with current drugs or medical devices. Cardiovascular disease, cancer, neurodegenerative diseases, diabetes, arthritis, epilepsy and other chronic diseases claim the lives of millions of Americans each year. These illnesses are prolonged, are rarely cured completely, and pose a significant societal burden in mortality, morbidity and cost. The Centers for Disease Control estimates that the major chronic diseases are responsible for approximately 1.7 million deaths or 70% of all deaths in the U.S. Chronic diseases cause major limitations in daily living for more than 25 million Americans. These diseases account for more than 70% of the \$1 trillion spent on health care each year in America. Demographic trends suggest that, as the U.S. population ages, the cost of treating chronic diseases will increase.

### *Current Approaches to Treatment*

Drugs are available to treat many chronic diseases, but harmful side effects can limit prolonged treatment. In addition, patients with chronic diseases commonly take multiple medications, often several times a day, for the remainder of their lives. If patients fail to take drugs as prescribed, they often do not receive the intended benefits or may experience side effects, which are harmful or decrease quality of life. These problems become more common as the number of drugs being taken increases, the regimen of dosing becomes more complicated, or the patient ages or becomes cognitively impaired. It is estimated that only half of prescribed medicines are taken correctly.

*The Pharmaceutical Industry.* The pharmaceutical industry has traditionally focused on the chemical structure of small molecules to create drugs that can treat diseases and medical conditions. The ability to use these molecules as drugs is based on their potency, safety and efficacy. Therapeutic outcome and ultimately the suitability of a molecule as a drug depends to a large extent on how it gets into the body, distributes throughout the body, reacts with its intended site of action and is eliminated from the body. However, small molecules can act in diverse tissues throughout the body resulting in unwanted side effects.

Most drugs require a minimum level in blood and tissues to have significant therapeutic effects. Above a maximum level, however, the drug becomes toxic or has some unwanted side effects. These two levels define the therapeutic range of the drug. With conventional oral dosing and injections, typically a large quantity of drug is administered to the patient at one time, which results in high blood levels of drug immediately after dosing. Because of these high levels, the patient can be over-medicated during the period immediately following dosing, resulting in wasted drug and possible side effects. Due to distribution processes and drug clearance, the blood level of drug falls as time elapses from the last dose. For some duration, the patient is within the desired therapeutic range of blood levels. Eventually, the blood level of drug falls sufficiently such that the patient becomes under-medicated and experiences little or no drug effect until the next dose is administered.

*The Biotechnology Industry.* Over the past twenty-five years, the biotechnology revolution and the expanding field of genomics have led to the discovery of huge numbers of proteins and genes. Tremendous resources have been committed in the hope of developing drug therapies that would better mimic the body's own processes and allow for greater therapeutic specificity than is possible with small molecule drugs. Unfortunately, this huge effort has led to only a limited number of therapeutic products. The proteins and genes identified by the biotechnology industry are large, complex, intricate molecules, and many are unsuitable as drugs. If these molecules are given orally, they are often digested before they can have an effect; if given by injection, they may

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be destroyed by the body's natural processes before they can reach their intended sites of action. The body's natural elimination processes require frequent, high dose injections that may result in unwanted side effects. As a result, the development of biotechnology molecules for the treatment of human diseases has been limited.

*The Drug Delivery Industry.* In the last thirty-five years, a multibillion dollar drug delivery industry has developed on the basis that medicine can be improved by delivering drugs to patients in a precise, controlled fashion. Several commercially successful oral controlled release products, transdermal controlled release patches, and injectable controlled release formulations have been developed. These products demonstrate that the delivery system can be as important to the ultimate therapeutic value of a pharmaceutical product as the drug itself. However, drug delivery products on the market today can still be improved, for example, by providing reduced abuse potential, targeted delivery to minimize systemic effects and longer delivery durations where useful. Furthermore, traditional drug delivery products are generally not capable of administering biotechnology agents such as proteins, peptides and genes.

*The Medical Device Industry.* Advances in the field of medical device technology have dramatically improved device miniaturization and sophistication and allowed minimally invasive surgical access to remote locations within the body. For example, a coronary bypass patient can be treated with a stent in a procedure with a relatively short recovery, rather than with major surgery. Most devices, however, apply only mechanical solutions, rather than delivering chemical or biological agents.

### **The DURECT Solution: Pharmaceutical Systems**

We are developing and commercializing pharmaceutical systems that will deliver the right drug to the right place in the right amount at the right time to treat chronic and episodic diseases and conditions. By integrating chemistry and engineering advancements, we can achieve what drugs or devices alone cannot. Our pharmaceutical systems enable optimized therapy for a given disease or patient population by controlling the rate and duration of drug administration. In addition, if advantageous for the therapy, our pharmaceutical systems can target the delivery of the drug to its intended site of action.

**The Right Drug:** By precisely controlling the dosage or targeting delivery to a specific site, we can expand the therapeutic use of compounds that otherwise would be too potent to be administered systemically, do not remain in the body long enough to be effective, or have significant side effects when administered systemically. This flexibility allows us to work with a variety of drug candidates including small molecules, proteins, peptides or genes.

**The Right Place:** In addition to enabling systemic delivery, if advantageous for the therapy, with precise placement of our proprietary catheters or biodegradable drug delivery formulations, we can design our pharmaceutical systems to deliver drugs directly to the intended site of action. This can ensure that the drug reaches the target tissue in effective concentrations, eliminate many side effects caused by delivery of drug to unintended sites in the body, and reduce the total amount of drug administered to the body.

**The Right Amount:** Our pharmaceutical systems can automatically deliver drug dosages continuously within the desired therapeutic range for the duration of the treatment period, from days to up to one year, without the fluctuations in drug levels associated with conventional pills or injections. This can reduce side effects, eliminate gaps in drug therapy, conveniently ensure accurate dosing and patient compliance, and may reduce the total amount of drug administered to the body.

**The Right Time:** Our pharmaceutical systems technologies are designed to minimize the need for intervention by the patient or care-giver and enhance dosing compliance. In addition to reducing the cost of care, continuous drug therapy frees the patient from repeated treatment or hospitalization, improving convenience and quality of life. Our systems are well-suited to deliver drug for the right period of time for the intended indication, whether for hours or days for acute indications or months or years for treating chronic, debilitating diseases such as chronic pain, cancer, heart disease, and neurodegenerative diseases. We believe that it is more effective to treat chronic diseases with continuous, long-term therapy than with alternatives such as multiple conventional injections or oral dosage forms that create short-term effects.

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### **DURECT Pharmaceutical Systems Technology**

DURECT's pharmaceutical systems combine technology innovations from the drug delivery and medical device industries with proprietary pharmaceutical and biologic drug formulations. These capabilities can enable new drug therapies or optimize existing therapies based on a broad range of compounds, including small molecule pharmaceuticals as well as biologics such as proteins, peptides and genes. We currently have six major technology platforms:

#### *The SABER Delivery System*

The SABER system is a patented controlled-release technology that can be formulated for systemic or local administration of active agents via the parenteral or oral route. We are researching and developing a variety of controlled-release products based on the SABER technology. These include injectable controlled release products for systemic and local delivery and oral products. We believe that our SABER system can provide the basis for the development of a state-of-the-art biodegradable, controlled-release injectable. The SABER system uses a high-viscosity base component, such as sucrose acetate isobutyrate (SAIB), to provide controlled release of the drug. When the high viscosity SAIB is formulated with drug, biocompatible excipients and other additives, the resulting formulation is liquid enough to inject easily with standard syringes and needles. After injection of a SABER formulation, the excipients diffuse away, leaving a viscous depot. Depending on how it is formulated, the SABER system can successfully deliver therapeutic levels of a wide spectrum of drugs from one day to three months from a single injection. Based on research and development work to date, our SABER technology has shown the following advantages:

*Peptide/Protein Delivery* The chemical nature of the SABER system tends to repel water and body enzymes from its interior and thereby stabilizes proteins and peptides. For this reason, we believe that the SABER system is well suited as a platform for biotechnology therapeutics based on proteins and peptides.

*Less Burst* Typically, controlled release injections are associated with an initial higher release of drug immediately after injection (also called "burst"). Animal and human studies have shown that injectables based on the SABER technology can be associated with less post-injection burst than is typically associated with other commercially available injectable controlled release technologies.

*High Drug Concentration* Drug concentration in a SABER formulation can be as high as 30%, considerably greater than is typical with other commercially available injectable controlled release technologies. As a result, smaller injection volumes are possible with this technology.

*Ease of Administration* Prior to injection, SABER formulations are fairly liquid and therefore can be injected through small needles. Additionally, because of the higher drug concentration of SABER formulations, less volume is required to be injected. Small injection volumes and more liquid solutions are expected to result in easier, less painful administration.

*Strong Patent Protection* The SABER system, SABER-like materials, and various applications of this technology to pharmaceuticals, medical devices and drug delivery are covered by United States and foreign patents. See Patents, Licenses and Proprietary Rights below.

*Ease of Manufacture* Compared to microspheres and other polymer-based controlled release injectable systems, SABER is readily manufacturable at low cost.

The SABER Technology is the basis of POSIDUR, which recently completed a Phase IIb clinical trial. In our clinical studies thus far, SABER formulations have been observed to be safe and well-tolerated, and no significant side effects or adverse events were reported.

#### *The TRANSDUR Transdermal Delivery System*

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Our TRANSDUR technology is a proprietary transdermal delivery system that enables delivery of drugs continuously for up to 7 days. The TRANSDUR technology is the basis for TRANSDUR-Sufentanil, which is currently in Phase II testing and which we have licensed to Endo in the U.S. and Canada. The TRANSDUR

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technology is also the basis for ELADUR, which is currently in Phase II testing and for which we have retained full commercialization rights.

### *The ORADUR Sustained Release Gel Cap Technology*

We are developing ORADUR sustained release oral technology based on our SABER technology. We believe that ORADUR can transform short-acting oral capsule dosage forms into sustained release oral products. Products based on our ORADUR technology can take the form of an easy to swallow gelatin capsule that uses a high-viscosity base component such as sucrose acetate isobutyrate (SAIB) to provide controlled release of active ingredients for a period of 12 to 24 hours of drug delivery. Oral dosage forms based on the ORADUR gel-cap may also have the added benefit of being less prone to abuse (e.g., by crushing or alcohol or water extraction) than other controlled release dosage forms on the market today. ORADUR-based products can be manufactured by a simple process using conventional methods making them readily scalable. These properties have the potential to make ORADUR-based products an attractive option for pharmaceutical companies that seek to develop abuse deterrent oral products. The ORADUR Technology is the basis of Remoxy, a novel long-acting oral formulation of the opioid oxycodone which is targeted to decrease the potential for oxycodone abuse. In December 2007, Remoxy successfully completed a pivotal Phase III study. Pain Therapeutics has stated that it anticipates filing the NDA for Remoxy in the second quarter of 2008. We also have a second ORADUR abuse-resistant opioid product in the Pain Therapeutics alliance, about which Pain Therapeutics has announced positive results from a Phase I clinical trial.

### *The DURIN Biodegradable Implant Technology*

Our DURIN technology is a proprietary biodegradable implant that enables parenteral delivery of drugs from several weeks to six months or more using our Lactel® brand polymers and co-polymers of lactic and glycolic acid. The DURIN technology can deliver a wide variety of drugs including small and large molecule compounds. Our proprietary implant design allows for a variety of possible delivery profiles including constant rate delivery. Because DURIN implants are biodegradable, at the end of its delivery life, what remains of the DURIN implant is absorbed by the body. The DURIN technology is the basis of Memryte for the treatment of Alzheimer's disease, with any future development controlled by Voyager.

### *The DUROS Technology*

The DUROS system is a miniature drug-dispensing pump which can be as small as a wooden matchstick. We have licensed the DUROS system for specified fields of use from ALZA, pursuant to a development and commercialization agreement entered into effective April 1998. The potential of the DUROS technology as a platform for providing drug therapy was demonstrated by the FDA's approval in March 2000 of ALZA's VIADUR® product (leuprolide acetate implant), a once-yearly implant for the palliative treatment of prostate cancer, the first approved product to incorporate the DUROS implant technology. The DUROS system can be used for therapies requiring systemic or site-specific administration of drug. To deliver drugs systemically as in our CHRONOGESIC product, the DUROS system is placed just under the skin, for example in the inner side of the upper arm, in an outpatient procedure that is completed in just a few minutes using local anesthetic. Removal or replacement of the product is also a simple and quick procedure completed in the doctor's office. The DUROS system is the basis of CHRONOGESIC under development in collaboration with Endo in the U.S. and Canada. Clinical trials have been suspended pending the redesign of the delivery system to address performance issues.

### *The MICRODUR Biodegradable Microparticulate Technology*

Our MICRODUR technology is a patented biodegradable microparticulate depot injectable. We have experience in microencapsulation of a broad spectrum of drugs using our Lactel® brand polymers and co-polymers of lactic and glycolic acid. In our MICRODUR process, both standard and proprietary polymers are used to entrap an active agent in solid matrices or capsules comprising particles generally between 10 and 125 microns in diameter. Through suitable choice of polymers and processing, sustained release from a few days to many months can be achieved. As with the DURIN technology, MICRODUR particles degrade fully in the body.

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after the active agent is released. Our range of experience extends from manufacture of the polymer raw material to process and product development, scale up and cGMP manufacture.

### **DURECT Strategy**

Our objective is to become a specialty pharmaceutical company by developing, and in the future, commercializing pharmaceutical systems that address significant medical needs and improve patients' quality of life. To achieve this objective, our strategy includes the following key elements:

*Focus on Chronic Debilitating Medical Conditions.* Many of the diseases that present the greatest challenges to medicine are chronic, debilitating diseases such as chronic pain, central nervous system disorders, cardiovascular disorders, cancer and degenerative neurological diseases. Our initial efforts will focus on using our versatile drug delivery platform technologies to develop products that address these diseases.

*Minimize Product Development Risk and Speed Time-to-Market.* Initially, we intend to minimize product development risk and speed time-to-market by using our drug delivery platform technologies to administer drugs for which medical data on efficacy and safety are available. This strategy reduces much of the development risk that is inherent in traditional pharmaceutical product discovery. We anticipate that we can expand the medical usefulness of existing well-characterized drugs in several ways:

expand uses or create new uses for existing drugs by delivering drugs continuously for convenient long dosing intervals;

create new uses for drugs which were previously considered to be too potent to be used safely by precisely controlling dosing or by delivering them directly to the site of action;

enhance drug performance by minimizing side effects; and

expand uses of drugs by delivering them to the target site.

We anticipate that our pharmaceutical systems can be more rapidly developed at lower cost than comparable products that are developed purely based on chemical solutions to the problems of efficacy, side effects, stability and delivery of the active agent. We believe that our ability to innovate more rapidly will allow us to respond more quickly to market feedback to optimize our existing pharmaceutical systems or develop line extensions that address new market needs.

*Enable the Development of Pharmaceutical Systems Based on Biotechnology and Other New Compounds.* We believe there is a significant opportunity for pharmaceutical systems to add value to therapeutic medicine by administering biologics, such as proteins, peptides and genes. We believe our technologies will improve the specificity, potency, convenience and cost-effectiveness of proteins, peptides, genes and other newly discovered drugs. Our systems can enable these compounds to be effectively administered, thus allowing them to become viable medicines. We can address the stability and storage needs of these compounds through our advanced formulation technology and package them in a suitable pharmaceutical system for optimum delivery. Through continuous administration, the SABER, TRANSDUR, ORADUR, DURIN, DUROS and MICRODUR technology platforms may eliminate or reduce the need for multiple injections of these drugs. In addition, through precise placement of our proprietary biodegradable drug formulations, proteins and genes can be delivered to specific tissues for extended periods of time, thus ensuring that large molecule agents are present at the desired site of action and minimizing the potential for adverse side effects elsewhere in the body.

*Diversify Risk by Pursuing Multiple Programs in Development.* In order to reduce the risks inherent in pharmaceutical product development, we have diversified our product pipeline such that we now presently have five different disclosed programs in clinical development, including two oral drugs, two transdermal patches and one injectable/implant drug. We believe that having multiple programs in development helps mitigate the negative consequences to us of any setbacks or delays in any one of our programs.

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*Enable Product Development Through Strategic Collaborations.* We believe that entering into selective collaborations with respect to our product development programs can enhance the success of our product development and commercialization, mitigate our risk and enable us to better manage our operating costs. Additionally, such collaborations enable us to leverage investment by our collaborators and reduce our net cash burn, while retaining significant economic rights.

*Build Our Own Sales and Marketing Organization.* Our goal is to become a specialty pharmaceutical company where we commercialize products with significant market potential. To that end, we intend, over the course of a few years, to build up commercial, sales and marketing capability and other required infrastructure in focused specialty areas. We may still choose to enter into strategic alliances from time to time consistent with our strategy to leverage the established sales organizations of third-party collaborators to achieve greater market penetration for some of our products than we could on our own. If we choose to enter into third-party collaborations to commercialize our pharmaceutical systems, we believe we have the flexibility to enter into these alliances under circumstances that allow us to retain greater economic participation because our pharmaceutical systems combine drugs for which medical data on efficacy and safety are available with proven technology platforms.

### **Third-Party Collaborations**

We have entered into the following collaboration agreements:

*Nycomed Danmark, APS.* In November 2006, we entered into a collaboration agreement with Nycomed. Under the terms of the agreement, we licensed to Nycomed the exclusive commercialization rights to POSIDUR for the European Union (E.U.) and select other countries. Nycomed paid us an upfront license fee of \$14.0 million in 2006 and an \$8.0 million milestone payment in 2007 triggered by achievement of a clinical development milestone, with future potential additional milestone payments of up to \$180.0 million upon achievement of defined development, regulatory and sales milestones. We will jointly direct and equally fund with Nycomed a development program for POSIDUR intended to secure regulatory approval in both the U.S. and the E.U. In addition, we will manufacture and supply the product to Nycomed for commercial sale in the territory licensed to Nycomed. Nycomed will pay us blended royalties on sales in the defined territory of 15-40% depending on annual sales, as well as a manufacturing markup. We retain full commercial rights to POSIDUR in the U.S., Canada, Asia and certain other countries. The agreement shall continue in effect until terminated. The agreement provides each party with specified termination rights, including the right of each party to terminate the agreement upon material breach of the agreement by the other party. In addition, Nycomed shall have the right to terminate the agreement after expiry of patents covering POSIDUR in all major market countries in the E.U. and for adverse product events.

*Pain Therapeutics, Inc.* In December 2002, we entered into an exclusive agreement with Pain Therapeutics to develop and commercialize on a worldwide basis oral sustained release, abuse deterrent opioid products incorporating four specified opioid drugs using our ORADUR technology. The agreement also provides Pain Therapeutics with the exclusive right to commercialize products developed under the agreement on a worldwide basis. In connection with the execution of the agreement, Pain Therapeutics paid us an upfront fee. In November 2005, Pain Therapeutics sublicensed the commercialization rights to products developed under the agreement to King. In December 2005, we amended our agreement with Pain Therapeutics in order to specify our obligations with respect to the supply of key excipients for use in the licensed products. Under the agreement, as amended, we are responsible for formulation development, supply of selected key excipients used in the manufacture of licensed product and other specified tasks. We will receive additional payments if certain development and regulatory milestones are achieved. We receive reimbursement for our research and development efforts on the licensed products and a manufacturing profit on our supply of key product excipients to Pain Therapeutics for use in the licensed products. In addition, if commercialized, we will receive royalties for Remoxy and other licensed products which do not contain an opioid antagonist of between 6.0% to 11.5% of net sales of the product depending on the sales volumes. This agreement can be terminated by either party for material breach by the other party and by Pain Therapeutics without cause.

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*Endo Pharmaceuticals Inc. (TRANSDUR-Sufentanil).* On March 10, 2005, we entered into a license agreement with Endo under which we granted to Endo the exclusive right to develop, market and commercialize TRANSDUR-Sufentanil in the U.S. and Canada. Under the terms of the agreement, Endo will assume all remaining development and regulatory filing responsibilities in the U.S. and Canada, including the funding thereof. We will perform all formulation development for Endo unless we default on such obligations and we will be reimbursed for our fully allocated cost in performance of such work. Endo will also be responsible and pay for the manufacture, marketing, sales and distribution of TRANSDUR-Sufentanil in the U.S. and Canada. Endo has paid us an upfront fee of \$10.0 million, and we will receive additional payments of up to approximately \$35.0 million in the aggregate if predetermined regulatory and commercial milestones are achieved. If commercialized, Endo will also pay us product royalties based on the net sales of TRANSDUR-Sufentanil under the agreement. We have the right to co-promote TRANSDUR-Sufentanil under terms specified in the agreement. The agreement shall continue in effect until terminated. The agreement provides each party with specified termination rights, including the right of each party to terminate the agreement upon material breach of the agreement by the other party. In addition, Endo shall have the right to terminate the agreement at any time without cause subject to a specified notice period and due to adverse product events, legal impediment or the issuance of a final, non-appealable court order enjoining Endo from selling TRANSDUR-Sufentanil in the U.S. and Canada as a result of an action for patent infringement by a third party, provided that in the latter instance, we will be required to pay Endo a termination fee ranging from \$5.0 million to \$10.0 million, depending on the date of termination. We have the right to terminate the agreement in the event that Endo pursues directly or indirectly any proceeding seeking to have any of our TRANSDUR-Sufentanil related patents revoked or declared invalid, unpatentable or unenforceable.

*Voyager Pharmaceutical Corporation.* In July 2002, we entered into a development and commercialization agreement with Voyager. Under the terms of the agreement, we will collaborate with Voyager to develop a product using our DURIN technology to provide sustained release of leuprolide based on Voyager's patented method of treatment of Alzheimer's disease. The agreement also provides Voyager with the right to commercialize the resulting product on a worldwide basis. We are responsible for preclinical development, product manufacture and other specified tasks. We will receive payments if certain development and regulatory milestones are achieved, and receive payments for our research and development efforts. If Memryte is commercialized, we will receive royalties based on product sales. This agreement can be terminated by either party for material breach by the other party. Effective January 2007, we amended our agreement with Voyager. Under the amendment, among other changes to the Agreement, the royalty rate that we will receive on net sales of Memryte, if commercialized, is doubled (to 10-14% of net sales after the amendment), and in addition, we will receive 10% of any upfront, milestone and other fees received by Voyager in the event that the product is sublicensed to a third party. In return, we paid Voyager \$1 million in cash and forgave approximately \$725,000 which was owed to us for previously provided services.

*Endo Pharmaceuticals Inc. (CHRONOGESIC).* In November 2002, we entered into a development, commercialization and supply license agreement with Endo under which the companies will collaborate on the development and commercialization of CHRONOGESIC for the U.S. and Canada. The agreement was amended in January 2004, in November 2004, January 2006 and April 2007 to take into account the increase in the CHRONOGESIC development program timeline due to DURECT's implementation of necessary design and manufacturing enhancements. In connection with the execution of the agreement in November 2002, Endo purchased 1,533,742 shares of newly issued common stock of DURECT at an aggregate purchase price of approximately \$5.0 million. Under the terms of the agreement, as amended, we will be responsible for the CHRONOGESIC product's design and development. Endo shall not be responsible for any development costs for CHRONOGESIC prior to May 1, 2008. Commencing on May 1, 2008, unless the agreement is earlier terminated by Endo, Endo will fund 50% of the ongoing development costs and will reimburse us for a portion of our prior development costs for CHRONOGESIC upon the achievement of certain milestones. Development-based milestone payments made by Endo under this agreement could total up to \$52.0 million. Under the agreement, Endo has licensed exclusive promotional rights to CHRONOGESIC in the U.S. and Canada. Endo will be responsible for marketing, sales and distribution, including providing specialty sales representatives dedicated to supplying technical and training support for CHRONOGESIC therapy and will pay for product

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launch costs. We will be responsible for the manufacture of CHRONOGESIC. If commercialized, we will share profits from the commercialization of CHRONOGESIC in the U.S. and Canada with Endo based on the financial performance of CHRONOGESIC. Our agreement with Endo provides each party with specified termination rights. In particular, our agreement can be terminated by Endo in the event that (i) we have not delivered to Endo on or before March 31, 2008 a written notice that a human pharmacokinetic trial had been completed with CHRONOGESIC, together with a full study report of the results of the trial or (ii) Endo, determines, in its sole discretion, to terminate the agreement during the sixty-day period after our delivery of our notice, provided, that, in each case Endo delivers to us its written notice of termination prior to April 30, 2008. We will not complete the requisite pharmacokinetic trial by March 31, 2008, which will give Endo the right to terminate this agreement.

*ALZA Corporation.* On April 21, 1998, we entered into a Development and Commercialization Agreement with ALZA Corporation (presently a Johnson & Johnson company), which was amended and restated on April 28, 1999, April 14, 2000 and October 1, 2002. Pursuant to this agreement, ALZA granted to us exclusive, worldwide rights under ALZA intellectual property, including patents, trade secrets and know-how, to develop and commercialize products using the DUROS drug delivery technology in the fields of the delivery of drugs by catheter (except for the sufentanil product) to the central nervous system to treat selected central nervous system disorders, the delivery of drugs by catheter to the middle and inner ear, the delivery of drugs by catheter into the pericardial sac of the heart, the delivery of selected drugs by catheter into vascular grafts and the delivery of selected cancer antigens. As part of the amendments made to the agreement in October 1, 2002, ALZA may obtain from us, for its own behalf or on behalf of one of its affiliates, the exclusive right to develop and commercialize a product in a field of use exclusively licensed to us, provided that such product does not incorporate a drug in the same drug class and is not intended for the same therapeutic indication as a product which is then being developed or commercialized by us or for which we have made commitments to a third party. In the event that ALZA or an affiliate commercializes such a product, ALZA or its affiliate will pay us a royalty on sales of such product at a specified rate. Under this agreement, we have the right to subcontract to third parties product development activities including development of components of the DUROS system, provided that design of the DUROS system and other development activities relating to the DUROS system must be performed by ourselves or ALZA unless ALZA permits us to subcontract out such development. We have the right to subcontract manufacturing activities relating to our products other than the assemblage of the components of the DUROS system itself. In the event of a change in our corporate control, including an acquisition of us, our right to develop and manufacture the DUROS system would terminate, and ALZA would have the right to develop and manufacture DUROS systems for us for so long as ALZA can meet our specification and supply requirements following such change in control. We also have the right to partner with third parties to commercialize our products on a product-by-product basis, provided that ALZA has options to distribute our cancer antigen products which do not incorporate proprietary molecules owned by a third party throughout the world. We must allow ALZA an opportunity to negotiate in good faith for commercialization rights to our products developed under the agreement prior to granting these rights to a third party, other than products that are subject to ALZA's option or products for which we have obtained funding or access to a proprietary drug from a third party to whom we have granted commercialization rights prior to commencement of human clinical trials. Any inventions and related intellectual property rights developed by us or ALZA under the agreement which relate to the DUROS system or its manufacture or to any combination of the DUROS system with other components, active agents, features or processes, shall be owned exclusively by ALZA. All other inventions and related intellectual property rights developed under the agreement, whether by us or ALZA, shall be owned exclusively by us. In consideration for the rights granted to us under this agreement, ALZA received 5,600,000 shares of our Series A-1 Preferred Stock which was converted into 5,600,000 shares of our common stock concurrent with our initial public offering of common stock. As additional consideration, ALZA is entitled to receive a royalty on the net sales of our DUROS-based products in an amount not less than 2.5% nor more than 5% of such net sales for so long as we sell the product. ALZA is also entitled to a percentage of any upfront license fees, milestone or any special fees, payments or other consideration we receive from the sublicense of any of our DUROS-based products, excluding research and development funding, in an amount of 5% of such payment. In connection with the amendment to the agreement made in April 2000, ALZA received

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1,000,000 shares of our common stock and a warrant to purchase 1,000,000 shares of common stock at an exercise price of \$12.00 per share. This warrant expired in September 2004, which was the fourth anniversary after the warrant first became exercisable.

*EpiCept Corporation.* On December 20, 2006, we entered into a license agreement with EpiCept Corporation (EpiCept) that provides us with the exclusive, worldwide rights to certain of EpiCept's intellectual property for a transdermal patch containing bupivacaine for the treatment of back pain. Pursuant to the agreement, we paid EpiCept \$1.0 million upfront in December 2006 and, subject to our achievement of specified milestones, will pay EpiCept an additional \$9.0 million in milestone payments as well as a royalty on net sales of any product covered by the license.

*NeuroSystec Corporation.* In May 2004, we entered into an exclusive license agreement with NeuroSystec Corporation (NeuroSystec), a privately-held corporation founded by Al Mann, under which we granted to NeuroSystec exclusive worldwide rights to develop and commercialize products designed for the treatment of tinnitus and to improve post-operative recovery and tolerance of surgical implantation of cochlear devices using specified DURECT proprietary drug treatment methods and drug delivery technologies to deliver precise doses of appropriate medications directly to the middle or inner ear. The first development product is currently in early clinical development. We are responsible for formulation development of products utilizing our drug delivery platforms and manufacture and supply of product components consisting of our drug delivery platforms. We will receive certain milestone payments if certain development and commercialization milestones are achieved, as well as royalties based on product sales if products are commercialized under the agreement. This agreement can be terminated by either party for material breach by the other party and by NeuroSystec without cause. In connection with the agreement, we received equity constituting a minority ownership interest in NeuroSystec.

## **Commercial Businesses**

### *ALZET®*

We currently make and sell the ALZET product line on a worldwide basis. We market the ALZET product line through a direct sales force in the U.S. and through a network of distributors outside the U.S.

The ALZET product line consists of miniature, implantable osmotic pumps and accessories used for experimental research in mice, rats and other laboratory animals. These pumps are neither approved nor intended for human use. ALZET pumps continuously deliver drugs, hormones and other test agents at controlled rates from one day to four weeks without the need for external connections, frequent handling or repeated dosing. In laboratory research, these infusion pumps can be used for systemic administration when implanted under the skin or in the body. They can be attached to a catheter for intravenous, intracerebral, or intra-arterial infusion or for targeted delivery, where the effects of a drug or test agent are localized in a particular tissue or organ.

We acquired the ALZET product line and assets used primarily in the manufacture, sale and distribution of this product line from ALZA in April 2000. We believe that the ALZET business provides us with innovative design and application opportunities for potential new products.

### *Lactel® Absorbable Polymers*

We currently design, develop and manufacture a wide range of standard and custom biodegradable polymers based on lactide, glycolide and caprolactone under the LACTEL® brand for pharmaceutical and medical device clients for use as raw materials in their products. These materials are manufactured and sold by us directly from our facility in Pelham, Alabama and are used by us and our third-party customers for a variety of controlled-release and medical-device applications, including several FDA-approved commercial products. Until December 31, 2004, this business was conducted by our wholly owned subsidiary, Absorbable Polymers International Corporation (API), formerly known as Birmingham Polymers Inc., an Alabama corporation. API was merged with and into DURECT on December 31, 2004.

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### **Marketing and Sales**

Historically, we have established strategic distribution and marketing alliances for our pharmaceutical systems to leverage the established sales organizations that certain pharmaceutical companies have in markets we are targeting. However, our goal is to become a specialty pharmaceutical company that commercializes its own products with significant market potential. To that end, we intend, over the course of a few years, to build up commercial, sales and marketing capability and other required infrastructure in focused specialty areas although there can be no assurance that we will be able to do so. We may still choose to enter into strategic alliances from time to time consistent with our strategy to leverage the established sales organizations of third-party collaborators to achieve greater market penetration for some of our products than we could on our own. If we choose to enter into third-party collaborations to commercialize our pharmaceutical systems, we believe we have the flexibility to enter into these alliances under circumstances that allow us to retain greater economic participation because our pharmaceutical systems combine drugs for which medical data on efficacy and safety are available with proven technology platforms.

We market and sell our ALZET product line in the U.S. through a direct sales force, and we have a network of distributors for this product line outside of the U.S.

### **Suppliers**

We purchase sucrose acetate isobutyrate, a raw material for our ORADUR and SABER-based pharmaceutical systems, including POSIDUR, Remoxy and other ORADUR-based opioid drug candidates licensed to Pain Therapeutics, pursuant to a supply agreement with Eastman Chemical Company. We also purchase sufentanil for CHRONOGESIC and TRANSDUR-Sufentanil pursuant to a supply agreement with Mallinckrodt, Inc., and we have entered into a supply agreement with Corium International, Inc. for clinical and commercial supplies of ELADUR and a supply agreement with Hospira Worldwide, Inc. for clinical and commercial supplies of POSIDUR. We believe that these agreements will provide a sufficient supply of these raw materials and drug product to meet our needs for the foreseeable future. We do not have in place long term supply agreements with respect to all of the components of any of our pharmaceutical systems, however, and are subject to the risk that we may not be able to procure all required components in adequate quantities with acceptable quality, within acceptable time frames or at reasonable cost.

### **Customers**

A substantial portion of our product revenues is derived from sale of the ALZET product line. Until such time that we are able to bring our pharmaceutical systems to market, if at all, we expect this trend to continue. We also receive revenue from collaborative research and development arrangements with our third-party collaborators. For the year ended December 31, 2007, revenues from our collaborative agreements with Pain Therapeutics, Endo (TRANSDUR-Sufentanil) and Nycomed represented 16%, 16% and 10% of our total collaborative research and development revenues, respectively. At December 31, 2007, three customers accounted for 36%, 19% and 16% of our net accounts receivable. At December 31, 2006, three customers accounted for 22%, 20% and 16% of our net accounts receivable.

### **Manufacturing**

The process for manufacturing our pharmaceutical systems is technically complex, requires special skills, and must be performed in a qualified facility. Our manufacturing facility in Cupertino, CA is a functional multi-discipline site that we have used to manufacture research and clinical supplies of several of our pharmaceutical systems under GMP, including POSIDUR, Remoxy, TRANSDUR-Sufentanil, ELADUR, Memryte and CHRONOGESIC. In the future, we intend to develop additional manufacturing capabilities for our pharmaceutical systems and components to meet our demands and those of our third party collaborators by contracting with third party manufacturers and by construction of additional manufacturing space at our current facilities in Cupertino, CA, Vacaville, CA and Pelham, AL. We manufacture our ALZET product at our Vacaville, CA facility.

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### **Patents, Licenses and Proprietary Rights**

Our success depends in part on our ability to obtain patents, to protect trade secrets, to operate without infringing upon the proprietary rights of others and to prevent others from infringing on our proprietary rights. Our policy is to seek to protect our proprietary position by, among other methods, filing U.S. and foreign patent applications related to our proprietary technology, inventions and improvements that are important to the development of our business. In the fourth quarter of 2007, we acquired from a third party a portfolio of worldwide patents relating to drug delivery technologies. This portfolio consists of approximately 22 issued and pending U.S. patents and patent applications as well as their international counterparts. We believe this portfolio will benefit our business by broadening our drug delivery technology base and strengthening our intellectual property position. As of February 29, 2008, we held 39 issued U.S. patents and 224 issued foreign patents (which include granted European patent rights that have been validated in various EU member states). In addition, we have 85 pending U.S. patent applications and have filed 80 patent applications under the Patent Cooperation Treaty, from which 352 national phase applications are currently pending in Europe, Australia, Japan, Canada, and other countries. Our patents expire at various dates starting in the year 2012.

Proprietary rights relating to our planned and potential products will be protected from unauthorized use by third parties only to the extent that they are covered by valid and enforceable patents or are effectively maintained as trade secrets. Patents owned by or licensed to us may not afford protection against competitors, and our pending patent applications now or hereafter filed by or licensed to us may not result in patents being issued. In addition, the laws of certain foreign countries may not protect our intellectual property rights to the same extent as do the laws of the U.S.

The patent positions of biopharmaceutical companies involve complex legal and factual questions and, therefore, their enforceability cannot be predicted with certainty. Our patents or patent applications, or those licensed to us, if issued, may be challenged, invalidated or circumvented, and the rights granted thereunder may not provide proprietary protection or competitive advantages to us against competitors with similar technology. Furthermore, our competitors may independently develop similar technologies or duplicate any technology developed by us. Because of the extensive time required for development, testing and regulatory review of a potential product, it is possible that, before any of our products can be commercialized, any related patent may expire or remain in existence for only a short period following commercialization, thus reducing any advantage of the patent, which could adversely affect our ability to protect future product development and, consequently, our operating results and financial position.

Because patent applications in the U.S. are maintained in secrecy for at least 18 months after filing and since publication of discoveries in the scientific or patent literature often lag behind actual discoveries, we cannot be certain that we were the first to make the inventions covered by each of our issued or pending patent applications or that we were the first to file for protection of inventions set forth in such patent applications.

Our planned or potential products may be covered by third-party patents or other intellectual property rights, in which case we would need to obtain a license to continue developing or marketing these products. Any required licenses may not be available to us on acceptable terms, if at all. If we do not obtain any required licenses, we could encounter delays in product introductions while we attempt to design around these patents, or could find that the development, manufacture or sale of products requiring such licenses is foreclosed. Litigation may be necessary to defend against or assert such claims of infringement, to enforce patents issued to us, to protect trade secrets or know-how owned by us, or to determine the scope and validity of the proprietary rights of others. In addition, interference proceedings declared by the U.S. Patent and Trademark Office may be necessary to determine the priority of inventions with respect to our patent applications. Litigation or interference proceedings could result in substantial costs to and diversion of effort by us, and could have a material adverse effect on our business, financial condition and results of operations. These efforts by us may not be successful.

We may rely, in certain circumstances, on trade secrets to protect our technology. However, trade secrets are difficult to protect. We seek to protect our proprietary technology and processes, in part, by confidentiality agreements with our employees and certain contractors. There can be no assurance that these agreements will not

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be breached, that we will have adequate remedies for any breach, or that our trade secrets will not otherwise become known or be independently discovered by competitors. To the extent that our employees, consultants or contractors use intellectual property owned by others in their work for us, disputes may also arise as to the rights in related or resulting know-how and inventions.

### **Government Regulation**

*The Food and Drug Administration.* The FDA and comparable regulatory agencies in state and local jurisdictions and in foreign countries impose substantial requirements upon the clinical development, manufacture and marketing of pharmaceutical products. These agencies and other federal, state and local entities regulate research and development activities and the testing, manufacture, quality control, safety, effectiveness, labeling, storage, distribution, record keeping, approval, advertising and promotion of our products. We believe that our initial pharmaceutical systems will be regulated as drugs by the FDA rather than as biologics or devices.

The process required by the FDA under the new drug provisions of the Federal Food, Drug and Cosmetics Act before our initial pharmaceutical systems may be marketed in the U.S. generally involves the following:

preclinical laboratory and animal tests;

submission of an IND application which must become effective before clinical trials may begin;

adequate and well-controlled human clinical trials to establish the safety and efficacy of the proposed pharmaceutical in our intended use; and

FDA approval of a new drug application.

The testing and approval process requires substantial time, effort, and financial resources, and we cannot be certain that any approval will be granted on a timely basis, if at all. Even though several of our pharmaceutical systems utilize active drug ingredients that are commercially marketed in the United States in other dosage forms, we need to establish safety and effectiveness of those active ingredients in the formulation and dosage forms that we are developing.

Preclinical tests include laboratory evaluation of the product, its chemistry, formulation and stability, as well as animal studies to assess the potential safety and efficacy of the pharmaceutical system. We then submit the results of the preclinical tests, together with manufacturing information and analytical data, to the FDA as part of an IND, which must become effective before we may begin human clinical trials. Each subsequent new clinical protocol must also be submitted to the IND. An IND automatically becomes effective 30 days after receipt by the FDA, unless the FDA, within the 30-day time period, raises concerns or questions about the conduct of the trials as outlined in the IND and imposes a clinical hold. In such a case, the IND sponsor and the FDA must resolve any outstanding concerns before clinical trials can begin. Our submission of an IND may not result in FDA authorization to commence clinical trials. Further, an independent Institutional Review Board at each medical center proposing to conduct the clinical trials must review and approve any clinical study as well as the related informed consent forms and authorization forms that permit us to use individually identifiable health information of study participants.

Human clinical trials are typically conducted in three sequential phases which may overlap:

PHASE I: The drug is initially introduced into healthy human subjects or patients and tested for safety, dosage tolerance, absorption, metabolism, distribution and excretion.

PHASE II: Involves studies in a limited patient population to identify possible adverse effects and safety risks, to determine the efficacy of the product for specific targeted diseases and to determine dosage tolerance and optimal dosage.

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PHASE III: When Phase II evaluations demonstrate that a dosage range of the product is effective and has an acceptable safety profile, Phase III trials are undertaken to further evaluate dosage, clinical efficacy and to further test for safety in an expanded patient population, at multiple, geographically dispersed clinical study sites.

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In the case of products for severe diseases, such as chronic pain, or life-threatening diseases such as cancer, the initial human testing is often conducted in patients with disease rather than in healthy volunteers. Since these patients already have the target disease or condition, these studies may provide initial evidence of efficacy traditionally obtained in Phase II trials, and thus these trials are frequently referred to as Phase I/II trials. We cannot be certain that we will successfully complete Phase I, Phase II or Phase III testing of our pharmaceutical systems within any specific time period, if at all. Furthermore, the FDA or the Institutional Review Board or the sponsor may suspend clinical trials at any time on various grounds, including a finding that the subjects or patients are being exposed to an unacceptable health risk. During the clinical development of products, sponsors frequently meet and consult with the FDA in order to ensure that the design of their studies will likely provide data both sufficient and relevant for later regulatory approval; however, no assurance of approvability can be given by the FDA.

The results of product development, preclinical studies and clinical studies are submitted to the FDA as part of a new drug application, or NDA, for approval of the marketing and commercial shipment of the product. Submission of an NDA requires the payment of a substantial user fee to the FDA, and although the agency has defined user fee goals for the time in which to respond to sponsor applications, we cannot assure you that the FDA will act in any particular timeframe. The FDA may deny a new drug application if the applicable regulatory criteria are not satisfied or may require additional clinical data. Even if such data is submitted, the FDA may ultimately decide that the new drug application does not satisfy the criteria for approval. Once issued, the FDA may withdraw product approval if compliance with regulatory standards is not maintained or if safety problems occur after the product reaches the market. Requirements for additional Phase IV studies to confirm safety and effectiveness in a broader commercial use population may be imposed as a condition of marketing approval. In addition, the FDA requires surveillance programs to monitor approved products which have been commercialized, and the agency has the power to require changes in labeling or to prevent further marketing of a product based on the results of these post-marketing programs. Any comparative claims that we would like to make for our products vis-à-vis other dosage forms or products will need to be substantiated generally by two adequate and well-controlled head-to-head clinical trials.

In addition to the drug approval requirements applicable through the Center for Drug Evaluation and Research (CDER), the FDA, through its Office of Combination Products, may require an intercenter consultation review by the Center for Devices and Radiological Health (CDRH), in order to determine a product's Primary Method of Action (PMOA). This request for consultation may be based on the device-like nature of a number of aspects of the DUROS technology.

Satisfaction of FDA requirements or similar requirements of state, local and foreign regulatory agencies typically takes several years and the actual time required may vary substantially, based upon the type, complexity and novelty of the pharmaceutical product. Government regulation may delay or prevent marketing of potential products for a considerable period of time and impose costly procedures upon our activities. We cannot be certain that the FDA or any other regulatory agency will grant approval for any of our pharmaceutical systems under development on a timely basis, if at all. Success in preclinical or early stage clinical trials does not assure success in later stage clinical trials. Data obtained from preclinical and clinical activities is not always conclusive and may be susceptible to varying interpretations which could delay, limit or prevent regulatory approval. Evolving safety concerns can result in the imposition of new requirements for expensive and time consuming tests, such as for QT interval cardiotoxicity testing. Even if a product receives regulatory approval, the approval may be significantly limited to specific indications. Further, even after regulatory approval is obtained, later discovery of previously unknown problems with a product may result in restrictions on the product or even complete withdrawal of the product from the market. Any pharmaceutical systems that we may develop and obtain approval for would also be subject to adverse findings of the active drug ingredients being marketed in different dosage forms and formulations. Delays in obtaining, or failures to obtain regulatory approvals would have a material adverse effect on our business. Marketing our pharmaceutical systems abroad will require similar regulatory approvals and is subject to similar risks. In addition, we cannot predict what adverse governmental regulations may arise from future U.S. or foreign governmental action.

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Any pharmaceutical systems manufactured or distributed by us pursuant to FDA approvals are subject to pervasive and continuing regulation by the FDA, including record-keeping requirements and reporting of adverse experiences with the drug. Drug manufacturers and their subcontractors are required to register their establishments with the FDA and state agencies, and are subject to periodic unannounced inspections by the FDA and state agencies for compliance with good manufacturing practices, which impose procedural and documentation requirements upon us and our third party manufacturers. We cannot be certain that we or our present or future suppliers will be able to comply with the GMP regulations and other FDA regulatory requirements.

The FDA regulates drug labeling and promotion activities. The FDA has actively enforced regulations prohibiting the marketing of products for unapproved uses, and federal and state authorities are also actively litigating against sponsors who promote their drugs for unapproved uses under various fraud and abuse and false claims act statutes. We and our pharmaceutical systems are also subject to a variety of state laws and regulations in those states or localities where our pharmaceutical systems are or will be marketed. Any applicable state or local regulations may hinder our ability to market our pharmaceutical systems in those states or localities. We are also subject to numerous federal, state and local laws relating to such matters as safe working conditions, manufacturing practices, environmental protection, fire hazard control, and disposal of hazardous or potentially hazardous substances. We may incur significant costs to comply with such laws and regulations now or in the future.

The FDA's policies may change and additional government regulations may be enacted which could prevent or delay regulatory approval of our potential pharmaceutical systems. Moreover, increased attention to the containment of health care costs in the U.S. and in foreign markets could result in new government regulations that could have a material adverse effect on our business. We cannot predict the likelihood, nature or extent of adverse governmental regulation that might arise from future legislative or administrative action, either in the U.S. or abroad.

*The Drug Enforcement Administration.* The Drug Enforcement Administration (DEA) regulates chemical compounds as Schedule I, II, III, IV or V substances, with Schedule I substances considered to present the highest risk of substance abuse and Schedule V substances the lowest risk. Certain active ingredients in TRANSDUR-Sufentanil, Remoxy and the other ORADUR-based opioid products licensed to Pain Therapeutics, and CHRONOGESIC are listed by the DEA as Schedule II under the Controlled Substances Act of 1970. Consequently, their manufacture, research, shipment, storage, sale and use are subject to a high degree of oversight and regulation. For example, all Schedule II drug prescriptions must be signed by a physician, physically presented to a pharmacist and may not be refilled without a new prescription. Furthermore, the amount of Schedule II substances we can obtain for clinical trials and commercial distribution is limited by the DEA and our quota may not be sufficient to complete clinical trials or meet commercial demand. There is a risk that DEA regulations may interfere with the supply of the drugs used in our clinical trials, and, in the future, our ability to produce and distribute our products in the volume needed to meet commercial demand.

## **Competition**

We may face competition from other companies in numerous industries including pharmaceuticals, medical devices and drug delivery. POSIDUR, TRANSDUR-Sufentanil, ELADUR, Remoxy and the other ORADUR-based opioid products licensed to Pain Therapeutics, and CHRONOGESIC, if approved, will compete with currently marketed oral opioids, transdermal opioids, local anesthetic patches, and implantable and external infusion pumps which can be used for infusion of opioids and local anesthetics. Products of these types are marketed by Purdue Pharma, Alpharma, Knoll, Janssen, Medtronic, Endo Pharmaceuticals, AstraZeneca, Arrow International, Tricumed, I-Flow and others. Numerous companies are applying significant resources and expertise to the problems of drug delivery and several of these are focusing or may focus on delivery of drugs to the intended site of action, including Alkermes, Pacira Pharmaceuticals, QLT, EpiCept, Innocoll, Inovio, Nektar, Anesiva, NeurogesX, Alexza, Focal, I-Flow and others. Some of these competitors may be addressing the same

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therapeutic areas or indications as we are. Our current and potential competitors may succeed in obtaining patent protection or commercializing products before us.

If approved, Memryte will compete against the five drugs currently approved for the treatment of Alzheimer's disease. Four of the drugs are ACIs, including: Aricept, marketed by Pfizer, Inc. and Eisai Company, Ltd.; Exelon, marketed by Novartis AG; Reminyl, marketed by Shire Pharmaceuticals Group plc and Janssen Pharmaceutical Products, LP; and Cognex, marketed by Sciele Pharma, Inc. The fifth drug, Namenda, marketed by Forest Pharmaceuticals, Inc., is an NMDA receptor antagonist. In addition, Memryte could face competition from other leuprolide acetate products that are already on the market or may later be approved for other indications, if they are used or prescribed off label for Alzheimer's disease.

Any products we develop using our pharmaceutical systems technologies will compete in highly competitive markets. Many of our potential competitors in these markets have greater development, financial, manufacturing, marketing, and sales resources than we do and we cannot be certain that they will not succeed in developing products or technologies which will render our technologies and products obsolete or noncompetitive. In addition, many of those potential competitors have significantly greater experience than we do in their respective fields.

## **Corporate History, Headquarters and Website Information**

DURECT Corporation was incorporated in Delaware in February 1998. We completed our initial public offering on September 28, 2000. Our principal executive offices are located at 2 Results Way, Cupertino, California, 95014. Our telephone number is (408) 777-1417, and our web site address is [www.durect.com](http://www.durect.com). We make our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports available free of charge on our web site as soon as reasonably practicable after we file these reports with the Securities and Exchange Commission. DURECT Corporation's Code of Ethics can be found on our website.

## **Employees**

As of February 29, 2008 we had 179 employees, including 118 in research and development, 24 in manufacturing and 37 in selling, general and administrative. From time to time, we also employ independent contractors to support our research, development and administrative organizations. None of our employees are represented by a collective bargaining unit, and we have never experienced a work stoppage. We consider our relations with our employees to be good.

## **Executive Officers of the Registrant**

The executive officers of DURECT Corporation and their ages as of February 29, 2008 are as follows:

| <b>Name</b>                    | <b>Age</b> | <b>Position</b>                                                           |
|--------------------------------|------------|---------------------------------------------------------------------------|
| Felix Theeuwes, D.Sc.          | 70         | Chairman, Chief Scientific Officer and Director                           |
| James E. Brown, D.V.M.         | 51         | President, Chief Executive Officer and Director                           |
| Matthew J. Hogan, M.B.A.       | 48         | Chief Financial Officer                                                   |
| Peter J. Langecker, M.D., Ph.D | 57         | Chief Medical Officer                                                     |
| Jean I Liu, J.D., M.S.         | 39         | Senior Vice President, General Counsel and Secretary                      |
| Paula Mendenhall, Pharm.D.     | 64         | Executive Vice President, Operations and Administration                   |
| Su Il Yum, Ph.D.               | 68         | Executive Vice President, Pharmaceutical Systems Research and Development |

Felix Theeuwes, D.Sc. co-founded DURECT in February 1998 and has served as our Chairman, Chief Scientific Officer and a Director since July 1998. Prior to that, Dr. Theeuwes held various positions at ALZA Corporation, including President of New Ventures from August 1997 to August 1998, President of ALZA Research and Development from 1995 to August 1997, President of ALZA Technology Institute from 1994 to April 1995 and Chief Scientist from 1982 to June 1997. Dr. Theeuwes holds a D.Sc. degree in Physics from the

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University of Leuven (Louvain), Belgium. He also served as a post-doctoral fellow and visiting research assistant professor in the Department of Chemistry at the University of Kansas and has completed the Stanford Executive Program.

James E. Brown, D.V.M. co-founded DURECT in February 1998 and has served as our President, Chief Executive Officer and a Director since June 1998. He previously worked at ALZA Corporation as Vice President of Biopharmaceutical and Implant Research and Development from June 1995 to June 1998. Prior to that, Dr. Brown held various positions at Syntex Corporation, a pharmaceutical company, including Director of Business Development from May 1994 to May 1995, Director of Joint Ventures for Discovery Research from April 1992 to May 1995, and held a number of positions including Program Director for Syntex Research and Development from October 1985 to March 1992. Dr. Brown holds a B.A. from San Jose State University and a D.V.M. (Doctor of Veterinary Medicine) from the University of California, Davis where he also conducted post-graduate work in pharmacology and toxicology.

Matthew J. Hogan, M.B.A. has served as our Chief Financial Officer since September 2006. He was the Chief Financial Officer at CIPHERGEN Biosystems, Inc. from 2000 to 2006, and a consultant from March 2006. Prior to joining CIPHERGEN, Mr. Hogan was the Chief Financial Officer at Avocet Medical, Inc. from 1999 to 2000. From 1996 to 1999, Mr. Hogan was the Chief Financial Officer at Microcide Pharmaceuticals, Inc. From 1986 to 1996, he held various positions in the investment banking group at Merrill Lynch & Co., most recently as a Director focusing on the biotechnology and pharmaceutical sectors. Mr. Hogan holds a B.A. in economics from Dartmouth College and an M.B.A. from the Amos Tuck School of Business Administration.

Peter J. Langecker, M.D., Ph.D. has served as our Chief Medical Officer since May 2006. Prior to joining DURECT, Dr. Langecker served as Chief Medical Officer and Vice President of Clinical Affairs at Intarcia Therapeutics, Inc. from October 1999 to April 2006. Prior to that, Dr. Langecker was Vice President of Clinical Affairs at Sugen, Inc. from 1997 to 1999, Vice President, Clinical Research at Coulter Pharmaceuticals from 1995 to 1997 and Director of Clinical Research, Oncology, at Schering-Plough from 1992 to 1995. Previously, Dr. Langecker worked as a Project Physician Central Medical Advisor, Oncology at Ciba-Geigy (now Novartis) in Basel, Switzerland. He received his M.D. degree and his doctorate in medical sciences from the Ludwig-Maximilians University in Munich.

Jean I Liu, J.D., M.S. has served as our Senior Vice President and General Counsel since February 2003. She was appointed Secretary of the corporation in March 2004. She served as our Vice President of Legal and General Counsel from February 1999 to February 2003. Previously, from October 1998, Ms. Liu served as our Vice President of Legal. Prior to that, Ms. Liu worked as an attorney at Venture Law Group, a law firm, from May 1997 to October 1998. Ms. Liu worked as an attorney at Pillsbury Madison & Sutro LLP, a law firm, from September 1993 to May 1997. Ms. Liu holds a B.S. in Cellular & Molecular Biology from University of Michigan, an M.S. in Biology from Stanford University and a J.D. from Columbia University School of Law. Ms. Liu is a member of the State Bar of California and is admitted to practice before the United States Patent and Trademark Office.

Paula Mendenhall, Pharm.D. has served as our Executive Vice President of Operations and Administration since January 2007 and as Senior Vice President of Operations since January 2005. Prior to joining DURECT, Dr. Mendenhall was an independent consultant for various pharmaceutical companies for in-house and outsourcing of pharmaceutical manufacturing, including development of manufacturing strategies and plans and development and training of personnel. From 1997 to 2000, Dr. Mendenhall served as Vice President, Group Vice President and President of Oread Pharmaceutical Manufacturing at Oread Inc. From 1979 to 1997, Dr. Mendenhall served in a variety of roles for Hoffmann-La Roche Inc./Syntex, including in the areas of manufacturing, quality assurance, finance, planning and facilities, as well as provided technical assistance and support to Syntex Global Operations for marketed products and new product launches. Dr. Mendenhall received a Pharm D. degree from the University of California, San Francisco, and is a member of the American Association of Pharmaceutical Scientists (AAPS) and the Parenteral Drugs Association.

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Su Il Yum, Ph.D. has served as our Executive Vice President of Pharmaceutical Systems Research and Development since January 2007 and as our Senior Vice President of Pharmaceutical Systems Research and Development since January 2006. Previously, Dr. Yum served as our Senior Vice President, Engineering since December 2003 and as our Vice President of Engineering from December 1999 to December 2003. Prior to joining DURECT, Dr. Yum served as Senior Technical Advisor at Amira Medical in Scotts Valley, California, where he participated in the development of a pain-free blood glucose detector called AtLast®. Prior to joining Amira, he held a number of senior positions in project management and engineering at Alza Corporation for 27 years. Dr. Yum earned his Ph.D. degree in Chemical Engineering from the University of Minnesota, and completed a Post-doctoral research in Biomedical Engineering at the University of Utah. Dr. Yum is a Fellow of the AAPS.

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### **Item 1A. Risk Factors.**

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

#### **Risks Related To Our Business**

*Development of our pharmaceutical systems is not complete, and we cannot be certain that our pharmaceutical systems will be able to be commercialized*

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

selecting and developing drug delivery platform technology to deliver the proper dose of drug over the desired period of time;

determining the appropriate drug dosage for use in the pharmaceutical system;

developing drug compound formulations that will be tolerated, safe and effective and that will be compatible with the system;

demonstrating the drug formulation will be stable for commercially reasonable time periods;

demonstrating through clinical trials that the drug and system combination is safe and effective in patients for the intended indication; and

completing the manufacturing development and scale-up to permit manufacture of the pharmaceutical system in commercial quantities and at acceptable prices.

The time frame necessary to achieve these developmental milestones for any individual product is long and uncertain, and we may not successfully complete these milestones for any of our products in development. Other than for Remoxy, we have not yet selected the drug dosages nor finalized the formulation or the system design of any of our pharmaceutical systems, including POSIDUR, TRANSDUR-Sufentanil, ELADUR, our second ORADUR-opioid, Memryte and CHRONOGESIC, and we have limited experience in developing such products. We may not be able to finalize the design or formulation of any of these pharmaceutical systems. In addition, we may select components, solvents, excipients or other ingredients to include in our pharmaceutical systems that have not been previously approved for use in pharmaceutical products, which may require us to perform additional studies and may delay clinical testing and regulatory approval of our pharmaceutical systems. Even after we complete the design of a pharmaceutical system, the pharmaceutical system must still complete required clinical trials and additional safety testing in animals before approval for commercialization. We are continuing testing and development of our pharmaceutical systems and may explore possible design or formulation changes to address issues of safety, manufacturing efficiency and performance. We may not be able to complete development of any pharmaceutical systems that will be safe and effective and that will have a commercially reasonable treatment and storage period. If we or our third-party collaborators are unable to complete development of POSIDUR, TRANSDUR-Sufentanil, ELADUR, Remoxy, our second ORADUR-opioid, Memryte, CHRONOGESIC or other pharmaceutical systems, we will not be able to earn revenue from them, which would materially harm our business.

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*We or our third-party collaborators must conduct and satisfactorily complete required laboratory performance and safety testing, animal studies and clinical trials for our pharmaceutical systems before they can be sold*

Before we or our third-party collaborators can obtain government approval to sell any of our pharmaceutical systems, we or they, as applicable, must demonstrate through laboratory performance studies and safety testing, nonclinical (animal) studies and clinical (human) trials that each system is safe and effective for human use for each targeted indication. The clinical development status of our publicly announced development programs is as follows:

**POSIDUR** A Phase IIb clinical trial was completed and an end of Phase II meeting was held with the FDA. We are currently in dialogue with the FDA regarding our POSIDUR Phase III program.

**TRANSDUR-Sufentanil Patch** Our collaborator Endo has commenced its Phase II clinical program for TRANSDUR-Sufentanil for the U.S. and Canadian markets.

**ELADUR** A Phase IIa clinical trial was completed and positive results were reported in the fourth quarter of 2007.

**Remoxy** In December 2007, Pain Therapeutics and King reported positive results from the pivotal Phase III trial with Remoxy under an approved Special Protocol Assessment (SPA) with the FDA; NDA preparation is underway and Pain Therapeutics anticipates filing the NDA in the second quarter of 2008.

**Second ORADUR** Opioid Drug Candidate under Pain Therapeutics/King alliance In November 2006, Pain Therapeutics announced positive results from a Phase I clinical trial.

**Memryte** In the second quarter of 2007, Voyager reported that it has observed positive outcome trends among women, but no positive effect among men in its truncated Phase III clinical trial for Memryte. Further development is pending Voyager's ability to raise additional funding and/or partner the program.

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

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



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susceptible to varying interpretations, which could delay, limit or prevent regulatory approval. A number of companies in the pharmaceutical industry have suffered significant setbacks in advanced clinical trials, even after promising results in earlier trials. The failure to adequately demonstrate the safety and effectiveness of a pharmaceutical system under development could delay or prevent regulatory clearance of the potential pharmaceutical system, resulting in delays to the commercialization of our pharmaceutical system, and could materially harm our business. Clinical trials may not demonstrate the sufficient levels of safety and efficacy necessary to obtain the requisite regulatory approvals for our pharmaceutical systems, and thus our pharmaceutical systems may not be approved for marketing.

*Regulatory action or failure to obtain product approvals could delay or limit development and commercialization of our pharmaceutical systems and result in failure to achieve anticipated revenues*

The manufacture and marketing of our pharmaceutical systems and our research and development activities are subject to extensive regulation for safety, efficacy and quality by numerous government authorities in the United States and abroad. We or our third-party collaborators must obtain clearance or approval from applicable regulatory authorities before we or they, as applicable, can perform clinical trials, market or sell our development products in the United States or abroad. Clinical trials, manufacturing and marketing of products are subject to the rigorous testing and approval process of the FDA and equivalent foreign regulatory authorities. In particular, recent recalls of and reported adverse side effects of marketed drugs have made regulatory agencies, including the FDA, increasingly focus on the safety of drug products. Regulatory agencies are requiring more extensive and ever increasing showings of safety at every stage of drug development and commercialization from initial clinical trials to regulatory approval and beyond. These rigorous and evolving standards may delay and increase the expenses of our development efforts. The FDA or other foreign regulatory agency may, at any time, halt our and our collaborators' development and commercialization activities due to safety concerns, in which case our business will be harmed.

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

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

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*We and our third-party collaborators may not be able to manufacture sufficient quantities of our pharmaceutical systems and components to support the clinical and commercial requirements of our collaborators and ourselves at an acceptable cost or in compliance with applicable government regulations, and we have limited manufacturing experience*

We or our third-party collaborators to whom we have assigned such responsibility must manufacture our pharmaceutical systems and components in clinical and commercial quantities, either directly or through third parties, in compliance with regulatory requirements and at an acceptable cost. The manufacturing processes associated with our pharmaceutical systems are complex. Except with respect to Remoxy, we and our third-party collaborators, where relevant, have not yet completed development of the manufacturing process for any pharmaceutical systems or components including POSIDUR, TRANSDUR-Sufentanil, ELADUR, Memryte, CHRONOGESIC and other ORADUR-based opioid drug candidates. If we and our third-party collaborators, where relevant, fail to timely complete the development of the manufacturing process for our pharmaceutical systems, we and our third-party collaborators, where relevant, will not be able to timely produce product for clinical trials and commercialization of our pharmaceutical systems. We have also committed to manufacture and supply pharmaceutical systems or components under a number of our collaborative agreements with third-party companies. We have limited experience manufacturing pharmaceutical products, and we may not be able to timely accomplish these tasks. If we and our third-party collaborators, where relevant, fail to develop manufacturing processes to permit us to manufacture a pharmaceutical system or component at an acceptable cost, then we and our third-party collaborators may not be able to commercialize that pharmaceutical system or we may be in breach of our supply obligations to our third-party collaborators.

Our manufacturing facility in Cupertino is a multi-disciplinary site that we have used to manufacture only research and clinical supplies of several of our pharmaceutical systems under good manufacturing practices (GMP), including POSIDUR, TRANSDUR-Sufentanil, ELADUR, Remoxy and a second ORADUR-opioid, Memryte and CHRONOGESIC. We have not manufactured commercial quantities of any of our pharmaceutical systems. In the future, we intend to develop additional manufacturing capabilities for our pharmaceutical systems and components to meet our demands and those of our third-party collaborators by contracting with third-party manufacturers and by construction of additional manufacturing space at our current facilities in Cupertino, CA, Vacaville, CA and Pelham, AL. We have limited experience building and validating manufacturing facilities, and we may not be able to accomplish these tasks in a timely manner.

If we and our third-party collaborators, where relevant, are unable to manufacture pharmaceutical systems or components in a timely manner or at an acceptable cost, quality or performance level, and attain and maintain compliance with applicable regulations, the clinical trials and the commercial sale of our pharmaceutical systems and those of our third-party collaborators could be delayed. Additionally, we may need to alter our facility design or manufacturing processes, install additional equipment or do additional construction or testing in order to meet regulatory requirements, optimize the production process, increase efficiencies or production capacity or for other reasons, which may result in additional cost to us or delay production of product needed for the clinical trials and commercial launch of our pharmaceutical systems and those of our third-party collaborators.

We have entered into a supply agreement with Corium International, Inc. for clinical and commercial supplies of ELADUR and a supply agreement with Hospira Worldwide, Inc. for clinical and commercial supplies of POSIDUR. These third parties are currently our sole source for drug product required for development and commercialization of these drug candidates. Furthermore, we and our third-party collaborators, where relevant, may also need or choose to subcontract with additional third-party contractors to perform manufacturing steps of our pharmaceutical systems or supply required components for our pharmaceutical systems. Where third party contractors perform manufacturing services for us, we will be subject to the schedule, expertise and performance of third parties as well as incur significant additional costs. Failure of third parties to perform their obligations could adversely our operations, development timeline and financials results. Under our development and commercialization agreement with ALZA, we cannot subcontract the manufacture of subassemblies of the DUROS system components of our DUROS-based pharmaceutical systems to third parties which have not been approved by ALZA.

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If we or our third-party collaborators cannot manufacture pharmaceutical systems or components in time to meet the clinical or commercial requirements of our collaborators or ourselves or at an acceptable cost, our operating results will be harmed.

*Failure to comply with ongoing governmental regulations for our pharmaceutical systems could materially harm our business in the future*

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

failure to obtain or maintain requisite governmental approvals;

failure to obtain approvals for clinically intended uses of our pharmaceutical systems under development; or

identification of serious and unanticipated adverse side effects in our pharmaceutical systems under development.

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

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

We have incurred significant operating losses since our inception in 1998 and, as of December 31, 2007, had an accumulated deficit of approximately \$239.7 million. We expect to continue to incur significant operating losses over the next several years as we continue to incur significant costs for research and development, clinical trials, manufacturing, sales and general and administrative functions. Our ability to achieve profitability depends upon our ability, alone or with others, to successfully complete the development of our proposed pharmaceutical systems, obtain the required regulatory clearances, and manufacture and market our proposed pharmaceutical systems. Development of pharmaceutical systems is costly and requires significant investment. In addition, we may choose to license from third parties either additional drug delivery platform technology or rights to particular drugs or other appropriate technology for use in our pharmaceutical systems. The license fees for these technologies or rights would increase the costs of our pharmaceutical systems.

To date, we have not generated significant revenue from the commercial sale of our pharmaceutical systems and do not expect to do so in the near future. Our current product revenues are from the sale of the ALZET product line and the sale of LACTEL biodegradable polymers, and from payments under collaborative research

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and development agreements with third parties. We do not expect our product revenues to increase significantly in the near future, and we do not expect that collaborative research and development revenues will exceed our actual operating expenses. We do not anticipate commercialization and marketing of our pharmaceutical systems in development in the near future, and therefore do not expect to generate sufficient revenues to cover expenses or achieve profitability in the near future.

*We may have difficulty raising needed capital in the future*

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

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

continued progress and cost of our research and development programs;

the continuation of our collaborative agreements that provide financial funding for our activities;

success in entering into collaboration agreements and meeting milestones under such agreements;

progress with preclinical studies and clinical trials;

the time and costs involved in obtaining regulatory clearance;

costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims;

costs of developing sales, marketing and distribution channels and our ability and that of our collaborators to sell our pharmaceutical systems;

costs involved in establishing manufacturing capabilities for clinical and commercial quantities of our pharmaceutical systems;

competing technological and market developments;

market acceptance of our pharmaceutical systems;

costs for recruiting and retaining employees and consultants; and

unexpected legal, accounting and other costs and liabilities related to our business.

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

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*If we are required to repay our convertible subordinated notes due June 15, 2008, we may have to take steps to defer programs and costs, and raise additional financing from the sale of equity or debt securities or otherwise restructure our existing debt obligations*

As of December 31, 2007, we had approximately \$23.6 million in short-term convertible subordinated notes which mature and are due in June 2008, \$141,000 in equipment financing obligations and \$465,000 in bonds payable. Our substantial indebtedness, which totaled \$24.2 million at December 31, 2007 has impacted and will continue to impact us by:

making it more difficult to obtain additional financing;

requiring interest payments to service the debt; and

constraining our ability to react quickly in an unfavorable economic climate.

Currently we are not generating positive cash flow. If the market price of our common stock on June 15, 2008, the due date of our notes, is below \$3.15 per share, the approximate equity conversion price of the notes, it will be highly unlikely that the holders of a large percentage of our outstanding convertible subordinated notes will convert such securities to equity in accordance with their existing terms, in which case we will be required to pay the balance of outstanding convertible notes in cash which will materially diminish our cash position. As of December 31, 2007, we had cash, cash equivalents and investments of \$62.0 million. We expect to use substantially all of these assets to fund our on-going operations over the next few years. If we are required to repay our convertible subordinated notes, we may have to take steps to defer programs and costs, and raise additional financing from the sale of equity or debt securities or otherwise restructure our existing debt obligations. There can be no assurance that any such financing or restructuring will be available to us on commercially acceptable terms, if at all. Should these events happen, the value of our common stock would be materially harmed.

*We may be required to redeem our outstanding convertible subordinated notes before maturity, and we may not have sufficient funds to do so. The redemption rights in our outstanding convertible subordinated notes could discourage a potential acquirer*

If a fundamental change occurs, we may be required to redeem all or part of the remaining \$23.6 million in outstanding principal, plus any accrued but unpaid interest on our outstanding convertible subordinated notes. A fundamental change is defined as:

any transaction or event in connection with which all or substantially all of our common stock is exchanged for, converted into, acquired for or constitutes solely the right to receive consideration which is not all or substantially all common stock listed on a United States national securities exchange or approved for quotation on the Nasdaq Global Market or any similar United States system of automated dissemination of quotations of securities prices, or,

if for any reason, our common stock is no longer listed for trading on a United States national securities exchange nor approved for trading on the Nasdaq Global Market.

If there is a fundamental change, we may not have enough funds to pay the redemption price for all tendered notes. In addition, any credit agreement or other agreements relating to our indebtedness may contain provisions prohibiting redemption of the notes under certain circumstances, or expressly prohibit our redemption of the notes upon a designated event or may provide that a designated event constitutes an event of default under that agreement. Our failure to redeem tendered notes would constitute an event of default under the indenture, which might also constitute a default under the terms of our other indebtedness. Any such default could cause us to seek to restructure our indebtedness or seek protection under applicable bankruptcy laws, either of which could materially impair the value of our common stock.

This redemption feature upon fundamental change could also discourage a potential acquirer. However, this redemption feature is not the result of management's knowledge of any specific effort to obtain control of us by

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means of a merger, tender offer or solicitation, or part of a plan by management to adopt a series of anti-takeover provisions. The term fundamental change is limited to specified transactions and may not include other events that might adversely affect our financial condition or business operations.

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

Our near-term revenues are based to a significant extent on collaborative arrangements with third parties, pursuant to which we receive payments based on our performance of research and development activities and the attainment of milestones set forth in the agreements. We may not be able to fulfill our obligations or attain milestones set forth in any specific agreement, which could cause our revenues to fluctuate or be less than anticipated and may expose us to liability for contractual breach. Furthermore, unless terminated or amended, commencing May 1, 2008, our agreement with Endo with respect to CHRONOGESIC requires us to pay fifty percent (50%) of the development cost of CHRONOGESIC for the U.S. and Canadian market, which may require us to devote significant funds in excess of what we may otherwise choose to spend on the program. In addition, these agreements may require us to devote significant time and resources to communicating with and managing our relationship with such collaborators and resolving possible issues of contractual interpretation which may detract from time our management would otherwise devote to managing our operations. Such agreements are generally complex and contain provisions that could give rise to legal disputes, including potential disputes concerning ownership of intellectual property under collaborations. Such disputes can delay or prevent the development of potential new pharmaceutical systems, or can lead to lengthy, expensive litigation or arbitration. In general, our collaboration agreements, including our agreements with Endo with respect to CHRONOGESIC and TRANSDUR-Sufentanil, Pain Therapeutics with respect to Remoxy and other ORADUR-based products incorporating specified opioids, Nycomed with respect to POSIDUR, and Voyager with respect to Memryte, may be terminated by the other party at will or upon specified conditions including, for example, if we fail to satisfy specified performance milestones or if we breach the terms of the agreement.

In addition to customary termination rights, our agreement with Endo for the development and commercialization of CHRONOGESIC in the United States and Canada can be terminated by Endo in the event that (i) we have not delivered to Endo on or before March 31, 2008 a written notice that a human pharmacokinetic trial had been completed with CHRONOGESIC, together with a full study report of the results of the trial or (ii) Endo, determines, in its sole discretion, to terminate the agreement during the sixty-day period after our delivery of the notice, provided, that, in each case Endo delivers to us its written notice of termination prior to April 30, 2008. We will not complete the requisite pharmacokinetic trial by March 31, 2008, which will give Endo the right to terminate this agreement.

If any of our collaborative agreements are terminated, our revenues will be reduced or not materialize, and our development products related to those agreements may not be commercialized.

*We depend to a large extent on third-party collaborators, and we have limited or no control over the development, sales, distribution and disclosure for our pharmaceutical systems which are the subject of third-party collaborative or license agreements*

Our future performance depends to a large extent on the ability of our third-party collaborators to successfully develop and obtain approvals for our pharmaceutical systems. We have entered into agreements with Endo related to the development, promotion and distribution of CHRONOGESIC and TRANSDUR-Sufentanil in the United States and Canada once such products are approved for commercialization. In addition, we have entered into agreements with Pain Therapeutics, Nycomed and Voyager under which we granted such third parties the right to develop, apply for regulatory approval for, market, promote or distribute Remoxy and

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other ORADUR-based products incorporating specified opioids, POSIDUR and Memryte, respectively, subject to payments to us in the form of product royalties and other payments. We have limited or no control over the expertise or resources that any collaborator may devote to the development, marketing or sale of these pharmaceutical systems, or the timing of their activities. Any of our present or future collaborators may not perform their obligations as expected. These collaborators may breach or terminate their agreement with us or otherwise fail to conduct their collaborative activities successfully and in a timely manner. Further, our collaborators may elect not to develop or commercialize pharmaceutical systems arising out of our collaborative arrangements or not devote sufficient resources to the development, manufacture, marketing or sale of these pharmaceutical systems. If any of these events occur, we may not be able to develop our technologies or recognize revenue from the commercialization of our pharmaceutical systems based on such collaborations. In addition, these third parties may have similar or competitive products to the ones which are the subject of their collaborations with us, or relationships with our competitors, which may reduce their interest in developing or selling our pharmaceutical systems. We may not be able to control public disclosures made by some of our third-party collaborators, which could negatively impact our stock price.

In the second quarter of 2007, Voyager informed its shareholders that it has observed positive outcome trends among women, but no positive effect among men in Voyager's truncated Phase III clinical trial for Memryte. Based on these results, Voyager has stated that it intends to focus its efforts on developing Memryte for the treatment of Alzheimer's disease in women and on seeking a potential collaborative partner for the program. If Voyager is unable to raise the required money to fund its continued operations or if Voyager is unable to enter into an arrangement with a collaborator, it will not be able to continue to develop or commercialize Memryte.

*Our business strategy includes the entry into additional collaborative agreements. We may not be able to enter into additional collaborative agreements or may not be able to negotiate commercially acceptable terms for these agreements*

Our current business strategy includes the entry into additional collaborative agreements for the development and commercialization of our pharmaceutical systems. The negotiation and consummation of these type of agreements typically involve simultaneous discussions with multiple potential collaborators and require significant time and resources from our officers, business development, legal and research and development staff. In addition, in attracting the attention of pharmaceutical and biotechnology company collaborators, we compete with numerous other third parties with product opportunities as well as the collaborators' own internal product opportunities. We may not be able to consummate additional collaborative agreements, or we may not be able to negotiate commercially acceptable terms for these agreements. If we do not consummate additional collaborative agreements, we may have to consume money more rapidly on our product development efforts, defer development activities or forego the exploitation of certain geographic territories, any of which could have a material adverse effect on our business.

*We may develop our own sales force to market POSIDUR and to co-promote, along with Endo, TRANSDUR-Sufentanil in the United States but we have limited sales experience and may not be able to do so effectively*

We currently plan to develop our own sales force to market POSIDUR in the United States and to co-promote, along with Endo, TRANSDUR-Sufentanil in the United States, if such pharmaceutical systems are approved for marketing by the FDA. Developing a sales force will require substantial expenditures. DURECT has limited sales and marketing experience, and may not be able to effectively recruit, train or retain sales personnel. We may not be able to effectively sell our pharmaceutical systems, if approved, and our failure to do so could limit or materially harm our business.

*We and our third-party collaborators may not sell our pharmaceutical systems effectively*

We and our third-party collaborators compete with many other companies that currently have extensive and well-funded marketing and sales operations. Our marketing and sales efforts and those of our third-party

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collaborations may be unable to compete successfully against these other companies. We and our third-party collaborators, if relevant, may be unable to establish a sufficient sales and marketing organization on a timely basis, if at all. We and our third-party collaborators, if relevant, may be unable to engage qualified distributors. Even if engaged, these distributors may:

fail to satisfy financial or contractual obligations to us;

fail to adequately market our pharmaceutical systems;

cease operations with little or no notice to us;

offer, design, manufacture or promote competing product lines;

fail to maintain adequate inventory and thereby restrict use of our pharmaceutical systems; or

build up inventory in excess of demand thereby limiting future purchases of our pharmaceutical systems resulting in significant quarter-to-quarter variability in our sales.

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

### *We rely heavily on third parties to support development, clinical testing and manufacturing of our pharmaceutical systems*

We rely on third-party contract research organizations, service providers and suppliers to provide critical services to support development, clinical testing, and manufacturing of our pharmaceutical systems. For example, we currently depend on third-party vendors to manage and monitor our clinical trials and to perform critical manufacturing steps for our pharmaceutical systems. These third parties may not execute their responsibilities and tasks competently or in a timely fashion. We rely on third-parties to manufacture or perform manufacturing steps relating to our pharmaceutical systems or components. We anticipate that we will continue to rely on these and other third-party contractors to support development, clinical testing, and manufacturing of our pharmaceutical systems. Failure of these contractors to provide the required services in a competent or timely manner or on reasonable commercial terms could materially delay the development and approval of our development products, increase our expenses and materially harm our business, financial condition and results of operations.

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

Certain components and drug substances used in our pharmaceutical systems (including POSIDUR, TRANSDUR-Sufentanil, ELADUR, Remoxy and our second ORADUR-opioid, Memryte and CHRONOGESIC) are currently purchased from a single or a limited number of outside sources. In particular, Eastman Chemicals is the sole supplier, pursuant to a supply agreement entered into in December 2005, of our requirements of sucrose acetate isobutyrate, a necessary component of POSIDUR, Remoxy, our second ORADUR-opioid and certain other pharmaceuticals systems we have under development. The reliance on a sole or limited number of suppliers could result in:

delays associated with redesigning a pharmaceutical system due to a failure to obtain a single source component;

an inability to obtain an adequate supply of required components; and

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reduced control over pricing, quality and delivery time.

We have supply agreements in place for certain components of our pharmaceuticals systems, but do not have in place long term supply agreements with respect to all of the components of any of our pharmaceutical system candidates. Therefore the supply of a particular component could be terminated at any time without

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penalty to the supplier. In addition, we may not be able to procure required components or drugs from third-party suppliers at a quantity, quality and cost acceptable to us. Any interruption in the supply of single source components could cause us to seek alternative sources of supply or manufacture these components internally. Furthermore, in some cases, we are relying on our third-party collaborators to procure supply of necessary components. If the supply of any components for our pharmaceutical systems is interrupted, components from alternative suppliers may not be available in sufficient volumes or at acceptable quality levels within required timeframes, if at all, to meet our needs or those of our third-party collaborators. This could delay our ability to complete clinical trials and obtain approval for commercialization and marketing of our pharmaceutical systems, causing us to lose sales, incur additional costs, delay new product introductions and could harm our reputation.

*If we are unable to adequately protect or enforce our intellectual property rights or secure rights to third-party patents, we may lose valuable assets, experience reduced market share or incur costly litigation to protect our rights or our third-party collaborators may choose to terminate their agreements with us*

Our success will depend in part on our ability to obtain patents, maintain trade secret protection and operate without infringing the proprietary rights of others. As of February 29, 2008, we held 39 issued U.S. patents and 224 issued foreign patents (which include granted European patent rights that have been validated in various EU member states). In addition, we have 85 pending U.S. patent applications and have filed 80 patent applications under the Patent Cooperation Treaty, from which 352 national phase applications are currently pending in Europe, Australia, Japan, Canada and other countries. Our patents expire at various dates starting in the year 2012.

Under our agreement with ALZA, we must assign to ALZA any intellectual property rights relating to the DUROS system and its manufacture and any combination of the DUROS system with other components, active agents, features or processes. In addition, ALZA retains the right to enforce and defend against infringement actions relating to the DUROS system, and if ALZA exercises these rights, it will be entitled to the proceeds of these infringement actions.

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

The patent laws of the U.S. have recently undergone changes through court decisions which may have significant impact on us and our industry. The recent decisions of the U.S. Supreme Court (e.g., *KSR v. Teleflex*, *EBay v. MercExchange*) and other courts (e.g., *In re Seagate*) with respect to the standards of patentability, enforceability, availability of injunctive relief and damages may make it more difficult for us to procure, maintain and enforce patents. In addition, bills are pending before the U.S. Congress including the Patent Reform Act of 2007 that may fundamentally change the patent laws of the U.S. on issues ranging from priority entitlement, filing and prosecution matters to enforcement and damages. These changes and proposed reforms have introduced significant uncertainty in the patent law landscape and may potentially negatively impact our ability to procure, maintain and enforce patents to provide exclusivity for our products.

We are party to several collaborative agreements. Our third-party collaborators have entered into these agreements based on the exclusivity that our intellectual property rights confer on the products being developed. The loss or diminution of our intellectual property rights could result in a decision by our third-party collaborators to terminate their agreements with us. In addition, these agreements are generally complex and contain provisions that could give rise to legal disputes, including potential disputes concerning ownership of intellectual property and data under collaborations. Such disputes can lead to lengthy, expensive litigation or

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arbitration requiring us to devote management time and resources to such dispute which we would otherwise spend on our business. To the extent that our agreements call for future royalties to be paid conditional on our having patents covering the royalty-bearing subject matter, the decision by the Supreme Court in the case of *MedImmune, Inc. v. Genentech, Inc.* could encourage our licensees to challenge the validity of our patents and thereby seek to avoid future royalty obligations without losing the benefit of their license. Should they be successful in such a challenge, our ability to collect future royalties could be substantially diminished.

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

We may be unable to meaningfully protect our rights in trade secrets, technical know-how and other non-patented technology. We may have to resort to litigation to protect our intellectual property rights, or to determine their scope, validity or enforceability. In addition, interference proceedings declared by the U.S. Patent and Trademark Office may be necessary to determine the priority of inventions with respect to our patent applications. Enforcing or defending our proprietary rights is expensive, could cause diversion of our resources and may not prove successful. Any failure to enforce or protect our rights could cause us to lose the ability to exclude others from using our technology to develop or sell competing products.

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

We and our collaborators may be exposed to future litigation by third parties based on claims that our pharmaceutical systems or activities infringe the intellectual property rights of others or that we or our collaborators have misappropriated the trade secrets of others. This risk is exacerbated by the fact that the validity and breadth of claims covered in medical technology patents and the breadth and scope of trade secret protection involve complex legal and factual questions for which important legal principles are unresolved. Any litigation or claims against us or our collaborators, whether or not valid, could result in substantial costs, could place a significant strain on our financial resources and could harm our reputation. We also may not have sufficient funds to litigate against parties with substantially greater resources. In addition, pursuant to our collaborative agreements, we have provided our collaborators with the right, under specified circumstances, to defend against any claims of infringement of the third party intellectual property rights, and such collaborators may not defend against such claims adequately or in the manner that we would do ourselves. Intellectual property litigation or claims could force us or our collaborators to do one or more of the following, any of which could harm our business or financial results:

cease selling, incorporating or using any of our pharmaceutical systems that incorporate the challenged intellectual property, which would adversely affect our revenue;

obtain a license from the holder of the infringed intellectual property right, which license may be costly or may not be available on reasonable terms, if at all; or

redesign our pharmaceutical systems, which would be costly and time-consuming.

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### *We may be required to obtain rights to certain drugs*

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

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

We may acquire technologies, products or businesses to broaden the scope of our existing and planned product lines and technologies. Future acquisitions expose us to:

increased costs associated with the acquisition and operation of the new businesses or technologies and the management of geographically dispersed operations;

the risks associated with the assimilation of new technologies, operations, sites and personnel;

the diversion of resources from our existing business and technologies;

the inability to generate revenues to offset associated acquisition costs;

the requirement to maintain uniform standards, controls, and procedures; and

the impairment of relationships with employees and customers or third party collaborators as a result of any integration of new management personnel.

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

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

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



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

We may incur significant non-cash charges related to impairment write-downs of our long-lived assets, including goodwill and other intangible assets. We will continue to incur non-cash charges related to amortization of other intangible assets. We are required to perform periodic impairment reviews of our goodwill at least annually. To the extent these reviews conclude that the expected future cash flows generated from our business activities are not sufficient to recover the cost of our long-lived assets, we will be required to measure and record an impairment charge to write down these assets to their realizable values. We completed our last review during the fourth quarter of 2007 and determined that goodwill was not impaired as of December 31, 2007. However, there can be no assurance that upon completion of subsequent reviews a material impairment charge will not be recorded. If future periodic reviews determine that our assets are impaired and a write-down is required, it will adversely impact or delay our profitability.

In December 2004, the FASB issued Statement No. 123 (revised 2004, or SFAS 123(R), *Share-Based Payment*, which was originally effective for annual or interim periods beginning after June 15, 2005. SFAS 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and will require companies to recognize compensation expense, using a fair-value based method, for costs related to share-based payments including stock options and stock issued under our employee stock purchase plans. We adopted SFAS 123(R) using the modified prospective basis on January 1, 2006. Our adoption of SFAS 123(R) has and will continue to have a material adverse impact on our condensed results of operations and will adversely impact or delay our profitability. Furthermore, we have issued to ALZA common stock and a warrant to purchase common stock with an aggregate value of approximately \$13.5 million, which will be amortized over time based on future sales of our DUROS-based products and which will also adversely impact or delay our profitability.

*Global credit and financial market conditions could negatively impact the value of our current portfolio of cash equivalents or short-term investments and our ability to meet our financing objectives.*

Our cash and cash equivalents are maintained in highly liquid investments with remaining maturities of 90 days or less at the time of purchase. Our short-term investments consist primarily of readily marketable debt securities with remaining maturities of more than 90 days and less than one year at the time of purchase. While as of the date of this filing, we are not aware of any downgrades, material losses, or other significant deterioration in the fair value of our cash equivalents or short-term investments since December 31, 2007, no assurance can be given that further deterioration in conditions of the global credit and financial markets would not negatively impact our current portfolio of cash equivalents or short-term investments or our ability to meet our financing objectives.

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

Our success will depend to a significant degree upon the continued services of key management, technical and scientific personnel, including Felix Theeuwes, our Chairman and Chief Scientific Officer and James E. Brown, our President and Chief Executive Officer. Although we have obtained key man life insurance policies for each of Messrs. Theeuwes and Brown in the amount of \$1.0 million, this insurance may not adequately compensate us for the loss of their services. In addition, our success will depend on our ability to attract and retain other highly skilled personnel. Competition for qualified personnel is intense, and the process of hiring and integrating such qualified personnel is often lengthy. We may be unable to recruit such personnel on a timely basis, if at all. Our management and other employees may voluntarily terminate their employment with us at any time. The loss of the services of key personnel, or the inability to attract and retain additional qualified personnel, could result in delays to product development or approval, loss of sales and diversion of management resources.

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### *We may not successfully manage our growth*

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

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

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

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

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

## **Risks Related To Our Industry**

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

The pharmaceutical industry is subject to rapid and substantial technological change. Developments by others may render our pharmaceutical systems under development or technologies noncompetitive or obsolete, or we may be unable to keep pace with technological developments or other market factors. Technological competition in the industry from pharmaceutical and biotechnology companies, universities, governmental entities and others diversifying into the field is intense and is expected to increase.

We may face competition from other companies in numerous industries including pharmaceuticals, medical devices and drug delivery. POSIDUR, TRANSDUR-Sufentanil, ELADUR, Remoxy and other ORADUR-based opioids, Memryte and CHRONOGESIC, if approved, will compete with currently marketed oral opioids,

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transdermal opioids, local anesthetic patches, and implantable and external infusion pumps which can be used for infusion of opioids and local anesthetics. Products of these types are marketed by Purdue Pharma, Alpharma, Knoll, Janssen, Medtronic, Endo Pharmaceuticals, AstraZeneca, Arrow International, Tricumed, I Flow and others. Numerous companies are applying significant resources and expertise to the problems of drug delivery and several of these are focusing or may focus on delivery of drugs to the intended site of action, including Alkermes, QLT, Pacira Pharmaceuticals, EpiCept, Innocoll, Inovio, Nektar, Focal, I-Flow, Anesiva, NeurogesX, Alexza and others. Some of these competitors may be addressing the same therapeutic areas or indications as we are. Our current and potential competitors may succeed in obtaining patent protection or commercializing products before us. Many of these entities have significantly greater research and development capabilities than we do, as well as substantially more marketing, manufacturing, financial and managerial resources. These entities represent significant competition for us. Acquisitions of, or investments in, competing pharmaceutical or biotechnology companies by large corporations could increase such competitors financial, marketing, manufacturing and other resources.

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

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

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

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

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

Our future financial performance will depend upon the successful introduction and customer acceptance of our future products, including POSIDUR, TRANSDUR-Sufentanil, ELADUR, Remoxy and other ORADUR-based opioids, Memryte and CHRONOGESIC. Even if approved for marketing, our pharmaceutical systems may

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not achieve market acceptance. The degree of market acceptance will depend upon a number of factors, including:

the receipt of regulatory clearance of marketing claims for the uses that we are developing;

the establishment and demonstration in the medical community of the safety and clinical efficacy of our products and their potential advantages over existing therapeutic products, including oral medication, transdermal drug delivery products such as drug patches, or external or implantable drug delivery products; and

pricing and reimbursement policies of government and third-party payors such as insurance companies, health maintenance organizations, hospital formularies and other health plan administrators.

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

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

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

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

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

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

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

Future changes in financial accounting standards may cause adverse, unexpected fluctuations in the timing of the recognition of revenues or expenses and may affect our financial position or results of operations. New pronouncements and varying interpretations of pronouncements have occurred with frequency and may occur in the future and we may make changes in our accounting policies in the future. Compliance with changing regulation of corporate governance and public disclosure may result in additional expenses. Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations, PCAOB pronouncements and Nasdaq Global Market rules, are creating uncertainty for companies such as ours and insurance, accounting and auditing costs are increasing as a result of this uncertainty and other factors. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we intend to invest all reasonably necessary resources to comply with evolving standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities.

## **Risks Related To Our Common Stock**

*Our operating history makes evaluating our stock difficult*

We have engaged primarily in research and development, licensing technology, raising capital and recruiting scientific and management personnel and, to a lesser extent, sales and marketing of products that we do not consider core to our business. We have no approved pharmaceutical system products. This history does not enable investors to fully assess our ability to successfully develop our pharmaceutical systems, achieve market acceptance of our pharmaceutical systems and respond to competition. Furthermore, we anticipate that our quarterly and annual results of operations will fluctuate for the foreseeable future. We believe that period-to-period comparisons of our operating results should not be relied upon as predictive of future performance. Our prospects must be considered in light of the risks, expenses and difficulties encountered by companies with no approved pharmaceutical products, particularly companies in new and rapidly evolving markets such as pharmaceuticals, drug delivery and biotechnology. To address these risks, we must, among other things, obtain regulatory approval for and commercialize our pharmaceutical systems, which may not occur. We may not be successful in addressing these risks and difficulties. We may require additional funds to complete the development of our pharmaceutical systems and to fund operating losses to be incurred in the next several years.

*Investors may experience substantial dilution of their investment*

In the past, we have issued and have assumed, pursuant to the SBS acquisition, options and warrants to acquire common stock. To the extent these outstanding options are ultimately exercised, there will be dilution to investors. In addition, conversion of some or all of the \$23.6 million aggregate principal amount of our 6.25% convertible subordinated notes that we issued in June and July 2003 will dilute the ownership interests of investors. Investors may experience further dilution of their investment if we raise capital through the sale of additional equity securities or debt securities or grant additional stock options to employees and consultants. Any sales in the public market of the common stock issuable upon such conversion could adversely affect prevailing market prices for our common stock.

*We may choose to purchase a portion of our convertible subordinated notes in exchange for shares of our common stock or pay note holders to convert out notes. These transactions could dilute existing stockholders, increase the volatility of our stock and consume our existing cash*

To the extent we are able to do so on terms favorable to us, we may choose to purchase a portion of our outstanding Notes due June 2008 from time to time in privately negotiated transactions under Section 3(a)(9) of the Securities Act of 1933. From the third quarter of 2005 through October 2007, we exchanged an aggregate of approximately \$36.4 million in principal amount of our 6.25% convertible subordinated notes in individually negotiated transactions with note holders, pursuant to which we issued approximately 11.6 million shares of our

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common stock, and made cash payments in the aggregate amount of \$3.8 million. The issuance of shares of our common stock in any such additional transactions will dilute our existing investors. To the extent such shares are resold, such transactions may increase the volatility of our stock. Such transactions also consume our cash in a manner that may not benefit our stockholders.

*The price of our common stock may be volatile*

The stock markets in general, and the markets for pharmaceutical stocks in particular, have experienced extreme volatility that has often been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the trading price of our common stock.

Price declines in our common stock could result from general market and economic conditions and a variety of other factors, including:

failure of our third-party collaborators (such as Endo, Pain Therapeutics or its commercialization sublicensee King Pharmaceuticals, Nycomed or Voyager) to develop and commercialize successfully the respective pharmaceutical systems they are developing;

adverse results (including adverse events) or delays in our clinical trials of POSIDUR, TRANSDUR-Sufentanil, ELADUR, Remoxy, our second ORADUR-opioid, Memryte, CHRONOGESIC or other pharmaceutical systems;

announcements of FDA non-approval of our pharmaceutical systems, or delays in the FDA or other foreign regulatory agency review process;

adverse actions taken by regulatory agencies with respect to our pharmaceutical systems, clinical trials, manufacturing processes or sales and marketing activities, or those of our third party collaborators;

announcements of technological innovations, patents or new products by our competitors;

regulatory developments in the United States and foreign countries;

any lawsuit involving us or our pharmaceutical systems including intellectual property infringement or product liability suits;

announcements concerning our competitors, or the biotechnology or pharmaceutical industries in general;

developments concerning our strategic alliances or acquisitions;

actual or anticipated variations in our operating results;

changes in recommendations by securities analysts or lack of analyst coverage;

deviations in our operating results from the estimates of analysts;

sales of our common stock by our executive officers or directors or sales of substantial amounts of common stock by others;

changes in accounting principles; and

loss of any of our key scientific or management personnel.

As of December 31, 2007, we had outstanding \$23.6 million in convertible subordinated notes which are convertible into shares of our common stock at a conversion rate of 317.4603 shares per \$1,000 principal amount of notes, subject to adjustment and will bear interest at a rate of 6.25% per annum. If substantial amounts of our common stock issued upon conversion of our promissory notes or otherwise were to be sold in the public market, the market price of our common stock could fall. In addition, the existence of our convertible subordinated notes may encourage short selling by market participants. The market price of our common stock may fluctuate significantly in response to factors which are beyond our control. The stock market in general has recently

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experienced extreme price and volume fluctuations. In addition, the market prices of securities of technology and pharmaceutical companies have also been extremely volatile, and have experienced fluctuations that often have been unrelated or disproportionate to the operating performance of these companies. These broad market fluctuations could result in extreme fluctuations in the price of our common stock, which could cause a decline in the value of our investors' stock.

In the past, following periods of volatility in the market price of a particular company's securities, litigation has often been brought against that company. If litigation of this type is brought against us, it could be extremely expensive and divert management's attention and our company's resources.

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

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

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

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

the election of directors;

the amendment of charter documents;

the approval of certain mergers and other significant corporate transactions, including a sale of substantially all of our assets; or

the defeat of any non-negotiated takeover attempt that might otherwise benefit the public stockholders.

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

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

authorizing the issuance of blank check preferred stock without any need for action by stockholders;

providing for a dividend on our common stock, commonly referred to as a poison pill, which can be triggered after a person or group acquires 17.5% or more of common stock;

providing for a classified board of directors with staggered terms;

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requiring supermajority stockholder voting to effect certain amendments to our certificate of incorporation and bylaws;

eliminating the ability of stockholders to call special meetings of stockholders;

prohibiting stockholder action by written consent; and

establishing advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted on by stockholders at stockholder meetings.

**Table of Contents****Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**

The following chart indicates the facilities that we lease, the location and size of each such facility and their designated use.

| Location      | Approximate Square Feet | Operation                            | Expiration                                                                 |
|---------------|-------------------------|--------------------------------------|----------------------------------------------------------------------------|
| Cupertino, CA | 30,000 sq. ft.          | Office, Laboratory and Manufacturing | Lease expires 2009 (with an option to renew for an additional five years)  |
| Cupertino, CA | 20,000 sq. ft.          | Office and Laboratory                | Lease expires 2009 (with an option to renew for an additional five years)  |
| Cupertino, CA | 40,560 sq. ft.          | Office                               | Lease expires 2012 (with an option to renew for an additional six years)   |
| Vacaville, CA | 17,452 sq. ft.          | Manufacturing                        | Lease expires 2008 (with an option to renew for an additional three years) |
| Pelham, AL    | 9,400 sq. ft.           | Office, Laboratory and Manufacturing | Lease expires 2009 (with an option to renew for an additional five years)  |

We believe that our existing facilities are adequate to meet our current and foreseeable requirements or that suitable additional or substitute space will be available as needed.

**Item 3. Legal Proceedings.**

We are not a party to any material legal proceedings.

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

No matters were submitted during the fourth quarter of the year ended December 31, 2007.

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matter and Issuer Purchases of Equity Securities.  
Price Range of Common Stock**

Our common stock has been traded on the Nasdaq Global Market under the symbol **DRRX** since our initial public offering on September 28, 2000. The following table sets forth, for the periods indicated, the high and low sales prices for our common stock as reported by the Nasdaq Global Market.

|                                     | <b>Common Stock<br/>Price</b> |             |
|-------------------------------------|-------------------------------|-------------|
|                                     | <b>Low</b>                    | <b>High</b> |
| <b>Year ended December 31, 2006</b> |                               |             |
| First Quarter                       | \$ 4.07                       | \$ 6.36     |
| Second Quarter                      | 3.62                          | 6.32        |
| Third Quarter                       | 2.76                          | 4.24        |
| Fourth Quarter                      | 3.77                          | 5.00        |
| <b>Year ended December 31, 2007</b> |                               |             |
| First Quarter                       | \$ 3.89                       | \$ 4.59     |
| Second Quarter                      | 3.78                          | 4.87        |
| Third Quarter                       | 3.68                          | 5.66        |
| Fourth Quarter                      | 5.00                          | 6.90        |

The closing sale price of the common stock as reported on the Nasdaq Global Market on February 29, 2008 was \$4.97 per share. As of that date there were approximately 152 holders of record of the common stock. This does not include the number of persons whose stock is in nominee or street name accounts through brokers. The market price of our common stock has been and may continue to be subject to wide fluctuations in response to a number of events and factors, such as progress in our development programs, quarterly variations in our operating results, announcements of technological innovations or new products by us or our competitors, changes in financial estimates and recommendations by securities analysts, the operating and stock performance of other companies that investors may deem comparable to us, and news reports relating to trends in our markets. These fluctuations, as well as general economic and market conditions, may adversely affect the market price for our common stock.

**Dividend Policy**

We have never paid cash dividends on our common stock. We currently intend to retain any future earnings to fund the development and growth of our business. Therefore, we do not currently anticipate paying any cash dividends in the foreseeable future.

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**STOCK PERFORMANCE GRAPH**

The following graph compares the cumulative total stockholder return data for our stock with the cumulative return of (i) The Nasdaq Stock Market (U.S.) Index and (ii) the Nasdaq Biotechnology Index since December 31, 2002. The graph assumes that \$100 was invested on December 31, 2002. The stock price performance on the following graph is not necessarily indicative of future stock price performance.

\* \$100 Invested on 12/31/02 in stock or index including reinvestment of dividends. Fiscal year ending December 31.

**DURECT CORPORATION**

|                            | Cumulative Total Return |          |          |          |          |          |
|----------------------------|-------------------------|----------|----------|----------|----------|----------|
|                            | 12/31/02                | 12/31/03 | 12/31/04 | 12/31/05 | 12/31/06 | 12/31/07 |
| DURECT CORPORATION         | 100.00                  | 123.76   | 162.38   | 250.99   | 219.80   | 318.32   |
| NASDAQ STOCK MARKET (U.S.) | 100.00                  | 150.01   | 162.89   | 165.13   | 180.85   | 198.60   |
| NASDAQ BIOTECHNOLOGY       | 100.00                  | 145.75   | 154.68   | 159.06   | 160.69   | 168.05   |

**Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

None.

**Table of Contents****Item 6. Selected Financial Data.**

The following selected consolidated financial data should be read in conjunction with and are qualified by reference to Management's Discussion and Analysis of Financial Condition and Results of Operations and our financial statements and related notes, which are included in this Form 10-K. The statement of operations data for the years ended December 31, 2007, 2006 and 2005 and the balance sheet data at December 31, 2007 and 2006 are derived from, and are qualified by reference to, the audited financial statements included elsewhere in this Form 10-K. The statement of operations data for the years ended December 31, 2004 and 2003, and the balance sheet data at December 31, 2005, 2004 and 2003 are derived from our audited statements not included in this Form 10-K. Historical operating results are not necessarily indicative of results in the future. See Note 1 of notes to financial statements for an explanation of the determination of the shares used in computing net loss per share.

|                                                               | 2007        | Year Ended December 31,               |                    |             |             | 2003 |
|---------------------------------------------------------------|-------------|---------------------------------------|--------------------|-------------|-------------|------|
|                                                               |             | 2006                                  | 2005               | 2004        |             |      |
|                                                               |             | (in thousands, except per share data) |                    |             |             |      |
| Statement of Operations Data:                                 |             |                                       |                    |             |             |      |
| Collaborative research and development and other revenue      | \$ 22,417   | \$ 13,786                             | \$ 20,032          | \$ 7,437    | \$ 5,144    |      |
| Product revenue, net                                          | 8,258       | 8,108                                 | 6,939              | 6,416       | 6,691       |      |
| Revenue from sale of intellectual property rights             |             |                                       | 1,600              |             |             |      |
| Total revenue                                                 | 30,675      | 21,894                                | 28,571             | 13,853      | 11,835      |      |
| Operating expenses:                                           |             |                                       |                    |             |             |      |
| Cost of revenue                                               | 3,225       | 3,248                                 | 2,815              | 2,730       | 2,445       |      |
| Research and development                                      | 38,342      | 37,241                                | 29,141             | 24,390      | 20,738      |      |
| Selling, general and administrative                           | 13,618      | 12,417                                | 11,034             | 9,793       | 8,588       |      |
| Amortization of intangible assets                             | 31          | 424                                   | 1,209              | 1,249       | 1,343       |      |
| Total operating expenses                                      | 55,216      | 53,330                                | 44,199             | 38,162      | 33,114      |      |
| Loss from operations                                          | (24,541)    | (31,436)                              | (15,628)           | (24,309)    | (21,279)    |      |
| Other income (expense):                                       |             |                                       |                    |             |             |      |
| Interest income and other                                     | 3,545       | 3,832                                 | 2,270              | 1,236       | 1,041       |      |
| Interest expense                                              | (2,625)     | (3,436)                               | (4,363)            | (4,546)     | (2,460)     |      |
| Debt conversion expense                                       | (718)       | (2,287)                               | (403)              |             |             |      |
| Net other income (expense)                                    | 202         | (1,891)                               | (2,496)            | (3,310)     | (1,419)     |      |
| Loss before income taxes                                      | (24,339)    | (33,327)                              | (18,124)           | (27,619)    | (22,698)    |      |
| Income tax provision                                          |             |                                       | 4                  | 18          |             |      |
| Net loss                                                      | \$ (24,339) | \$ (33,327)                           | \$ (18,128)        | \$ (27,637) | \$ (22,698) |      |
| Basic and diluted net loss per share                          | \$ (0.35)   | \$ (0.51)                             | \$ (0.34)          | \$ (0.54)   | \$ (0.45)   |      |
| Shares used in computing basic and diluted net loss per share | 70,483      | 65,961                                | 53,719             | 51,507      | 50,510      |      |
|                                                               | 2007        | 2006                                  | As of December 31, |             | 2003        |      |
|                                                               |             |                                       | 2005               | 2004        |             |      |
|                                                               |             | (in thousands)                        |                    |             |             |      |
| Balance Sheet Data:                                           |             |                                       |                    |             |             |      |
| Cash, cash equivalents and investments                        | \$ 62,016   | \$ 81,607                             | \$ 90,997          | \$ 61,813   | \$ 85,167   |      |
| Working capital                                               | 25,700      | 63,100                                | 84,202             | 42,082      | 61,050      |      |
| Total assets                                                  | 84,020      | 102,485                               | 117,414            | 85,468      | 112,407     |      |
| Convertible subordinated notes                                | 23,559      | 37,337                                | 57,337             | 60,000      | 60,000      |      |
| Other long-term liabilities, net of current portion           | 10,351      | 15,417                                | 6,848              | 1,589       | 2,278       |      |
| Stockholders' equity                                          | 34,581      | 37,032                                | 43,352             | 18,390      | 45,115      |      |



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### **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

*This Management's Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2007, 2006, and 2005 should be read in conjunction with our Financial Statements, including the Notes thereto, and Risk Factors section included elsewhere in this Form 10-K. This Form 10-K contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. When used in this report or elsewhere by management from time to time, the words believe, anticipate, intend, plan, estimate, expect and similar expressions are forward-looking statements. Such forward-looking statements contained herein are based on current expectations. Any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties. Actual events or results may differ materially from those discussed in the forward-looking statements as a result of various factors. For a more detailed discussion of such forward looking statements and the potential risks and uncertainties that may impact upon their accuracy, see the Risk Factors section and Overview section of this Management's Discussion and Analysis of Financial Condition and Results of Operations. These forward-looking statements reflect our view only as of the date of this report. We undertake no obligations to update any forward-looking statements. You should also carefully consider the factors set forth in other reports or documents that we file from time to time with the Securities and Exchange Commission.*

### **Overview**

We are an emerging specialty pharmaceutical company focused on the development of pharmaceutical systems based on proprietary drug delivery technology platforms. We are developing and commercializing pharmaceutical systems that will deliver the right drug to the right place in the right amount at the right time to treat chronic or episodic diseases and conditions. By integrating chemistry and engineering advancements, we seek to achieve what drugs or devices alone cannot. Our pharmaceutical systems enable optimized therapy for a given disease or patient population by controlling the rate and duration of drug administration and providing sustained drug delivery.

In addition to developing our own proprietary products, we enter into strategic collaborations with pharmaceutical companies to develop and commercialize proprietary and enhanced pharmaceutical products based on our technologies. We have five disclosed on-going product candidates in development of which four are in collaboration with third-party pharmaceutical companies. The following are our publicly announced product candidates in development:

#### **POSIDUR**

Our post-operative pain relief depot, POSIDUR, is a sustained release injectable using our SABER delivery system to deliver bupivacaine, an off-patent anesthetic agent. SABER is a patented controlled drug delivery technology that can be formulated for systemic or local administration of drugs via the parenteral (i.e., injectable) route. POSIDUR is designed to be administered to a surgical site at the time of surgery for post-operative pain relief and is intended to provide local analgesia for up to 3 days, which we believe coincides with the time period of the greatest need for post surgical pain control in most patients.

In November 2006, we entered into a collaboration agreement with Nycomed Danmark, APS. Under the terms of the agreement, we licensed to Nycomed the exclusive commercialization rights to POSIDUR for the European Union (E.U.) and select other countries. Nycomed paid us an upfront license fee of \$14.0 million in 2006 and an \$8.0 million milestone payment in 2007 triggered by achievement of a clinical development milestone, with future potential additional milestone payments of up to \$180.0 million upon achievement of

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

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defined development, regulatory and sales milestones. We jointly direct and equally fund with Nycomed a development program for POSIDUR intended to secure regulatory approval in both the U.S. and the E.U. In addition, we will manufacture and supply the product to Nycomed for commercial sale in the territory licensed to Nycomed. Nycomed will pay us blended royalties on sales in the defined territory of 15-40% depending on annual sales, as well as a manufacturing markup. We retain full commercial rights to POSIDUR in the U.S., Canada, Asia and certain other countries.

In 2007, we successfully completed a 122 patient Phase IIb clinical trial of POSIDUR for treatment of post-operative pain in patients undergoing inguinal hernia repair. In the Phase IIb trial, POSIDUR at a dose of 5 mL demonstrated statistically significant reductions in pain and in total consumption of supplemental opioid analgesic medications versus placebo. These successful results triggered an \$8.0 million milestone payment by Nycomed to us under our agreement with Nycomed.

We have held an end-of-Phase II meeting with the FDA and are in dialogue with the FDA regarding our anticipated POSIDUR Phase III program.

### *Remoxy and other ORADUR-based opioid products licensed to Pain Therapeutics*

In December 2002, we entered into an agreement with Pain Therapeutics, amended in December 2005, under which we granted Pain Therapeutics the exclusive, worldwide right to develop and commercialize selected long-acting oral opioid products using our ORADUR technology incorporating four specified opioid drugs. The first product being developed under the collaboration is Remoxy, a novel long-acting oral formulation of the opioid oxycodone targeted to decrease the potential for oxycodone abuse. Remoxy is intended for patients with chronic pain.

In December 2007, Pain Therapeutics and King Pharmaceuticals announced that the pivotal Phase III trial for Remoxy successfully met its primary endpoint ( $p < 0.01$ ) that was prospectively defined by the U.S. Food and Drug Administration (FDA) during the Special Protocol Assessment process. In addition, the study achieved statistically significant results in secondary endpoints such as Quality of Analgesia ( $p < 0.01$ ) and Global Assessment ( $p < 0.01$ ). Pain Therapeutics has stated that they expect to file the NDA for Remoxy in the second quarter of 2008.

During 2006 and 2007, we also worked with King and Pain Therapeutics on the development of a second ORADUR abuse-resistant opioid product. In August 2006, King and Pain Therapeutics announced the initiation of a Phase I clinical trial for this ORADUR-based opioid drug candidate, and that the IND application for this drug candidate had been accepted by the FDA. In November 2006, Pain Therapeutics announced positive results from that Phase I clinical trial.

### *TRANSDUR -Sufentanil*

Our transdermal sufentanil patch (TRANSDUR-Sufentanil) uses our proprietary TRANSDUR delivery system to deliver sufentanil, an opioid medication. TRANSDUR-Sufentanil is designed to provide extended chronic pain relief for up to seven days, as compared to the three days of relief provided with currently available opiate patches. We anticipate that the small size of our sufentanil patch (potentially as small as 1/5<sup>th</sup> the size of currently marketed transdermal fentanyl patches for a therapeutically equivalent dose) may offer improved convenience and compliance for patients. In 2005, we successfully completed a Phase II clinical trial of TRANSDUR-Sufentanil in chronic pain. In March 2005, we entered into an agreement with Endo Pharmaceuticals (Endo) granting Endo exclusive rights to develop, market and commercialize TRANSDUR-Sufentanil in the U.S. and Canada. Endo has entered into an agreement with a contract manufacturer, 3M Company (3M), related to manufacturing process development and scale-up for TRANSDUR-Sufentanil. Endo commenced its Phase II program designed to evaluate the conversion of chronic pain patients treated with oral opioid products to TRANSDUR-Sufentanil in the second quarter of 2007.

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### *ELADUR*

Our transdermal bupivacaine patch (ELADUR) uses our proprietary TRANSDUR transdermal technology and is intended to provide continuous delivery of bupivacaine for up to three days from a single application, as compared to a wearing time limited to 12 hours with currently available lidocaine patches.

In 2007, we successfully completed a 60 patient Phase IIa clinical trial for ELADUR. In this study of patients suffering from post-herpetic neuralgia, ELADUR showed improved pain control versus placebo during the 3-day continuous treatment period. In addition, ELADUR appeared well tolerated overall, and patients treated with ELADUR and placebo exhibited similar safety profiles. We are currently conducting manufacturing scale-up and processing studies to secure additional Phase II and Phase III supplies, and are developing our clinical and regulatory strategy.

### *Other Programs*

#### *Memryte*

In July 2002, we entered into a development and commercialization agreement with Voyager under which we granted Voyager the exclusive, worldwide rights to develop and commercialize a product, Memryte, using the DURIN implant system to deliver the peptide leuprolide acetate to treat Alzheimer's disease based on Voyager's patented method of treatment. Effective January 2007, we amended our agreement with Voyager. Under the amendment, among other changes to the Agreement, the royalty rate that we will receive on net sales of Memryte, if commercialized, was doubled (to 10-14% of net sales after the amendment), and in addition, we will receive 10% of any upfront, milestone and other fees received by Voyager in the event that the product is sublicensed to a third party. In return, we paid Voyager \$1.0 million in cash and forgave approximately \$725,000 which was owed to us for previously provided services.

In October 2005, Voyager initiated a Phase III clinical trial for Memryte, but the Phase III trial was truncated by Voyager in order to get an early look at potential efficacy. In the second quarter of 2007, Voyager informed its shareholders that it has observed positive outcome trends among women, but no positive effect among men in Voyager's truncated Phase III clinical trial for Memryte. Based on these results, Voyager has stated that it intends to focus its efforts on developing Memryte for the treatment of Alzheimer's disease in women and on seeking a potential collaborative partner for the program. There can be no assurance that Voyager or any other party will continue development of Memryte.

#### *CHRONOGESIC® (sufentanil) Pain Therapy System*

The CHRONOGESIC (sufentanil) Pain Therapy System is an osmotic implant that is intended to continuously deliver sufentanil for an extended duration. CHRONOGESIC is intended to treat chronic pain, and is based on the DUROS® System, a miniature osmotic pump capable of continuously delivering drugs for up to a year in duration. We have granted to Endo exclusive commercialization rights for CHRONOGESIC in the U.S. and Canada. In 2002, we completed a pilot Phase III clinical trial for CHRONOGESIC. Clinical trials have been suspended pending system redesign which is on-going. Our agreement with Endo can be terminated by Endo in the event that (i) we have not delivered to Endo on or before March 31, 2008 a written notice that a human pharmacokinetic trial had been completed with CHRONOGESIC, together with a full study report of the results of the trial or (ii) Endo, determines, in its sole discretion, to terminate the agreement during the sixty-day period after our delivery of our notice, provided, that, in each case Endo delivers to us its written notice of termination prior to April 30, 2008. We will not complete the requisite pharmacokinetic trial by March 31, 2008, which will give Endo the right to terminate this agreement.

### *Biologics Programs*

The proteins and genes identified by the biotechnology industry are large, complex, intricate molecules, and many are unsuitable as drugs. If these molecules are given orally, they are often digested before they can have an

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effect; if given by injection, they may be destroyed by the body's natural processes before they can reach their intended sites of action. The body's natural elimination processes require frequent, high dose injections that may result in unwanted side effects. As a result, the development of biotechnology molecules for the treatment of human diseases has been limited, and advanced drug delivery systems such as we possess are required to realize the full potential of many of these protein and peptide drugs. We have active programs underway to apply our drug delivery systems to various biotechnology drugs and drug candidates, and have entered into a number of feasibility studies with biotechnology and pharmaceutical companies to test their products in our systems.

### *Research Programs in Other Therapeutic Categories*

We have underway a number of research programs covering medical diseases and conditions other than pain. Such programs include various diseases and disorders of the central nervous system (CNS), including schizophrenia and attention deficit/hyperactivity disorder. Another area of focus includes cardiovascular disease, including congestive heart failure. In conducting our research programs and determining which particular efforts to prioritize for formal development, we employ a rigorous opportunity assessment process that takes into account the unmet medical need, commercial opportunity, technical feasibility, clinical viability, intellectual property considerations, and the development path including costs to achieve various critical milestones.

### *Collaborative Research and Development Revenues*

Collaborative research and development revenues consist of three broad categories: (a) the amortization of upfront license payments on a straight-line basis over the period of our continuing involvement with the third party, (b) the reimbursement of qualified research expenses by third parties, and (c) milestone payments in connection with our collaborative agreements. During the last two years, we generated substantially all collaborative research and development revenues from three collaborative agreements related to TRANSDUR-Sufentanil, Remoxy and other specified ORADUR-based oral opioids, and POSIDUR. Due to the signing of the Nycomed agreement related to POSIDUR in November 2006, a small amount of collaborative research and development revenue was recognized in 2006 from the amortization of the upfront payment of \$14.0 million received from Nycomed. In 2007 a full year of amortization was recognized. However, in contrast to our other collaborations, due to the terms and nature of this collaboration, we will not recognize revenue from the reimbursement of qualified research expenses by Nycomed. Rather, we will record research and development expense equal to our net share of the joint research and development expenses undertaken under the product development plan.

### *Product Revenues*

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

ALZET® osmotic pumps for animal research use; and

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

Since our inception in 1998, we have had a history of operating losses. At December 31, 2007, we had an accumulated deficit of \$239.7 million and our net losses were \$24.3 million, \$33.3 million and \$18.1 million for the years ended December 31, 2007, 2006 and 2005, respectively. These losses have resulted primarily from costs incurred to research and develop our product candidates and to a lesser extent, from selling, general and administrative costs associated with our operations and product sales. We expect our research and development

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expenses to increase in the near future as we expect to continue to expand our nonclinical studies, clinical trials and other research and development activities as well as to incur additional stock-based compensation cost related to research and development personnel under SFAS 123(R). We expect selling, general and administrative expenses to increase in the near future due to expected increases in employee related costs to support our business activities and in stock-based compensation cost related to selling, general and administrative personnel under SFAS 123(R). We also expect to incur non-cash expenses relating to amortization of intangible assets. We do not anticipate revenues from our pharmaceutical systems, should they be approved, for at least the next twelve months. Therefore, we expect to incur continuing losses and negative cash flow from operations for the foreseeable future.

**Critical Accounting Policies and Estimates**
*General*

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

*Revenue Recognition*

Revenue from the sale of products is recognized when there is persuasive evidence that an arrangement exists, the product is shipped and title transfers to customers, provided no continuing obligation exists, the price is fixed or determinable and the collectibility of the amounts owed is reasonably assured. We recognize revenue from the sale of our products and license and collaboration agreements pursuant to Staff Accounting Bulletin No. 104, *Revenue Recognition*, and Emerging Issues Task Force (EITF) Issue 00-21 *Revenue Arrangements with Multiple Deliverables*. Multiple element agreements entered into are evaluated under the provision of EITF 00-21. We evaluate whether there is stand-alone value for the delivered elements and objective and reliable evidence of fair value to allocate revenue to each element in multiple element agreements. When the delivered element does not have stand-alone value or there is insufficient evidence of fair value for the undelivered element(s), we recognize the consideration for the combined unit of accounting in the same manner as the revenue is recognized for the final deliverable, which is generally ratably over the longest period of involvement.

Upfront payments received upon execution of collaborative agreements are recorded as deferred revenue and recognized as collaborative research and development revenue based on a straight-line basis over the period of our continuing involvement with the third party collaborator pursuant to the applicable agreement. Such period generally represents the research and development period set forth in the work plan defined in the respective agreements between us and our third-party collaborators.

Research and development revenue related to services performed under the collaborative arrangements with our corporate collaborators is recognized as the related research and development services are performed and the collectibility of the amounts owed is reasonably assured. These research payments received under each respective agreement are not refundable and are generally based on reimbursement of qualified expenses, as defined in the agreements. Research and development expenses under the collaborative research and development agreements generally approximate or exceed the revenue recognized under such agreements over the term of the respective agreements. Deferred revenue may result when we do not expend the required level of effort during a specific period in comparison to funds received under the respective agreement. Of note, in regard to our collaboration with Nycomed, in contrast to our other collaborations, because we and Nycomed jointly control and fund the development of POSIDUR, we will not recognize revenue from the reimbursement of qualified research expenses from Nycomed but instead those reimbursements receivable from Nycomed will be recorded as a reduction in research and development expense.

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Milestone payments under collaborative arrangements are recognized as revenue upon achievement of the at risk milestone events, which represent the culmination of the earnings process related to that milestone. Milestone payments are triggered either by the results of our research and development efforts or by events external to us, such as regulatory approval to market a product or the achievement of specified sales levels by a third-party collaborator. As such, the milestones are substantially at risk at the inception of the collaboration agreement, and the amounts of the payments assigned thereto are commensurate with the milestone achieved. In addition, upon the achievement of a milestone event, we have no future performance obligations related to that milestone payment.

### *Research and Development Expenses*

Research and development expenses are primarily comprised of salaries and benefits associated with research and development personnel, overhead and facility costs, preclinical and non-clinical development costs, clinical trial and related clinical manufacturing costs, contract services, and other outside costs. Research and development costs are expensed as incurred. Research and development costs paid to third parties under sponsored research agreements are recognized as expense as the related services are performed, generally ratably over the period of service. In addition, reimbursements by Nycomed for research and development expenses incurred by the Company are recorded as a reduction to research and development expenses. Research and development expenses incurred by Nycomed and reimbursable by the Company are recorded as an addition to the Company's research and development expenses.

### *Intangible Assets and Goodwill*

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

Goodwill is not amortized to expense but rather periodically assessed for impairment. The allocation of the cost of an acquisition to intangible assets and goodwill therefore has a significant impact on our future operating results. The allocation process requires the extensive use of estimates and assumptions, including estimates of future cash flows expected to be generated by the acquired assets. We are also required to estimate the useful lives of those intangible assets subject to amortization, which determines the amount of amortization that will be recorded in a given future period and how quickly the total balance will be amortized. We periodically review the estimated remaining useful lives of our intangible assets. A reduction in our estimate of remaining useful lives, if any, could result in increased amortization expense in future periods. We assess the impairment of identifiable intangible assets, long-lived assets and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of our use of the acquired assets or the strategy for our overall business;

significant negative industry or economic trends;

significant decline in our stock price for a sustained period; and

our market capitalization relative to net book value.

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

We perform a review for impairment of goodwill at least annually in accordance with SFAS 142, *Goodwill and Other Intangible Assets*. No impairment of goodwill has been recorded through December 31, 2007. However, there can be no assurance that at the time other periodic reviews are completed, a material impairment charge will not be recorded.

### *Accrued Liabilities and Contract Research Liabilities*

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

### *Stock-Based Compensation*

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123(R), *Share-Based Payment*, using the modified prospective transition method. Under that transition method, compensation expense that we recognize beginning on that date includes: (a) compensation expense for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based payments granted on or after January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Because we elected to use the modified prospective transition method, results for prior periods have not been restated.

We estimate the fair value of options granted using the Black-Scholes option valuation model. As allowed by Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*, we have opted to use the simplified method for estimating our expected term equal to the midpoint between the vesting period and the contractual term of our stock options. We estimate the volatility of our common stock at the date of grant based on the historical volatility of our common stock, consistent with SFAS 123(R) and SAB 107. We base the risk-free rate that we use in the Black-Scholes option valuation model on the implied yield in effect at the time of option grant on U.S. Treasury zero-coupon issues with equivalent remaining terms. We have never paid any cash dividends on our common stock and we do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes option valuation model. SFAS 123(R) requires us to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. For options granted before January 1, 2006, we amortize the fair value on an accelerated basis. For options granted on or after January 1, 2006, we amortize the fair value on a straight-line basis. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods. We may elect to use different assumptions under the Black-Scholes option valuation model in the future, which could materially affect our net income or loss and net income or loss per share.

### *Recent Accounting Pronouncements*

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48). Under FIN 48 a company would recognize the benefit from a

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tax position only if it is more-likely-than-not that the position would be sustained upon audit based solely on the technical merits of the tax position. FIN 48 clarifies how a company would measure the income tax benefits from the tax positions that are recognized, provides guidance as to the timing of the derecognition of previously recognized tax benefits and describes the methods for classifying and disclosing the liabilities within the financial statements for any unrecognized tax benefits. FIN 48 also addresses when a company should record interest and penalties related to tax positions and how the interest and penalties may be classified within the income statement and presented in the balance sheet. FIN 48 is effective for fiscal years beginning after December 15, 2006, and has been adopted by us effective January 1, 2007. Pursuant to FIN 48, the cumulative effects, if any, of applying FIN 48 would be recorded as an adjustment to accumulated deficit as of the beginning of the period of adoption. We adopted FIN 48 effective January 1, 2007 as described in Note 12. The adoption of FIN 48 did not have any impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements. SFAS 157 does not require any new fair value measurement SFAS 157 requires prospective application for fiscal year ending December 31, 2008.

In February 2007, FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB No. 115* ( SFAS 159 ). The Statement permits entities to choose, at specified election dates, to measure many financial instruments and certain other items at fair value that are not currently measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected would be reported in earnings at each subsequent reporting date. SFAS 159 also establishes presentation and disclosure requirements in order to facilitate comparisons between entities choosing different measurement attributes for similar types of assets and liabilities. SFAS 159 does not affect existing accounting requirements for certain assets and liabilities to be carried at fair value. This statement is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by us for the fiscal year ending December 31, 2008. We do not believe that the adoption of SFAS 159 will have a material impact on our financial statements.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* ( SFAS No. 141R ). SFAS No. 141R amends SFAS 141 and provides revised guidance for recognizing and measuring identifiable assets and goodwill acquired, liabilities assumed, and any noncontrolling interest in the acquiree. It also provides disclosure requirements to enable users of the financial statements to evaluate the nature and financial effects of the business combination. It is effective for fiscal years beginning on or after December 15, 2008 and will be applied prospectively. We do not believe that the adoption of SFAS 141R will have a material impact on our financial statements.

## **Results of Operations**

### *Comparison of years ended December 31, 2007 and 2006*

**Revenues.** Net revenues were \$30.7 million in 2007 compared to \$21.9 million in 2006. The increase in total revenues in 2007 is primarily attributable to milestone revenue of \$8.0 million recognized from our Nycomed collaboration related to POSIDUR as well as increased collaborative research and development revenue from Endo, from feasibility agreements with third parties and from the amortization of the Nycomed upfront fee, partially offset by decreased collaborative research and development revenue from Pain Therapeutics and Voyager.

### *Collaborative research and development and other revenue*

We recognize revenues from collaborative research and development activities and service contracts. We recorded \$22.4 million of collaborative research and development and other revenue in 2007 compared to \$13.8 million in 2006. Collaborative research and development revenue primarily represents reimbursement of qualified expenses related to the collaborative agreements with various third parties to research, develop and commercialize potential products using our drug delivery technologies, amortization of upfront fees and

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milestone payments associated with the license agreements. The increase in collaborative research and development revenue in 2007 was primarily attributable to higher revenue recognized from amortization of the upfront fee received from Nycomed and \$8.0 million of milestone payment in connection with our agreement for POSIDUR, and higher collaborative research and development revenue recognized in connection with increased development activities associated with TRANSDUR-Sufentanil (collaboration with Endo) and feasibility agreements, partially offset by decreased development activities for Remoxy and other opioids (collaboration with Pain Therapeutics) and Memryte (collaboration with Voyager), compared with 2006. We ceased to recognize collaborative research and development revenue related to Memryte from August 2006 because the collectibility of the amounts owed was not reasonably assured.

We received a \$10.0 million upfront fee in connection with the license agreement signed with Endo in March 2005 relating to TRANSDUR-Sufentanil. The \$10.0 million upfront fee is recognized as collaborative research and development revenue ratably over the term of our continuing involvement with Endo with respect to TRANSDUR-Sufentanil. We recognized \$2.2 million in both 2007 and 2006 from amortization of the upfront fee. The term of the continuing involvement has been estimated based on the product development plan pursuant to the agreement.

We also received a \$14.0 million upfront fee in connection with the development and license agreement with Nycomed in November 2006 relating to POSIDUR. The \$14.0 million upfront fee is recognized as collaborative research and development revenue ratably over the term of our continuing involvement with Nycomed with respect to POSIDUR. The amount recognized in 2007 as collaborative research and development revenue from the amortization of the upfront fee was \$3.1 million compared to \$271,000 in 2006. The term of the continuing involvement has been estimated based on the product development plan pursuant to the agreement.

We expect our collaborative research and development revenue to fluctuate in future periods pending our efforts to enter into potential new collaborations and our existing third party collaborators' commitment to and progress in the research and development programs. The collaborative research and development and other revenues associated with our major collaborators are as follows (in thousands):

| <b>Collaborator</b>                                                   | <b>Year ended<br/>December 31,</b> |                  |
|-----------------------------------------------------------------------|------------------------------------|------------------|
|                                                                       | <b>2007</b>                        | <b>2006</b>      |
| Nycomed(1)                                                            | \$ 11,051                          | \$ 271           |
| Pain Therapeutics, Inc.                                               | 4,864                              | 7,477            |
| Endo Pharmaceuticals, Inc.(2)                                         | 4,818                              | 4,438            |
| Voyager Pharmaceutical Corporation                                    |                                    | 777              |
| Others                                                                | 1,684                              | 823              |
| <b>Total collaborative research and development and other revenue</b> | <b>\$ 22,417</b>                   | <b>\$ 13,786</b> |

(1) Amounts related to amortization of upfront fees were \$3.1 million in 2007 and \$271,000 in 2006, respectively. Research and development expenses incurred by us in conjunction with the Nycomed collaboration and reimbursable by Nycomed are recorded as a reduction to total research and development expense. The 2007 figure also includes \$8.0 million of milestone revenue recognized in connection with the Nycomed agreement.

(2) Amounts related to amortization of upfront fees were \$2.2 million for 2007 and 2006.

We amortize upfront fees on a straight-line basis over the period in which we have continuing involvement with the third-party collaborator pursuant to the applicable agreement. Such period generally represents the research and development period set forth in the work plan under each collaboration agreement between us and our third-party collaborator.

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Milestone payments under collaborative arrangements are recognized as revenue upon achievement of the milestone events, which represent the culmination of the earnings process related to that milestone. Milestone payments are triggered either by the results of our research and development efforts or by events external to us, such as regulatory approval to market a product or the achievement of specified sales levels by a third-party collaborator. As such, the milestones are substantially at risk at the inception of the collaboration agreement, and the amounts of the payments assigned thereto are commensurate with the milestone achieved. In addition, upon the achievement of a milestone event, we have no future performance obligations related to that milestone payment. We recorded \$8.0 million of milestone revenue from our Nycomed collaboration due to the achievement of a clinical development milestone for POSIDUR in 2007 and \$100,000 of milestone revenue from our collaboration with another third-party collaborator in 2006.

*Product revenue*

A portion of our revenues is derived from our product sales, which include our ALZET mini pump product line, and to a lesser extent our LACTEL biodegradable polymer products. Net product revenues were \$8.3 million in 2007 compared with \$8.1 million in 2006. The increase was primarily due to higher LACTEL polymer sales in 2007 compared with 2006. Alzet mini pump product sales remained comparable in both years. Beginning in 2008, we expect to generate initial product revenue from commercial production of certain excipients that are components of Remoxy.

*Cost of revenues.* Cost of revenues was \$3.2 million in 2007, essentially unchanged from \$3.2 million in 2006. Cost of revenues includes cost of product revenue from our ALZET mini pump product line and our LACTEL polymer products. Stock based compensation expense related to cost of revenue was \$130,000 recognized under SFAS 123(R) in 2007 compared with \$75,000 in 2006.

As of December 31, 2007 and 2006, we had 23 and 22 manufacturing employees, respectively. We expect cost of revenue to increase in 2008 as we begin to generate product revenue from selling certain excipients that are components of Remoxy.

*Research and Development.* Research and development expenses are primarily comprised of salaries, benefits and stock based compensation associated with research and development personnel, overhead and facility costs, preclinical and non-clinical development costs, clinical trial and related clinical manufacturing costs, contract services, and other outside costs. In addition, research and development expenses incurred by the Company and reimbursed by Nycomed are recorded as a reduction to research and development expenses.

Research and development expenses were \$38.3 million in 2007 and \$37.2 million in 2006. The increase in 2007 was primarily attributable to higher employee costs (primarily related to stock based compensation) and higher development expenses for TRANSDUR-Sufentanil and other research programs, partially offset by lower development expenses for Remoxy and other ORADUR-based opioid product candidates, POSIDUR (due largely to the sharing of various research and development costs with Nycomed after signing our license agreement on November 29, 2006), ELADUR and CHRONOGESIC, compared with the same period in 2006. In 2007, the company recorded a net reduction of \$5.0 million in research and development expenses related to POSIDUR compared with \$426,000 in 2006. The net reduction in research and development expenses represents a net reimbursement from Nycomed reflecting that both parties bore 50% of the development expenses defined under the collaboration agreement for POSIDUR. The 2007 research and development figures include our recording \$1.0 million in research and development expense associated with our payment of \$1.0 million to Voyager in connection with our amended agreement with Voyager related to Memryte in the first quarter of 2007. The 2006 research and development figures include our recording \$1.0 million as research and development expense associated with our payment of an upfront fee upon execution of a license agreement with Epicept. Stock-based compensation expense related to research and development personnel increased from \$2.9 million in 2006 to \$4.3 million in 2007.

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### *POSIDUR*

Our research and development expenses for POSIDUR decreased to \$10.9 million in 2007 from \$12.0 million in 2006 due to a higher net reduction in research and development expense related to POSIDUR under our agreement with Nycomed, partially offset by an increase in costs associated with the Phase II clinical program and contract manufacturing development activities.

Research and development expenses for POSIDUR incurred by us but reimbursable by Nycomed under the terms of our agreement with Nycomed were \$6.2 million in 2007 compared with \$426,000 in 2006, which was accounted for as a reduction of research and development expenses. Research and development expenses for POSIDUR incurred by Nycomed but reimbursable by us under the terms of our agreement with Nycomed were \$1.2 million in 2007 compared with \$0 in 2006, which was accounted for as additional research and development expenses. As a result of the collaboration agreement with Nycomed, our research and development expenses were reduced by \$5.0 million in 2007 compared to \$426,000 in 2006. The net reduction in research and development expenses represents a net reimbursement from Nycomed reflecting that both parties bore 50% of the development expenses defined under the collaboration agreement for POSIDUR.

### *ELADUR*

Our research and development expenses for ELADUR decreased to \$5.1 million in 2007 from \$6.9 million in 2006 primarily due to lower contract manufacturing expenses, partially offset by higher clinical trials expenses for a Phase II clinical trial in 2007.

### *Remoxy and other ORADUR-based opioid products*

Our research and development expenses for Remoxy and other opioids partnered with Pain Therapeutics decreased to \$4.4 million in 2007 from \$6.0 million in 2006 due to reduced formulation and clinical manufacturing activities for Remoxy and other ORADUR-based opioid projects performed by us in 2007 compared with 2006.

### *TRANSDUR-Sufentanil*

Our research and development expenses for TRANSDUR-Sufentanil increased to \$2.8 million in 2007 from \$2.2 million in 2006 due to slightly higher clinical manufacturing related activities performed in support of this product candidate.

### *Biologics Programs*

Our research and development expenses for biologics programs increased to \$3.2 million in 2007 from \$2.8 million in 2006 due to higher external cost and employee related cost in support of our various programs for biologics.

### *CHRONOGESIC® (sufentanil) Pain Therapy System*

Our research and development expenses for CHRONOGESIC decreased to \$1.7 million in 2007 from \$2.1 million in 2006 primarily due to lower external development expenses in 2007.

### *Memryte*

Our research and development expenses for Memryte were \$1.3 million in 2007 and \$1.2 million in 2006. The reported research and development expense in 2007 includes a one-time cash payment of \$1.0 million which we made in January 2007 in accordance with our amended license agreement with Voyager.

**Table of Contents***Other DURECT Research Programs*

Our research and development expenses for all other activities increased to \$8.9 million in 2007 from \$4.0 million in 2006 primarily due to higher employee related costs and increased formulation development activities for other programs in 2007.

As of December 31, 2007, we had 117 research and development employees compared with 116 as of the corresponding date in 2006. We expect research and development expenses to increase in the near future as we continue product development efforts for our internal and partnered product candidates and incur additional stock-based compensation cost under SFAS 123(R) related to research and development personnel.

The research and development expenses associated with our major development products approximate the following (in thousands):

|                                                                             | Year ended<br>December 31, |           |
|-----------------------------------------------------------------------------|----------------------------|-----------|
|                                                                             | 2007                       | 2006      |
| POSIDUR(1)                                                                  | \$ 10,924                  | \$ 12,005 |
| ELADUR                                                                      | 5,132                      | 6,946     |
| Remoxy and other ORADUR-based opioid products licensed to Pain Therapeutics | 4,372                      | 5,987     |
| Biologics Programs                                                          | 3,193                      | 2,782     |
| TRANSDUR-Sufentanil                                                         | 2,843                      | 2,189     |
| CHRONOGESIC                                                                 | 1,719                      | 2,104     |
| Memryte                                                                     | 1,271                      | 1,213     |
| Others                                                                      | 8,888                      | 4,015     |
| Total research and development expenses(2)                                  | \$ 38,342                  | \$ 37,241 |

(1) Research and development expenses for POSIDUR incurred by us but reimbursable by Nycomed under the terms of our agreement with Nycomed were \$6.2 million and \$427,000 in 2007 and 2006, respectively, which were accounted for as a reduction of research and development expenses. Research and development expenses for POSIDUR incurred by Nycomed but reimbursable by us under the terms of our agreement with Nycomed were \$1.2 million and \$0 in 2007 and 2006, respectively, which were accounted for as additional research and development expenses. The agreement with Nycomed was signed in November 2006.

(2) Includes stock-based compensation expenses of \$4.3 million and \$2.9 million in 2007 and 2006, respectively.

We cannot reasonably estimate the timing and costs of our research and development programs due to the risks and uncertainties associated with developing pharmaceutical systems as outlined in the Risk Factors section of this report. The duration of development of our research and development programs may span as many as ten years or more, and estimation of completion dates or costs to complete would be highly speculative and subjective due to the numerous risks and uncertainties associated with developing pharmaceutical products, including significant and changing government regulation, the uncertainties of future preclinical and clinical study results, the uncertainties with our collaborators commitment to and progress in the programs and the uncertainties associated with process development and manufacturing as well as sales and marketing. In addition, with respect to our development programs subject to third-party collaborations, the timing and expenditures to complete the programs are subject to the control of our collaborators. Therefore, we cannot reasonably estimate the timing and estimated costs of the efforts necessary to complete the research and development programs. For additional information regarding these risks and uncertainties, see Risk Factors above.

*Selling, General and Administrative.* Selling, general and administrative expenses are primarily comprised of salaries, benefits and stock-based compensation associated with finance, legal, business development, sales

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and marketing and other administrative personnel, overhead and facility costs, and other general and administrative costs. Selling, general and administrative expenses were \$13.6 million in 2007 compared with \$12.4 million in 2006. The increase in selling general and administrative expenses was primarily attributable to higher employee related costs (which in turn were largely a function of increased stock based compensation) as well as increased patent related expenses in 2007 compared with 2006. Stock-based compensation expense recognized under SFAS 123(R) related to selling, general and administrative personnel was \$2.3 million in 2007 compared with \$1.4 million in 2006.

As of December 31, 2007, we had 36 selling, general and administrative personnel compared with 34 as of the corresponding date in 2006. We expect selling, general and administrative expenses to increase in the near future due to expected increases in patent related costs, in employee related costs to support our business activities and in stock-based compensation costs related to selling, general and administrative personnel under SFAS 123(R).

*Amortization of intangible assets.* Amortization of intangible assets was \$31,000 in 2007 compared with \$424,000 in 2006. The amortization of intangible assets decreased in 2007 as certain intangible assets became fully amortized in 2006. We continue to amortize the existing intangible assets at a constant rate over their estimated useful lives. In the fourth quarter of 2007, goodwill was evaluated for impairment in accordance with SFAS 142. Based on our evaluation, no indicators of impairment were noted. Should goodwill become impaired in the future, we would be required to record an impairment charge to write the goodwill down to its estimated fair value.

In December 2007, we acquired from a third party a portfolio of worldwide patents relating to drug delivery technologies. We paid \$100,000 to this third party upon execution of the agreement. We recorded \$100,000 as intangible assets on our balance sheet as of December 31, 2007 and will amortize these patents over a useful life of 7 years.

The net amount of other intangible assets at December 31, 2007 was \$180,000, which will be amortized as follows: \$45,250 in each of the years ending December 31, 2008 and 2009, \$32,300 for the year ending December 31, 2010, and \$14,300 in each of the years ending December 31, 2011, 2012, 2013 and 2014. We periodically evaluate acquired intangible assets for impairment or obsolescence. Should the intangible assets become impaired or obsolete, we will write them down to their estimated fair value.

*Other Income (Expense).* Interest and other income was \$3.5 million in 2007 compared with \$3.8 million in 2006. The decrease in interest income was primarily the result of lower average cash and investment balances in 2007 compared with 2006, partially offset by higher yields on our investments in 2007.

Interest expense was \$2.6 million in 2007 compared with \$3.4 million in 2006. The decrease in interest expense in 2006 was primarily due to lower remaining balances on our convertible notes in 2007 compared with 2006 due to the conversion of \$13.7 million in aggregate principal amount of convertible notes in 2007.

Debt conversion expense was \$718,000 in 2007 compared with \$2.3 million in 2006. The debt conversion expense in 2007 was recorded in connection with the conversion of \$13.7 million in aggregate principal amount of the 6.25% convertible notes into 4.4 million shares of our common stock in 2007. The debt conversion expense in 2006 was recorded in connection with the conversion of \$20.0 million in aggregate principal amount of the 6.25% convertible notes into 6.3 million shares of our common stock in 2006.

*Income taxes.* Income tax provision was \$0 in both 2007 and 2006. As of December 31, 2007, we had net operating loss carryforwards for federal income tax purposes of approximately \$180.3 million, which expire in the years 2018 through 2027 and federal research and development tax credits of approximately \$3.5 million, which expire at various dates beginning in 2018 through 2027, if not utilized. As of December 31, 2007, we had net operating loss carryforwards for state income tax purpose of approximately \$100.0 million, which expire in

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the years 2008 through 2017 and state research and development tax credits of approximately \$3.5 million, which do not expire. Utilization of the net operating losses may be subject to a substantial annual limitation due to federal and state ownership change limitations. The annual limitation may result in the expiration of net operating losses and credits before utilization.

As of December 31, 2007 and 2006, we had net deferred tax assets of \$86.0 million and \$76.1 million. Deferred tax assets reflect the net tax effects of net operating loss and credit carryforwards and the temporary differences between the carrying amounts of assets and liabilities for financial reporting and the amounts used for income tax purposes. 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.

Because realization of such tax benefits is uncertain, we provided a 100% valuation allowance as of December 31, 2006 and December 31, 2007. Utilization of the NOL and R&D credits carryforwards may be subject to a substantial annual limitation due to ownership change limitations that have occurred previously or that could occur in the future provided by Sections 382 and 383 of the Internal Revenue Code of 1986, as well as similar state and foreign provisions. These ownership changes may limit the amount of NOL and R&D credits carryforwards that can be utilized annually to offset future taxable income and tax, respectively. In general, an ownership change, as defined by Section 382, results from transactions increasing the ownership of certain shareholders or public groups in the stock of a corporation by more than 50 percentage points over a three-year period. Since our formation, we have raised capital through the issuance of capital stock on several occasions which, combined with the purchasing shareholders' subsequent disposition of those shares, may have resulted in a change of control, as defined by Section 382, or could result in a change of control in the future upon subsequent disposition. In addition, we issued \$60.0 million of convertible notes in 2003 and subsequently converted approximately \$36.4 million of these notes as of December 31, 2007 into our common stock in 2005, 2006 and 2007. These transactions may also have resulted in a change of control or could result in a change of control in the future upon conversion of the notes to shares and subsequent disposition of the shares.

We have not currently completed a study to assess whether a change in control has occurred or whether there have been multiple changes of control since its formation due to the significant complexity and cost associated with such a study and that there could be additional changes in the future. If we have experienced a change of control at any time since its formation, utilization of its NOL or R&D credits carryforwards would be subject to an annual limitation under Sections 382 and 383 which is determined by first multiplying the value of our stock at the time of the ownership change by the applicable long-term tax-exempt rate, and then could be subject to additional adjustments, as required. Any limitation may result in expiration of a portion of the NOL or R&D credits carryforwards before utilization. Further, until a study is completed and any limitation known, no amounts are being presented as an uncertain tax position under FIN 48. Interest and penalties related to uncertain tax positions will be reflected in income tax expense. Tax years 1998 to 2007 remain subject to future examination by the major tax jurisdictions in which the Company is subject to tax.

### *Comparison of years ended December 31, 2006 and 2005*

**Revenues.** Net revenues were \$21.9 million in 2006 compared to \$28.6 million in 2005. The decrease in total revenues is primarily attributable to lower collaborative research and development revenue recognized from our agreements with Voyager and Endo, partially offset by higher collaborative research and development revenue from our agreement with Pain Therapeutics and higher product revenues from our ALZET and LACTEL product lines.

### *Collaborative research and development and other revenue*

We recognize revenues from collaborative research and development activities and service contracts. We recorded \$13.8 million of collaborative research and development and other revenue in 2006 compared to

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\$20.0 million in 2005. Collaborative research and development revenue primarily represents reimbursement of qualified expenses related to the collaborative agreements with various third parties to research, develop and commercialize potential products using our drug delivery technologies, amortization of upfront fees and milestone payments associated with the license agreements. The decrease in collaborative research and development and other revenue in 2006 was primarily attributable to our decreased development activities for Memryte (collaboration with Voyager) and TRANSDUR-Sufentanil (collaboration with Endo), partially offset by higher collaborative research and development revenue recognized in connection with our agreement for Remoxy and other ORADUR-based opioid products (collaboration with Pain Therapeutics) compared with 2005. We ceased to recognize collaborative research and development revenue related to Memryte from August 2006 because the collectibility of the amounts owed was not reasonably assured.

We received a \$10.0 million upfront fee in connection with the license agreement signed with Endo in March 2005 relating to TRANSDUR-Sufentanil. The \$10.0 million upfront fee is recognized as collaborative research and development revenue ratably over the term of our continuing involvement with Endo with respect to TRANSDUR-Sufentanil. We recognized \$2.2 million in 2006 compared with \$1.8 million in 2005. The amount included in 2005 represented the amount recognized over the period from March 10, 2005 to December 31, 2005, since the license agreement with Endo relating to TRANSDUR-Sufentanil was executed on March 10, 2005. The term of the continuing involvement has been estimated based on the current product development plan pursuant to the agreement.

We also received a \$14.0 million upfront fee in connection with the development and license agreement with Nycomed in November 2006 relating to POSIDUR. The \$14.0 million upfront fee is recognized as collaborative research and development revenue ratably over the term of our continuing involvement with Nycomed with respect to POSIDUR. The amount recognized in 2006 as collaborative research and development revenue from the amortization of the upfront fee was \$271,000. The term of the continuing involvement has been estimated based on the current product development plan pursuant to the agreement.

We expect our collaborative research and development revenue to fluctuate in future periods pending our efforts to enter into potential new collaborations and our existing third party collaborators' commitment to and progress in the research and development programs. The collaborative research and development and other revenues associated with our major collaborators are as follows (in thousands):

| <b>Collaborator</b>                                                   | <b>Year ended<br/>December 31,</b> |                  |
|-----------------------------------------------------------------------|------------------------------------|------------------|
|                                                                       | <b>2006</b>                        | <b>2005</b>      |
| Pain Therapeutics, Inc.                                               | \$ 7,477                           | \$ 4,873         |
| Endo Pharmaceuticals, Inc.(1)                                         | 4,438                              | 7,325            |
| Voyager Pharmaceutical Corporation                                    | 777                                | 7,046            |
| Nycomed(2)                                                            | 271                                |                  |
| Others(3)                                                             | 823                                | 788              |
| <b>Total collaborative research and development and other revenue</b> | <b>\$ 13,786</b>                   | <b>\$ 20,032</b> |

(1) Amounts related to amortization of upfront fees were \$2.2 million and \$1.8 million 2006 and 2005, respectively.

(2) Amounts related to amortization of upfront fees were \$271,000 in 2006 and \$0 in 2005, respectively.

(3) No service or license revenue in 2006. Includes \$79,000 of service and \$5,000 license revenues in 2005.

We amortize upfront fees on a straight-line basis over the period in which we have continuing involvement with the third-party collaborator pursuant to the applicable agreement. Such period generally represents the research and development period set forth in the work plan under each collaboration agreement between us and our third-party collaborator.



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We did not recognize any revenue from service contracts in 2006 compared to \$79,000 in 2005. Service contract revenues recognized in 2005 were related to certain polymer related service contracts we signed with various customers. The decrease was primarily due to completion of certain service contracts in the second half of 2005. We currently do not expect to increase our effort to generate significant revenue from our service contracts related to our polymer business in the future.

We did not recognize any license revenue in 2006 compared to \$5,000 in 2005. The license revenue in 2005 was recognized in connection with our agreement with NeuroSystec Corporation signed in 2004.

Milestone payments under collaborative arrangements are recognized as revenue upon achievement of the milestone events, which represent the culmination of the earnings process related to that milestone. Milestone payments are triggered either by the results of our research and development efforts or by events external to us, such as regulatory approval to market a product or the achievement of specified sales levels by a third-party collaborator. As such, the milestones are substantially at risk at the inception of the collaboration agreement, and the amounts of the payments assigned thereto are commensurate with the milestone achieved. In addition, upon the achievement of a milestone event, we have no future performance obligations related to that milestone payment. We recorded \$100,000 and \$250,000 of milestone revenue from our collaborations with third-party collaborators in 2006 and 2005, respectively.

### *Product revenue*

A portion of our revenues is derived from our product sales, which include our ALZET mini pump product line, and to a lesser extent our LACTEL biodegradable polymer products. Net product revenues were \$8.1 million compared with \$6.9 million in 2005. The increase was primarily due to higher product revenue from our ALZET mini pump product line due to a greater number of units sold and higher average selling price as well as slightly higher LACTEL polymer sales in 2006 compared with 2005.

### *Revenue from sale of intellectual property rights*

We did not record any revenue from the sale of intellectual property rights in 2006 compared with \$1.6 million in 2005. The \$1.6 million of revenue was recognized upon our assignment of certain intellectual property rights to Intervet, Inc. ( Intervet ) in the third quarter of 2005. Under the agreement, we assigned to Intervet our entire right, title and interest to a U.S. patent, previously jointly owned by the parties. In connection with this agreement, Intervet paid us \$1.6 million in the third quarter of 2005. We do not have any continuing obligations under the agreement, except for the on-going de minimus assistance we would provide to Intervet with respect to the maintenance of such patent. In the foreseeable future, we do not expect to increase our efforts to generate this type of revenue.

*Cost of revenues.* Cost of revenues was \$3.2 million in 2006 compared with \$2.8 million in 2005. Cost of revenues includes cost of product revenue from our ALZET mini pump product line and our LACTEL polymer products and, to a lesser extent, cost of certain polymer related service contracts. The increase in the cost of revenues was primarily due to higher product volumes from our existing commercial product lines in 2006. Stock based compensation expense related to cost of revenue was \$75,000 recognized under SFAS 123(R) in 2006 compared with none in 2005.

Cost of product revenue were \$3.2 million in 2006 compared with \$2.7 million in 2005. The increase in the cost of product revenue in 2006 was primarily as the result of an increase in product volumes of our ALZET mini pump product line.

Cost of service revenue was \$0 in 2006 compared with \$72,000 in 2005 due to a decline in our service contract revenue related to our polymer business in 2006.

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As of December 31, 2006 and 2005, we had 22 and 20 manufacturing employees, respectively.

**Research and Development.** Research and development expenses are primarily comprised of salaries and benefits associated with R&D personnel, overhead and facility costs, preclinical and non-clinical development costs, clinical trial and related clinical manufacturing costs, contract services, and other outside costs. In addition, research and development expenses incurred by us and reimbursed by Nycomed are recorded as a reduction to research and development expenses. Research and development expenses were \$37.2 million in 2006 and \$29.1 million in 2005. The increase in 2006 was primarily attributable to higher employee costs and higher development expenses for POSIDUR, ELADUR, Remoxy and other ORADUR-based opioid products as well as certain internal projects, partially offset by lower development expenses for TRANSDUR-Sufentanil and Memryte, compared with 2005. In addition, we paid Epicept an upfront fee of \$1.0 million, which we recognized as research and development expense in December 2006 upon execution of the license agreement. In 2006, we recorded a reduction of \$426,000 in research and development expenses representing 50% of the development expenses for POSIDUR which will be reimbursed by Nycomed since the execution of the agreement on November 29, 2006. Stock-based compensation expense related to research and development personnel increased from \$237,000 in 2005 to \$2.9 million in 2006 as a result of the adoption of SFAS 123(R) as of January 1, 2006.

In 2006, we incurred higher research and development expenses for POSIDUR associated with multiple Phase II clinical trials in the U.S. and in other countries and other development activities compared with 2005. We incurred lower development expenses for TRANSDUR-Sufentanil in 2006 compared with 2005 as Endo performed the majority of the development work for this product after the license agreement was signed in March 2005. We incurred higher research and development expenses for Remoxy in 2006 to support development activities for Remoxy and formulation work related to other ORADUR-based opioids products compared with 2005. We incurred lower research and development expenses in 2006 for Memryte compared with 2005 due to the reduced formulation development work for Voyager as the program moved to Phase III clinical trials.

As of December 31, 2006, we had 116 research and development employees compared with 86 as of the corresponding date in 2005.

The research and development expenses associated with our major development products approximate the following (in thousands):

|                                                                             | <b>Year ended<br/>December 31,</b> |                  |
|-----------------------------------------------------------------------------|------------------------------------|------------------|
|                                                                             | <b>2006</b>                        | <b>2005</b>      |
| POSIDUR                                                                     | \$ 12,005                          | \$ 7,878         |
| ELADUR                                                                      | 6,946                              | 1,262            |
| Remoxy and other ORADUR-based opioid products licensed to Pain Therapeutics | 5,987                              | 3,634            |
| Biologics Programs                                                          | 2,782                              | 656              |
| TRANSDUR-Sufentanil                                                         | 2,189                              | 6,159            |
| CHRONOGESIC                                                                 | 2,104                              | 1,866            |
| Memryte                                                                     | 1,213                              | 5,679            |
| Others                                                                      | 4,015                              | 2,007            |
| <b>Total research and development expenses(1)</b>                           | <b>\$ 37,241</b>                   | <b>\$ 29,141</b> |

(1) Includes stock-based compensation expenses of \$2.9 million and \$237,000 in 2006 and 2005, respectively.

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*Selling, General and Administrative.* Selling, general and administrative expenses are primarily comprised of salaries and benefits associated with finance, legal, business development, sales and marketing and other administrative personnel, overhead and facility costs, and other general and administrative costs. Selling, general and administrative expenses were \$12.4 million in 2006 compared with \$11.0 million in 2005. The increases in 2006 were primarily attributable to the stock-based compensation expense of \$1.4 million related to selling, general and administrative personnel recognized under SFAS 123(R) in 2006, as well as higher employee costs and market research related expenses, partially offset by lower legal and patent expenses in 2006.

As of December 31, 2006, we had 34 selling, general and administrative personnel compared with 32 as of the corresponding date in 2005.

*Amortization of intangible assets.* Amortization of intangible assets was \$424,000 in 2006 compared with \$1.2 million in 2005. The amortization of intangible assets decreased in 2006 as certain intangible assets became fully amortized in the second and third quarters of 2006. We continue to amortize the existing intangible assets at a constant rate over their estimated useful lives. In the fourth quarter of 2006, goodwill was evaluated for impairment in accordance with SFAS 142.

Based on our evaluation, no indicators of impairment were noted. Should goodwill become impaired in the future, we would be required to record an impairment charge to write the goodwill down to its estimated fair value.

The net amount of other intangible assets at December 31, 2006 was \$111,000.

*Other Income (Expense).* Interest and other income was \$3.8 million in 2006 compared with \$2.3 million in 2005. The increase in interest income was primarily the result of higher yields on investments as well as higher average cash and investment balances in 2006 compared with 2005.

Interest expense was \$3.4 million in 2006 compared with \$4.4 million in 2005. The decrease in interest expense in 2006 was primarily due to lower remaining balances on our convertible notes in 2006 compared with 2005 due to the conversion of \$20.0 million in aggregate principal amount of convertible notes in the second quarter of 2006.

Debt conversion expense was \$2.3 million in 2006 compared with \$403,000 in 2005. The debt conversion expense of \$2.3 million in 2006 was recorded in connection with the conversion of \$20.0 million in aggregate principal amount of the 6.25% convertible notes into 6.3 million shares of our common stock in the second quarter of 2006. The debt conversion expense of \$403,000 in 2005 was recorded as an inducement fee in connection with the conversion of approximately \$2.2 million in aggregate principal amount of the 6.25% convertible notes in the third quarter of 2005.

*Income taxes.* Income tax provision was zero in 2006 compared with \$4,000 in 2005 due to state income taxes paid for our former subsidiary, Absorbable Polymers International Corporation ( API ) in 2005. Prior to 2004, we had no provision for income taxes, as we incurred losses for all periods presented.

As of December 31, 2006, we had net operating loss carryforwards for federal income tax purposes of approximately \$160.0 million, which expire in the years 2018 through 2026 and federal research and development tax credits of approximately \$1.7 million, which expire at various dates beginning in 2018 through 2026, if not utilized. As of December 31, 2006, we had net operating loss carryforwards for state income tax purpose of approximately \$82.7 million, which expire in the years 2008 through 2016 and state research and development tax credits of approximately \$1.7 million, which do not expire. Utilization of the net operating losses may be subject to a substantial annual limitation due to federal and state ownership change limitations. The annual limitation may result in the expiration of net operating losses and credits before utilization.

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As of December 31, 2006 and 2005, we had net deferred tax assets of \$76.1 million and \$64.8 million. Deferred tax assets reflect the net tax effects of net operating loss and credit carryforwards and the temporary differences between the carrying amounts of assets and liabilities for financial reporting and the amounts used for income tax purposes. 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.

### **Liquidity and Capital Resources**

We had cash, cash equivalents, and investments totaling \$62.0 million, \$81.6 million and \$91.0 million at December 31, 2007, 2006 and 2005, respectively. This includes \$1.0 million, \$1.3 million and \$2.0 million of interest-bearing marketable securities classified as restricted investments on our balance sheet as of December 31, 2007, 2006 and 2005, respectively, which primarily serve as collateral for letters of credit securing our leased facilities and Alabama State Industrial Development Bonds payments which were assumed by us as part of our acquisition of SBS (SBS Bonds). The letters of credit related to security deposit of the leased facilities and the SBS bonds will expire in December 2012 and November 2009, respectively.

The decrease in cash, cash equivalents and investments from 2006 to 2007 was primarily attributable to increased operating and capital expenditures, partially offset by an \$8 million milestone payment from Nycomed and other payments received from our customers and third-party collaborators. The decrease in cash, cash equivalents and investments from 2005 to 2006 was primarily the result of increased operating expenses, partially offset by the upfront payment of \$14.0 million from Nycomed as well as payments received from customers and third-party collaborators.

Working capital was \$25.7 million, \$63.1 million and \$84.2 million at December 31, 2007, 2006 and 2005, respectively. The decrease in working capital from 2006 to 2007 was primarily attributable to the reclassification of convertible notes due June 2008 from a long term liability at December 31, 2006 to a current liability at December 31, 2007 as well as cash used in operating activities in 2007. The decrease in working capital from 2005 to 2006 was primarily attributable to higher expenditures related to our research and development efforts in general, and an increase in the purchases of certain long-term investments in 2006.

We used \$18.3 million, \$9.5 million and \$7.2 million of cash in operating activities in the years ended December 31, 2007, 2006 and 2005, respectively. The increase in cash used in operating activities in 2007 was primarily due to higher operating expenses in our development programs and lower payments received from our collaborators compared with 2006, partially offset by an \$8.0 million milestone payment received from Nycomed in 2007. The increase in cash used in operating activities in 2006 compared to 2005 was primarily attributable to higher operating expenses related to our research and development efforts, partially offset by the \$14.0 million upfront fee received in connection with our November 2006 agreement with Nycomed related to POSIDUR.

We generated \$13.1 million and \$14.0 million of cash in investing activities in the years ended December 31, 2007 and 2005, respectively, and used \$16.7 million of cash from investing activities in the year ended December 31, 2006. The increase in cash received in investing activities in 2007 was primarily due to higher net proceeds received from maturing of our investments compared with 2006, partially offset by higher purchases of property and equipment as well as patents in 2007. The increase in cash used in investing activities in 2006 compared with 2005 was primarily a result of higher purchases of investments in 2006.

We generated \$1.3 million, \$2.1 million and \$38.7 million of cash from financing activities in the years ended December 31, 2007, 2006 and 2005, respectively. The decrease in cash received from financing activities in 2007 was primarily due to lower proceeds from exercises of stock options compared with 2006. The decrease in cash received from financing activities in 2006 compared with 2005 was primarily due to the follow-on public equity offering in 2005, partially offset by higher proceeds in 2006 from exercises of stock options and purchases of our common stock under our employee stock purchase plan.

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In October 2005, we filed a shelf registration statement on Form S-3 with the SEC, which will allow us to offer up to \$75 million of securities from time to time in one or more public offerings of our common stock. In November 2005, we closed a follow-on public offering of 8,183,274 shares of our common stock at \$5.00 per share and received net proceeds of approximately \$38.1 million, after deducting underwriting discounts and related expenses.

In June and July 2003, we completed a private placement of an aggregate of \$60.0 million in convertible subordinated notes. The notes bear interest at a fixed rate of 6.25% per annum and are due on June 15, 2008. The notes are convertible at the option of the note holders into our common stock at a conversion rate of 317.4603 shares per \$1,000 principal amount of notes, or \$3.15 per share, subject to adjustment in certain circumstances. Interest on the notes is payable semi-annually in arrears in June and December. We received net proceeds of approximately \$56.7 million after deducting underwriting fees of \$3.0 million and related expenses of \$300,000. The convertible subordinated notes are unsecured obligations of ours and are subordinate to any secured debt we currently have or any future senior debt we may have. From the third quarter of 2005 through October 2007, we exchanged an aggregate of approximately \$36.4 million in principal amount of our 6.25% convertible subordinated notes in individually negotiated transactions with note holders, pursuant to which we issued approximately 11.6 million shares of our common stock, and made cash payments in the aggregate amount of approximately \$3.8 million. We may enter into similar transactions from time to time with holders of our convertible notes if we are able to do so on acceptable terms and depending on capital market conditions. As of December 31, 2007, the remaining principal balance of our convertible subordinated notes was \$23.6 million, which is due on June 15, 2008.

In conjunction with the acquisition of SBS in April 2001, we assumed the SBS Bonds with remaining principal payments of \$1.7 million as of April 30, 2001, and an interest rate of 6.35% increasing each year up to 7.20% at maturity on November 1, 2009. As part of the acquisition agreement, we were required to guarantee and collateralize these bonds with a letter of credit of approximately \$2.4 million that we secured with investments deposited with a financial institution in July 2001. Interest payments are due semi-annually and principal payments are due annually. Principal payments increase in annual increments from \$150,000 to \$240,000 over the term of the bonds until the principal is fully amortized in 2009. We have an option to call the SBS Bonds at any time. On December 31, 2002, SBS was merged into DURECT, and the SBS bonds were assigned to DURECT with the terms unchanged. At December 31, 2007, the remaining principal payments of the bonds were \$465,000.

We anticipate that cash used in operating activities will increase in the near future as we continue to research, develop, and manufacture our pharmaceutical systems. In aggregate, we are required to make future payments pursuant to our existing contractual obligations as follows (in thousands):

| <b>Contractual Obligations</b>            | <b>2008</b>      | <b>2009</b>     | <b>2010</b>     | <b>2011</b>     | <b>2012</b>     | <b>2013 and thereafter</b> | <b>Total</b>     |
|-------------------------------------------|------------------|-----------------|-----------------|-----------------|-----------------|----------------------------|------------------|
| Convertible subordinated notes(1)         | \$ 24,275        | \$              | \$              | \$              | \$              |                            | \$ 24,275        |
| Long-term debt(1)                         | 258              | 257             |                 |                 |                 |                            | 515              |
| Capital lease(1)                          | 52               | 52              | 52              | 12              |                 |                            | 168              |
| Purchase commitments                      | 100              | 850             | 1,500           | 500             | 500             | 3,000                      | 6,450            |
| Operating lease obligations               | 2,072            | 996             | 740             | 762             | 763             |                            | 5,333            |
| <b>Total contractual cash obligations</b> | <b>\$ 26,757</b> | <b>\$ 2,155</b> | <b>\$ 2,292</b> | <b>\$ 1,274</b> | <b>\$ 1,263</b> | <b>\$ 3,000</b>            | <b>\$ 36,741</b> |

(1) Includes principal and interest payments.

We also anticipate incurring capital expenditures of approximately \$2.0 million over the next 12 months to purchase research and development and manufacturing equipment. The amount and timing of these capital expenditures will depend, among other things, on the success of clinical trials for our product candidates and our collaborative research and development activities.

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We believe that our existing cash, cash equivalents and investments will be sufficient to fund our planned operations, existing debt and contractual commitments, and planned capital expenditures through at least the next 12 months. We may consume available resources more rapidly than currently anticipated, resulting in the need for additional funding. Additionally, we do not expect to generate revenues from our pharmaceutical systems currently under development for at least the next twelve months, if at all. Depending on the extent to which our convertible notes convert to common stock before they become due and payable in June 2008 and whether we enter into additional collaborative agreements in the near term, we may be required to raise additional capital through a variety of sources, including:

the public equity markets;

private equity financings;

collaborative arrangements; and/or

public or private debt.

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

We have not utilized off-balance sheet arrangements to fund our operations or otherwise manage our financial position.

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

### **Item 7A. Quantitative and Qualitative Disclosures About Market Risk. Interest Rate Sensitivity**

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio and long-term debt obligations. Fixed rate securities and borrowings may have their fair market value adversely impacted due to fluctuations in interest rates, while floating rate securities may produce less income than expected if interest rates fall and floating rate borrowings may lead to additional interest expense if interest rates increase. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates. Since our convertible notes bear interest at a fixed rate of 6.25% per annum, the fair value of our convertible notes will fluctuate due to changes in interest rates and the price of our common stock.

Our primary investment objective is to preserve principal while at the same time maximizing yields without significantly increasing risk. Our portfolio includes money markets funds, commercial paper, medium-term notes, corporate notes, government securities and corporate bonds. The diversity of our portfolio helps us to achieve our investment objectives. As of December 31, 2007, approximately 93% of our investment portfolio is composed of investments with original maturities of one year or less and approximately 58% of our investment portfolio matures less than 90 days from the date of purchase.

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The following table presents the amounts of our cash equivalents and investments that may be subject to interest rate risk and the average interest rates as of December 31, 2007 by year of maturity (dollars in thousands):

|                             | 2008      | 2009     | 2010   | Total     |
|-----------------------------|-----------|----------|--------|-----------|
| Cash equivalents:           |           |          |        |           |
| Fixed rate                  | \$ 33,272 | \$       | \$     | \$ 33,272 |
| Average fixed rate          | 5.83%     |          |        | 5.83%     |
| Variable rate               | \$ 74     |          |        | \$ 74     |
| Average variable rate       | 4.63%     |          |        | 4.63%     |
| Short-term investments:     |           |          |        |           |
| Fixed rate                  | \$ 19,710 | \$       |        | \$ 19,710 |
| Average fixed rate          | 4.96%     |          |        | 4.96%     |
| Long-term investments:      |           |          |        |           |
| Fixed rate                  | \$        | \$ 3,697 | \$     | \$ 3,697  |
| Average fixed rate          |           | 4.71%    |        | 4.71%     |
| Restricted investments:     |           |          |        |           |
| Fixed rate                  | \$ 626    | \$       | \$ 394 | \$ 1,020  |
| Average fixed rate          | 5.11%     |          | 2.62%  | 3.45%     |
| Total investment securities | \$ 53,682 | \$ 3,697 | \$ 394 | \$ 57,773 |

Average rate 5.13% 4.71% 2.62% 4.72%

The following table presents the amounts of our cash equivalents and investments that may be subject to interest rate risk and the average interest rates as of December 31, 2006 by year of maturity (dollars in thousands):

|                             | 2007      | 2008     | 2009   | Total     |
|-----------------------------|-----------|----------|--------|-----------|
| Cash equivalents:           |           |          |        |           |
| Fixed rate                  | \$ 33,620 | \$       | \$     | \$ 33,620 |
| Average fixed rate          | 5.30%     |          |        | 5.30%     |
| Variable rate               | \$ 5,668  |          |        | \$ 5,668  |
| Average variable rate       | 5.27%     |          |        | 5.27%     |
| Short-term investments:     |           |          |        |           |
| Fixed rate                  | \$ 28,297 | \$       |        | \$ 28,297 |
| Average fixed rate          | 4.98%     |          |        | 4.98%     |
| Long-term investments:      |           |          |        |           |
| Fixed rate                  | \$        | \$ 9,474 | \$ 998 | \$ 10,472 |
| Average fixed rate          |           | 4.16%    | 5.35%  | 4.33%     |
| Restricted investments:     |           |          |        |           |
| Fixed rate                  | \$ 1,284  | \$       | \$     | \$ 1,284  |
| Average fixed rate          | 3.26%     |          |        | 3.26%     |
| Total investment securities | \$ 68,870 | \$ 9,473 | \$ 998 | \$ 79,341 |

Average rate 5.02% 4.16% 5.35% 4.93%

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**Item 8. Financial Statements and Supplementary Data.**

**DURECT CORPORATION**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of

DURECT Corporation

We have audited the accompanying balance sheets of DURECT Corporation as of December 31, 2007 and 2006, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2007. 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 DURECT Corporation at December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2007, 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.

As discussed in Notes 1, to the financial statements, Durect Corporation changed its method of accounting for stock-based compensation as of January 1, 2006.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), DURECT Corporation's internal control over financial reporting as of December 31, 2007, 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 10, 2008 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

Palo Alto, California

March 10, 2008

**Table of Contents****DURECT CORPORATION****BALANCE SHEETS**

(in thousands, except per share amounts)

|                                                                                                                                                          | December 31, |            |
|----------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|------------|
|                                                                                                                                                          | 2007         | 2006       |
| <b><u>ASSETS</u></b>                                                                                                                                     |              |            |
| Current assets:                                                                                                                                          |              |            |
| Cash and cash equivalents                                                                                                                                | \$ 37,589    | \$ 41,554  |
| Short-term investments                                                                                                                                   | 19,710       | 28,297     |
| Accounts receivable (net of allowances of \$49 in 2007 and \$1 in 2006)                                                                                  | 3,622        | 2,152      |
| Inventories                                                                                                                                              | 1,963        | 2,052      |
| Prepaid expenses and other current assets                                                                                                                | 1,904        | 1,744      |
| Total current assets                                                                                                                                     | 64,788       | 75,799     |
| Property and equipment, net                                                                                                                              | 7,658        | 7,451      |
| Goodwill                                                                                                                                                 | 6,399        | 6,399      |
| Intangible assets, net                                                                                                                                   | 180          | 111        |
| Long-term investments                                                                                                                                    | 3,697        | 10,472     |
| Restricted investments                                                                                                                                   | 1,020        | 1,284      |
| Other long-term assets                                                                                                                                   | 278          | 969        |
| Total assets                                                                                                                                             | \$ 84,020    | \$ 102,485 |
| <b><u>LIABILITIES AND STOCKHOLDERS' EQUITY</u></b>                                                                                                       |              |            |
| Current liabilities:                                                                                                                                     |              |            |
| Accounts payable                                                                                                                                         | \$ 1,834     | \$ 864     |
| Accrued liabilities                                                                                                                                      | 5,499        | 4,522      |
| Contract research liabilities                                                                                                                            | 1,946        | 1,624      |
| Deferred revenue, current portion                                                                                                                        | 5,728        | 5,348      |
| Convertible subordinated notes, current portion                                                                                                          | 23,599       |            |
| Other short-term liabilities                                                                                                                             | 482          | 341        |
| Total current liabilities                                                                                                                                | 39,088       | 12,699     |
| Convertible subordinated notes, non-current portion                                                                                                      |              | 37,337     |
| Deferred revenue, non-current portion                                                                                                                    | 9,268        | 14,507     |
| Other long-term liabilities                                                                                                                              | 1,083        | 910        |
| Commitments (Note 10)                                                                                                                                    |              |            |
| Stockholders' equity:                                                                                                                                    |              |            |
| Common stock, \$0.0001 par value: 110,000 shares authorized; 74,107 and 69,213 shares issued and outstanding at December 31, 2007 and 2006, respectively | 7            | 7          |
| Additional paid-in capital                                                                                                                               | 287,689      | 265,896    |
| Deferred royalties and commercial rights                                                                                                                 | (13,480)     | (13,480)   |
| Accumulated other comprehensive income (loss)                                                                                                            | 50           | (45)       |
| Accumulated deficit                                                                                                                                      | (239,685)    | (215,346)  |
| Stockholders' equity                                                                                                                                     | 34,581       | 37,032     |
| Total liabilities and stockholders' equity                                                                                                               | \$ 84,020    | \$ 102,485 |

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



**Table of Contents****DURECT CORPORATION****STATEMENTS OF OPERATIONS****(in thousands, except per share amounts)**

|                                                                      | <b>Year ended December 31,</b> |                    |                    |
|----------------------------------------------------------------------|--------------------------------|--------------------|--------------------|
|                                                                      | <b>2007</b>                    | <b>2006</b>        | <b>2005</b>        |
| Collaborative research and development and other revenue             | \$ 22,417                      | \$ 13,786          | \$ 20,032          |
| Product revenue, net                                                 | 8,258                          | 8,108              | 6,939              |
| Revenue from sale of intellectual property rights                    |                                |                    | 1,600              |
| <b>Total revenues</b>                                                | <b>30,675</b>                  | <b>21,894</b>      | <b>28,571</b>      |
| <b>Operating expenses:</b>                                           |                                |                    |                    |
| Cost of revenues(1)                                                  | 3,225                          | 3,248              | 2,815              |
| Research and development(1)                                          | 38,342                         | 37,241             | 29,141             |
| Selling, general and administrative(1)                               | 13,618                         | 12,417             | 11,034             |
| Amortization of intangible assets                                    | 31                             | 424                | 1,209              |
| <b>Total operating expenses</b>                                      | <b>55,216</b>                  | <b>53,330</b>      | <b>44,199</b>      |
| <b>Loss from operations</b>                                          | <b>(24,541)</b>                | <b>(31,436)</b>    | <b>(15,628)</b>    |
| <b>Other income (expense):</b>                                       |                                |                    |                    |
| Interest and other income                                            | 3,545                          | 3,832              | 2,270              |
| Interest expense                                                     | (2,625)                        | (3,436)            | (4,363)            |
| Debt conversion expense                                              | (718)                          | (2,287)            | (403)              |
| <b>Net other income (expense)</b>                                    | <b>202</b>                     | <b>(1,891)</b>     | <b>(2,496)</b>     |
| <b>Loss before income taxes</b>                                      | <b>(24,339)</b>                | <b>(33,327)</b>    | <b>(18,124)</b>    |
| Income tax provision                                                 |                                |                    | 4                  |
| <b>Net loss</b>                                                      | <b>\$ (24,339)</b>             | <b>\$ (33,327)</b> | <b>\$ (18,128)</b> |
| <b>Net loss per share, basic and diluted</b>                         | <b>\$ (0.35)</b>               | <b>\$ (0.51)</b>   | <b>\$ (0.34)</b>   |
| <b>Shares used in computing basic and diluted net loss per share</b> | <b>70,483</b>                  | <b>65,961</b>      | <b>53,719</b>      |

(1) Stock-based compensation related to the following:

|                                     |          |          |        |
|-------------------------------------|----------|----------|--------|
| Cost of revenues                    | \$ 130   | \$ 75    | \$     |
| Research and development            | 4,286    | 2,885    | 237    |
| Selling, general and administrative | 2,273    | 1,431    | 354    |
|                                     | \$ 6,689 | \$ 4,391 | \$ 591 |

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



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**DURECT CORPORATION**  
**STATEMENT OF STOCKHOLDERS' EQUITY**

(in thousands)

|                                                                                                  | Common Stock |        | Additional<br>Paid-In<br>Capital | Notes<br>Receivable  |  | Deferred<br>Compensation | Deferred<br>Royalties<br>And<br>Commercial<br>Rights | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Accumulated<br>Deficit | Total<br>Stockholders'<br>Equity |
|--------------------------------------------------------------------------------------------------|--------------|--------|----------------------------------|----------------------|--|--------------------------|------------------------------------------------------|-----------------------------------------------------------|------------------------|----------------------------------|
|                                                                                                  | Shares       | Amount |                                  | From<br>Stockholders |  |                          |                                                      |                                                           |                        |                                  |
| Balance at December 31, 2004                                                                     | 51,870       | \$ 5   | \$ 196,065                       | \$ (37)              |  | \$ (4)                   | \$ (13,480)                                          | \$ (268)                                                  | \$ (163,891)           | \$ 18,390                        |
| Issuance of common stock upon exercise of stock options and purchases of ESPP shares             | 602          |        | 1,115                            |                      |  |                          |                                                      |                                                           |                        | 1,115                            |
| Repayment of notes receivable                                                                    |              |        |                                  | 37                   |  |                          |                                                      |                                                           |                        | 37                               |
| Issuance of common stock in connection with acquisition of Absorbable Polymer Technologies, Inc. | 42           |        | 250                              |                      |  |                          |                                                      |                                                           |                        | 250                              |
| Amortization of deferred stock compensation                                                      |              |        |                                  |                      |  | 4                        |                                                      |                                                           |                        | 4                                |
| Stock compensation related to modifications of employee stock option terms                       |              |        | 336                              |                      |  |                          |                                                      |                                                           |                        | 336                              |
| Noncash charges related to equity securities issued to non-employees                             |              |        | 251                              |                      |  |                          |                                                      |                                                           |                        | 251                              |
| Conversion of subordinated convertible notes                                                     | 912          |        | 2,975                            |                      |  |                          |                                                      |                                                           |                        | 2,975                            |
| Secondary equity offering                                                                        | 8,183        | 1      | 38,065                           |                      |  |                          |                                                      |                                                           |                        | 38,066                           |
| Net change in unrealized gain on available-for-sale securities                                   |              |        |                                  |                      |  |                          |                                                      | 56                                                        |                        | 56                               |
| Net loss                                                                                         |              |        |                                  |                      |  |                          |                                                      |                                                           | (18,128)               | (18,128)                         |
| Total comprehensive net loss                                                                     |              |        |                                  |                      |  |                          |                                                      |                                                           |                        | (18,072)                         |
| Balance at December 31, 2005 (carried forward)                                                   | 61,609       | \$ 6   | \$ 239,057                       | \$                   |  | \$                       | \$ (13,480)                                          | \$ (212)                                                  | \$ (182,019)           | \$ 43,352                        |

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

**Table of Contents****DURECT CORPORATION****STATEMENT OF STOCKHOLDERS' EQUITY (Continued)**

(in thousands)

|                                                                                                           | Common Stock |        | Notes              |                      |                          | Deferred<br>Royalties<br>And<br>Commercial<br>Rights | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Accumulated<br>Deficit | Total<br>Stockholders'<br>Equity |
|-----------------------------------------------------------------------------------------------------------|--------------|--------|--------------------|----------------------|--------------------------|------------------------------------------------------|-----------------------------------------------------------|------------------------|----------------------------------|
|                                                                                                           | Shares       | Amount | Paid-In<br>Capital | From<br>Stockholders | Deferred<br>Compensation |                                                      |                                                           |                        |                                  |
| Balance at December 31, 2005<br>(carried forward)                                                         | 61,609       | \$ 6   | \$ 239,057         | \$                   | \$                       | \$ (13,480)                                          | \$ (212)                                                  | \$ (182,019)           | \$ 43,352                        |
| Issuance of common stock upon<br>exercise of stock options and<br>purchases of ESPP shares                | 1,105        |        | 2,428              |                      |                          |                                                      |                                                           |                        | 2,428                            |
| Issuance of common stock in<br>connection with acquisition of<br>Absorbable Polymer Technologies,<br>Inc. | 150          |        | 500                |                      |                          |                                                      |                                                           |                        | 500                              |
| Stock-based compensation expense<br>from stock options and ESPP shares                                    |              |        | 4,431              |                      |                          |                                                      |                                                           |                        | 4,431                            |
| Conversion of subordinated<br>convertible notes                                                           | 6,349        | 1      | 19,480             |                      |                          |                                                      |                                                           |                        | 19,481                           |
| Net change in unrealized gain on<br>available-for-sale securities                                         |              |        |                    |                      |                          |                                                      | 167                                                       |                        | 167                              |
| Net loss                                                                                                  |              |        |                    |                      |                          |                                                      |                                                           | (33,327)               | (33,327)                         |
| Total comprehensive net loss                                                                              |              |        |                    |                      |                          |                                                      |                                                           |                        | (33,160)                         |
| Balance at December 31, 2006                                                                              | 69,213       | \$ 7   | \$ 265,896         | \$                   | \$                       | \$ (13,480)                                          | \$ (45)                                                   | \$ (215,346)           | \$ 37,032                        |
| Issuance of common stock upon<br>exercise of stock options and<br>purchases of ESPP shares                | 533          |        | 1,498              |                      |                          |                                                      |                                                           |                        | 1,498                            |
| Stock-based compensation expense<br>from stock options and ESPP shares                                    |              |        | 6,687              |                      |                          |                                                      |                                                           |                        | 6,687                            |
| Conversion of subordinated<br>convertible notes                                                           | 4,361        |        | 13,608             |                      |                          |                                                      |                                                           |                        | 13,608                           |
| Net change in unrealized gain on<br>available-for-sale securities                                         |              |        |                    |                      |                          |                                                      | 95                                                        |                        | 95                               |
| Net loss                                                                                                  |              |        |                    |                      |                          |                                                      |                                                           | (24,339)               | (24,339)                         |
| Total comprehensive net loss                                                                              |              |        |                    |                      |                          |                                                      |                                                           |                        | (24,244)                         |
| Balance at December 31, 2007                                                                              | 74,107       | \$ 7   | \$ 287,689         | \$                   | \$                       | \$ (13,480)                                          | \$ 50                                                     | \$ (239,685)           | \$ 34,581                        |

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

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**DURECT CORPORATION**  
**STATEMENTS OF CASH FLOWS**

(in thousands)

|                                                                             | Year ended December 31, |                  |                  |
|-----------------------------------------------------------------------------|-------------------------|------------------|------------------|
|                                                                             | 2007                    | 2006             | 2005             |
| <b>Cash flows from operating activities</b>                                 |                         |                  |                  |
| Net loss                                                                    | \$ (24,339)             | \$ (33,327)      | \$ (18,128)      |
| Adjustments to reconcile net loss to net cash used in operating activities: |                         |                  |                  |
| Depreciation                                                                | 2,287                   | 2,039            | 1,960            |
| Amortization                                                                | 31                      | 424              | 1,209            |
| Stock-based compensation                                                    | 6,689                   | 4,391            | 591              |
| Loss on impairment and disposal of fixed assets                             | 31                      | 34               | 245              |
| Inventory write-off                                                         | 167                     | 100              | 86               |
| Debt conversion expense                                                     |                         |                  | 403              |
| Changes in assets and liabilities:                                          |                         |                  |                  |
| Accounts receivable                                                         | (1,470)                 | 2,336            | (2,007)          |
| Inventories                                                                 | (82)                    | (64)             | (204)            |
| Prepaid expenses and other assets                                           | 402                     | 2,411            | (1,745)          |
| Accounts payable                                                            | 970                     | (971)            | 177              |
| Accrued liabilities                                                         | 1,591                   | 1,522            | 1,051            |
| Contract research liability                                                 | 322                     | 206              | 864              |
| Interest payable on convertible notes                                       | (35)                    | (52)             | (18)             |
| Deferred revenue                                                            | (4,859)                 | 11,472           | 8,305            |
| <b>Total adjustments</b>                                                    | <b>6,044</b>            | <b>23,848</b>    | <b>10,917</b>    |
| <b>Net cash used in operating activities</b>                                | <b>(18,295)</b>         | <b>(9,479)</b>   | <b>(7,211)</b>   |
| <b>Cash flows from investing activities</b>                                 |                         |                  |                  |
| Purchase of property and equipment                                          | (2,545)                 | (2,220)          | (2,397)          |
| Purchase of intangible assets                                               | (100)                   |                  |                  |
| Purchase of available-for-sale securities                                   | (33,458)                | (56,254)         | (13,852)         |
| Proceeds from sales of available-for-sale securities                        | 1,032                   |                  |                  |
| Proceeds from maturities of available-for-sale securities                   | 48,147                  | 41,823           | 30,234           |
| <b>Net cash provided by (used in) investing activities</b>                  | <b>13,076</b>           | <b>(16,651)</b>  | <b>13,985</b>    |
| <b>Cash flows from financing activities</b>                                 |                         |                  |                  |
| Payments on term loan and equipment financing obligations                   | (34)                    | (86)             | (292)            |
| Payment on long term debt                                                   | (210)                   | (200)            | (190)            |
| Net proceeds from issuances of common stock through secondary offering      |                         |                  | 38,066           |
| Net proceeds from issuances of common stock and stockholders' notes         | 1,498                   | 2,428            | 1,152            |
| <b>Net cash provided by financing activities</b>                            | <b>1,254</b>            | <b>2,142</b>     | <b>38,736</b>    |
| <b>Net (decrease) increase in cash and cash equivalents</b>                 | <b>(3,965)</b>          | <b>(23,988)</b>  | <b>45,510</b>    |
| <b>Cash and cash equivalents at beginning of year</b>                       | <b>41,554</b>           | <b>65,542</b>    | <b>20,032</b>    |
| <b>Cash and cash equivalents at end of year</b>                             | <b>\$ 37,589</b>        | <b>\$ 41,554</b> | <b>\$ 65,542</b> |
| <b>Supplemental disclosure of cash flow information</b>                     |                         |                  |                  |
| Cash paid for income taxes                                                  | \$                      | \$               | \$ 4             |

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|                                                                              |           |           |          |
|------------------------------------------------------------------------------|-----------|-----------|----------|
| Cash paid for interest                                                       | \$ 2,236  | \$ 2,413  | \$ 3,753 |
| Cash paid upon debt conversion                                               | \$ 718    | \$ 2,287  | \$       |
| <b>Supplemental disclosure of noncash investing and financing activities</b> |           |           |          |
| Issuance of common stock for acquisition of APT                              | \$        | \$ 500    | \$ 250   |
| Conversion of convertible subordinated notes for common stock                | \$ 13,738 | \$ 20,000 | \$ 2,663 |

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

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**1. Summary of Significant Accounting Policies**

***Nature of Operations and Basis of Presentation***

DURECT Corporation (the Company) was incorporated in the state of Delaware on February 6, 1998. The Company is a pharmaceutical company developing therapies based on its proprietary drug formulations and delivery platform technologies. The Company has several products under development by itself and with third party collaborators. The Company also manufactures and sells osmotic pumps used in laboratory research. In addition, the Company conducts research and development of pharmaceutical products in collaboration with third party pharmaceutical and biotechnology companies.

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

***Reclassifications***

Certain prior period amounts related to milestone revenue and stock-based compensation expenses in the statements of operations have been reclassified to conform to current period presentation. Such reclassification did not impact the Company's net loss or financial position.

***Use of Estimates***

The preparation of financial statements in conformity with US generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Actual results could differ materially from those estimates. Management makes estimates when preparing the financial statements including those related to revenue recognition, accrued but unbilled expenses for clinical trials and other services and stock-based compensation.

***Cash, Cash Equivalents and Investments***

The Company considers all highly liquid investments with maturities of 90 days or less from the date of purchase to be cash equivalents. Investments with original maturities of greater than 90 days from the date of purchase but less than one year from the balance sheet date are classified as short-term investments, while investments with maturities beyond one year from the balance sheet date are classified as long-term investments. Management determines the appropriate classification of its cash equivalents and investment securities at the time of purchase and re-evaluates such determination as of each balance sheet date. Management has classified the Company's cash equivalents and investments as available-for-sale securities in the accompanying financial statements. Available-for-sale securities are carried at fair value, with unrealized gains and losses reported as a component of accumulated other comprehensive income (loss). Realized gains and losses are included in interest income. There were no material realized gains or losses in the periods presented. The cost of securities sold is based on the specific identification method.

The Company invests its excess cash in debt instruments of government agencies and corporations, and money market funds with high credit ratings. The Company has established guidelines regarding diversification of its investments and their maturities with the objectives of maintaining safety and liquidity, while maximizing yield.

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)*****Concentrations of Credit Risk***

Financial instruments that potentially subject the Company to credit risk consist principally of interest-bearing investments and trade receivables. The Company maintains cash, cash equivalents and investments with various major financial institutions. The Company performs periodic evaluations of the relative credit standing of these financial institutions and limits the amount of credit exposure with any one institution. In addition, the Company performs periodic evaluations of the relative credit quality of its investments.

Universities, pharmaceutical companies and hospitals account for a substantial portion of the Company's trade receivables. The Company provides credit in the normal course of business to its customers and collateral for these receivables is generally not required. The risk associated with this concentration is limited due to the large number of accounts and their geographic dispersion. The Company monitors the creditworthiness of its customers to which it grants credit terms in the normal course of business. The Company maintains reserves for estimated credit losses and, to date, such losses have been within management's expectations. At December 31, 2007, three customers accounted for 36%, 19% and 16% of the Company's net accounts receivable. At December 31, 2006, three customers accounted for 22%, 20% and 16% of the Company's net accounts receivable.

***Customer and Product Line Concentrations***

A portion of the Company's revenue is derived from its ALZET mini pump product line, which accounted for 21%, 29% and 20% of total revenues in fiscal years 2007, 2006 and 2005, respectively.

In fiscal year 2007, Nycomed, Pain Therapeutics and Endo accounted for 36%, 16% and 16% of the Company's total revenues, respectively. In fiscal year 2006, Pain Therapeutics, Endo and Voyager accounted for 34%, 20% and 4% of the Company's total revenues, respectively. In fiscal year 2005, Pain Therapeutics, Endo and Voyager accounted for 17%, 26% and 25% of the Company's total revenues, respectively.

Total revenue by geographic region for the years 2007, 2006 and 2005 is as follows (in thousands):

|               | Year ended December 31, |                  |                  |
|---------------|-------------------------|------------------|------------------|
|               | 2007                    | 2006             | 2005             |
| United States | \$ 16,589               | \$ 18,535        | \$ 25,869        |
| Japan         | 1,111                   | 1,236            | 916              |
| Europe        | 12,344                  | 1,382            | 953              |
| Other         | 631                     | 741              | 833              |
| <b>Total</b>  | <b>\$ 30,675</b>        | <b>\$ 21,894</b> | <b>\$ 28,571</b> |

Revenue by geography is determined by the location of the customer.

***Inventories***

Inventories are stated at the lower of cost or market, with cost determined on a first-in, first-out basis. The Company's inventories consisted of the following (in thousands):

|               | December 31, |        |
|---------------|--------------|--------|
|               | 2007         | 2006   |
| Raw materials | \$ 161       | \$ 185 |

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|                   |          |          |
|-------------------|----------|----------|
| Work in-process   | 747      | 711      |
| Finished goods    | 1,055    | 1,156    |
| Total inventories | \$ 1,963 | \$ 2,052 |

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

***Property and Equipment***

Property and equipment are stated at cost less accumulated depreciation, which is computed using the straight-line method over the estimated useful lives of the assets, which range from three to five years. Leasehold improvements are amortized using the straight-line method over the estimated useful lives of the assets, or the terms of the related leases, whichever are shorter.

***Acquired Intangible Assets and Goodwill***

Acquired intangible assets consist of patents, developed technology, trademarks, assembled workforce and customer lists related to the Company's acquisitions accounted for using the purchase method. Amortization of these purchased intangibles is calculated on a straight-line basis over the respective estimated useful lives of the assets ranging from four to seven years. Acquired in-process research and development without alternative future use is charged to operations when acquired. In July 2001, the FASB issued Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), which requires the elimination of the amortization of goodwill and assembled workforce to be replaced with the periodic evaluation of intangibles for impairment. The Company assesses goodwill for impairment at least annually in accordance with SFAS 142.

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

In accordance with the provisions of Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144), the Company reviews long-lived assets, including property and equipment, intangible assets, and other long-term assets, for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable. Factors we consider important which could trigger an impairment review include, but are not limited to, the following:

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of our use of the acquired assets or the strategy for our overall business;

significant negative industry or economic trends;

significant decline in our stock price for a sustained period; and

a significant change in our market capitalization relative to net book value.

Under SFAS 144, an impairment loss would be recognized when estimated undiscounted future cash flows expected to result from the use of the asset and its eventual disposition is less than its carrying amount. Impairment, if any, is calculated as the amount by which an asset's carrying value exceeds its fair value, typically using discounted cash flows to determine fair value. Through December 31, 2007, there have been no material impairment losses.

***Stock-Based Compensation***

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R), *Share-Based Payment*, using the modified prospective transition method. Under that transition method, compensation cost recognized in the year ended December 31, 2006 included: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date

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fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted on or after January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Because the Company elected to use the modified prospective transition method, results for prior periods have not been restated. In March 2005, the Securities and Exchange Commission issued

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

Staff Accounting Bulletin (SAB) No. 107, which provides supplemental implementation guidance for SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). The adoption of SFAS 123(R) had no impact on cash flows from operations or financing activities.

Prior to the adoption of SFAS 123R, the Company applied SFAS 123, amended by SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS 148), which allowed companies to apply the existing accounting rules under APB 25, *Accounting for Stock Issued to Employees*, and related Interpretations. In general, as the exercise price of options granted under the Company's plans was equal to the market price of the underlying common stock on the grant date, no stock-based employee compensation cost was recognized in the Company's net income (loss) for periods prior to the adoption of SFAS 123R. As required by SFAS 148 prior to the adoption of SFAS 123R, the Company provided pro forma net income (loss) and pro forma net income (loss) per common share disclosures for stock-based awards, as if the fair-value-based method defined in SFAS 123 had been applied. See Note 11 for further information regarding stock-based compensation.

***Revenue Recognition***

Revenue from the sale of products is recognized when there is persuasive evidence that an arrangement exists, the product is shipped and title transfers to customers, provided no continuing obligation exists, the price is fixed or determinable and the collectibility of the amounts owed is reasonably assured. The Company recognizes revenue from the sale of its products and license and collaboration agreements pursuant to Staff Accounting Bulletin No. 104, *Revenue Recognition*, and Emerging Issues Task Force (EITF) Issue 00-21, *Revenue Arrangements with Multiple Deliverables*. Multiple element agreements entered into are evaluated under the provision of EITF 00-21. The Company evaluates whether there is stand-alone value for the delivered elements and objective and reliable evidence of fair value to allocate revenue to each element in multiple element agreements. When the delivered element does not have stand-alone value or there is insufficient evidence of fair value for the undelivered element(s), the Company recognizes the consideration for the combined unit of accounting in the same manner as the revenue is recognized for the final deliverable, which is generally ratably over the longest period of involvement.

Milestone payments under collaborative arrangements are recognized as revenue upon achievement of the at risk milestone events, which represent the culmination of the earnings process related to that milestone. Milestone payments are triggered either by the results of our research and development efforts or by events external to us, such as regulatory approval to market a product or the achievement of specified sales levels by a third-party collaborator. As such, the milestones are substantially at risk at the inception of the collaboration agreement, and the amounts of the payments assigned thereto are commensurate with the milestone achieved. In addition, upon the achievement of a milestone event, we have no future performance obligations related to that milestone payment.

Revenue from the sale of intellectual property rights is recognized upon assignment of such rights by the Company to a third party, provided the collectibility is assured, and the Company has no future performance obligations related to such rights, except for the on-going de minimus assistance the Company would provide to the third party with respect to the maintenance of such rights.

Upfront payments received upon execution of collaborative agreements are recorded as deferred revenue and recognized as collaborative research and development revenue based on a straight-line basis over the period of the Company's continuing involvement with the third-party collaborator pursuant to the applicable agreement. Such period generally represents the research and development period set forth in the work plan defined in the respective agreements between the Company and its third-party collaborators.

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)**

Research and development revenue related to services performed under the collaborative arrangements with the Company's third-party collaborators is recognized as the related research and development services are performed. These research payments received under each respective agreement are not refundable and are generally based on reimbursement of qualified expenses, as defined in the agreements. Research and development expenses under the collaborative research and development agreements generally approximate or exceed the revenue recognized under such agreements over the term of the respective agreements. Deferred revenue may result when the Company does not expend the required level of effort during a specific period in comparison to funds received under the respective agreement.

The collaborative research and development and other revenues associated with the Company's major third-party collaborators are as follows (in thousands):

| <b>Collaborator</b>                                                   | <b>Year ended December 31,</b> |                  |                  |
|-----------------------------------------------------------------------|--------------------------------|------------------|------------------|
|                                                                       | <b>2007</b>                    | <b>2006</b>      | <b>2005</b>      |
| Nycomed(1)                                                            | \$ 11,051                      | \$ 271           | \$               |
| Pain Therapeutics, Inc                                                | 4,864                          | 7,477            | 4,873            |
| Endo Pharmaceuticals, Inc.(2)                                         | 4,818                          | 4,438            | 7,325            |
| Voyager Pharmaceutical Corporation                                    |                                | 777              | 7,046            |
| Others(3)                                                             | 1,684                          | 823              | 788              |
| <b>Total collaborative research and development and other revenue</b> | <b>\$ 22,417</b>               | <b>\$ 13,786</b> | <b>\$ 20,032</b> |

(1) Amounts related to amortization of upfront fees were \$3.1 million, \$271,000 and \$0 in 2007, 2006 and 2005, respectively. Research and development expenses incurred by us in conjunction with the Nycomed collaboration and reimbursable by Nycomed are recorded as a reduction to total research and development expense. The 2007 figure also includes \$8.0 million of milestone revenue recognized in connection with the Nycomed agreement.

(2) Amounts related to amortization of upfront fees were \$2.2 million, \$2.2 million and \$1.8 million in 2007, 2006 and 2005, respectively.

(3) Amount includes service and license revenues of \$0 in 2007 and 2006, and \$84,000 in 2005, respectively.

The Company amortizes upfront fees on a straight-line basis over the period in which the Company has continuing involvement with the third-party collaborator pursuant to the applicable agreement. Such period generally represents the research and development period set forth in the work plan under each collaboration agreement between the Company and its third-party collaborator.

Milestone payments under collaborative arrangements are recognized as revenue upon achievement of the milestone events, which represent the culmination of the earnings process related to that milestone. Milestone payments are triggered either by the results of the Company's research and development efforts or by events external to the Company, such as regulatory approval to market a product or the achievement of specified sales levels by a third-party collaborator. As such, the milestones are substantially at risk at the inception of the collaboration agreement, and the amounts of the payments assigned thereto are commensurate with the milestone achieved. In addition, upon the achievement of a milestone event, the Company has no future performance obligations related to that milestone payment.

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)*****Research and Development Expenses***

Research and development expenses are primarily comprised of salaries and benefits associated with research and development personnel, overhead and facility costs, preclinical and non-clinical development costs, clinical trial and related clinical manufacturing costs, contract services, and other outside costs. Research and development costs are expensed as incurred. Research and development costs paid to third parties under sponsored research agreements are recognized as the related services are performed, generally ratably over the period of service. In addition, reimbursements by Nycomed for research and development expenses incurred by the Company are recorded as a reduction to research and development expenses. Research and development expenses incurred by Nycomed and reimbursed by the Company are recorded as additional research and development expenses.

The research and development expenses associated with our major development products approximate the following (in thousands):

|                                                                             | Year Ended December 31, |           |           |
|-----------------------------------------------------------------------------|-------------------------|-----------|-----------|
|                                                                             | 2007                    | 2006      | 2005      |
| POSIDUR                                                                     | \$ 10,924               | \$ 12,005 | \$ 7,878  |
| ELADUR                                                                      | 5,132                   | 6,946     | 1,262     |
| Remoxy and other ORADUR-based opioid products licensed to Pain Therapeutics | 4,372                   | 5,987     | 3,634     |
| Biologics Programs                                                          | 3,193                   | 2,782     | 656       |
| TRANSDUR-Sufentanil                                                         | 2,843                   | 2,189     | 6,159     |
| CHRONOGESIC                                                                 | 1,719                   | 2,104     | 1,866     |
| Memryte                                                                     | 1,271                   | 1,213     | 5,679     |
| Others                                                                      | 8,888                   | 4,015     | 2,007     |
| Total research and development expenses                                     | \$ 38,342               | \$ 37,241 | \$ 29,141 |

***Comprehensive Loss***

Components of other comprehensive income (loss), including unrealized gains and losses on the Company's available-for-sale securities, are included in total comprehensive loss. The difference between net loss and comprehensive loss in all periods presented resulted from unrealized gains and losses on available-for-sale investments.

|                                                                             | Year Ended December 31, |             |             |
|-----------------------------------------------------------------------------|-------------------------|-------------|-------------|
|                                                                             | 2007                    | 2006        | 2005        |
| Net loss                                                                    | \$ (24,339)             | \$ (33,327) | \$ (18,128) |
| Net change in unrealized gain on available-for-sale investments, net of tax | 95                      | 167         | 56          |
| Comprehensive loss                                                          | \$ (24,244)             | \$ (33,160) | \$ (18,072) |

The component of accumulated other comprehensive income (loss) is as follows (in thousands):

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|                                                                      | Year Ended<br>December 31, |         |
|----------------------------------------------------------------------|----------------------------|---------|
|                                                                      | 2007                       | 2006    |
| Unrealized gain (loss) on available-for-sale investments, net of tax | \$ 50                      | \$ (45) |
| Accumulated other comprehensive income (loss)                        | \$ 50                      | \$ (45) |

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)*****Segment Reporting***

The Company follows Statement of Financial Accounting Standard No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131). SFAS 131 establishes standards for reporting financial information about operating segments in financial statements, as well as additional disclosures about products and services, geographic areas, and major customers. The Company operates in one operating segment, research and development of pharmaceutical systems.

***Net Loss Per Share***

Basic net loss per share is calculated by dividing the net loss by the weighted-average number of common shares outstanding, less the weighted average number of common shares during the year subject to repurchase or held in escrow pursuant to an acquisition agreement. Diluted net loss per share is computed using the weighted-average number of common shares outstanding and common stock equivalents (i.e., options and warrants to purchase common stock, convertible subordinated notes) outstanding during the year, if dilutive, using the treasury stock method for options and warrants and the if-converted method for convertible subordinated notes.

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

|                                                                                                                | Year ended December 31, |             |             |
|----------------------------------------------------------------------------------------------------------------|-------------------------|-------------|-------------|
|                                                                                                                | 2007                    | 2006        | 2005        |
| Net loss                                                                                                       | \$ (24,339)             | \$ (33,327) | \$ (18,128) |
| Basic and diluted weighted average shares:                                                                     |                         |             |             |
| Weighted-average shares of common stock outstanding and used in computing basic and diluted net loss per share | 70,483                  | 65,961      | 53,719      |
| Basic and diluted net loss per share                                                                           | \$ (0.35)               | \$ (0.51)   | \$ (0.34)   |

The computation of diluted net loss per share for the fiscal year ended December 31, 2007 excludes the impact of options to purchase 11.6 million shares of common stock, warrants to purchase 770 shares of common stock and 10.2 million shares of common stock issuable upon conversion of the subordinated notes at December 31, 2007, as such impact would be antidilutive.

The computation of diluted net loss per share for the fiscal year ended December 31, 2006 excludes the impact of options to purchase 9.5 million shares of common stock, warrants to purchase 770 shares of common stock and 14.5 million shares of common stock issuable upon conversion of the subordinated notes at December 31, 2006, as such impact would be antidilutive.

The computation of diluted net loss per share for the fiscal year ended December 31, 2005 excludes the impact of options to purchase 8.0 million shares of common stock, warrants to purchase 770 shares of common stock and 18.7 million shares of common stock issuable upon conversion of the subordinated notes at December 31, 2005, as such impact would be antidilutive.

***Shipping and Handling***

Costs related to shipping and handling are included in cost of revenues for all periods presented.

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

***Operating Leases***

The Company leases administrative, manufacturing and laboratory facilities under operating leases. Lease agreements may include rent holidays, rent escalation clauses and tenant improvement allowances. The Company recognizes scheduled rent increases on a straight-line basis over the lease term beginning with the date the Company takes possession of the leased space. The Company records tenant improvement allowances as deferred rent liabilities on the balance sheets and amortizes the deferred rent over the terms of the lease to rent expense on the statements of operations.

***Recent Accounting Pronouncements***

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* ( FIN 48 ). Under FIN 48 a company would recognize the benefit from a tax position only if it is more-likely-than-not that the position would be sustained upon audit based solely on the technical merits of the tax position. FIN 48 clarifies how a company would measure the income tax benefits from the tax positions that are recognized, provides guidance as to the timing of the derecognition of previously recognized tax benefits and describes the methods for classifying and disclosing the liabilities within the financial statements for any unrecognized tax benefits. FIN 48 also addresses when a company should record interest and penalties related to tax positions and how the interest and penalties may be classified within the income statement and presented in the balance sheet. FIN 48 is effective for fiscal years beginning after December 15, 2006, and has been adopted by us effective January 1, 2007. Pursuant to FIN 48, the cumulative effects, if any, of applying FIN 48 would be recorded as an adjustment to accumulated deficit as of the beginning of the period of adoption. The Company adopted FIN48 effective January 1, 2007 as described in Note 12. The adoption of FIN 48 had no impact on the Company's financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements. SFAS 157 does not require any new fair value measurement SFAS 157 requires prospective application for fiscal year ending December 31, 2008.

In February 2007, FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB No. 115* ( SFAS 159 ). The Statement permits entities to choose, at specified election dates, to measure many financial instruments and certain other items at fair value that are not currently measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected would be reported in earnings at each subsequent reporting date. SFAS 159 also establishes presentation and disclosure requirements in order to facilitate comparisons between entities choosing different measurement attributes for similar types of assets and liabilities. SFAS 159 does not affect existing accounting requirements for certain assets and liabilities to be carried at fair value. This statement is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by the Company for the fiscal year ending December 31, 2008. The Company does not believe that the adoption of SFAS 159 will have a material impact on its financial statements.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* ( SFAS No. 141R ). SFAS No. 141R amends SFAS 141 and provides revised guidance for recognizing and measuring identifiable assets and goodwill acquired, liabilities assumed, and any noncontrolling interest in the acquiree. It also provides disclosure requirements to enable users of the financial statements to evaluate the nature and financial effects of the business combination. It is effective for fiscal years beginning on or after December 15, 2008 and will be applied prospectively. The Company does not believe that the adoption of SFAS 141R will have a material impact on its financial statements.

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**2. Strategic Agreements**

***Agreement with Nycomed***

In November 2006, the Company entered into a collaboration agreement ( the Agreement ) with Nycomed Danmark, APS ( Nycomed ). Under the terms of the agreement, the Company licensed to Nycomed the exclusive commercialization rights to POSIDUR for the European Union (E.U.) and select other countries. Nycomed paid an upfront license fee of \$14.0 million in 2006 and a milestone payment of \$8.0 million in 2007, with future potential additional milestone payments of up to \$180.0 million upon achievement of defined development, regulatory and sales milestones. The Company will jointly direct and equally fund with Nycomed a development program for POSIDUR intended to secure regulatory approval in both the U.S. and the E.U. In addition, the Company will manufacture and supply the product to Nycomed for commercial sale in the territory licensed to Nycomed. Nycomed will pay the Company blended royalties on sales in the defined territory of 15-40% depending on annual sales, as well as a manufacturing markup. The Company retains full commercial rights to POSIDUR in the U.S., Canada, Asia and other countries. The agreement shall continue in effect until terminated. The agreement provides each party with specified termination rights, including the right of each party to terminate the agreement upon material breach of the agreement by the other party. In addition, Nycomed shall have the right to terminate the agreement after expiry of patents covering POSIDUR in all major market countries in the E.U. and for adverse product events.

In contrast to the Company's other collaborations, because the Company and Nycomed jointly control and fund the development of POSIDUR, the Company does not recognize revenue from the reimbursement of qualified research expenses by Nycomed. Rather, the Company records research expense equal to its share of the joint expenses incurred under the product development plan. In 2007 and 2006, the Company recorded a net reduction of \$5.0 million and \$427,000, respectively, in research and development expenses representing a net reimbursement from Nycomed in order that both parties bore 50% of the development expenses for POSIDUR. In addition, the Company recognized \$3.1 million and \$271,000 million in 2007 and 2006, respectively, as collaborative research and development revenue from the amortization of the \$14.0 million upfront fee received in 2006.

Milestone payments under collaborative arrangements are recognized as revenue upon achievement of the milestone events, which represent the culmination of the earnings process related to that milestone. The Company recorded \$8.0 million of milestone revenue from our Nycomed collaboration due to the achievement of a clinical development milestone for POSIDUR in 2007 compared to \$0 in 2006.

***Agreements with Endo Pharmaceuticals***

***CHRONOGESIC***

In November 2002, the Company entered into a development, commercialization and supply license agreement with Endo Pharmaceuticals, Inc. ( Endo ) under which the companies will collaborate on the development and commercialization of CHRONOGESIC for the U.S. and Canada. The agreement was amended in January 2004, in November 2004, January 2006 and April 2007 to take into account the increase in the CHRONOGESIC development program timeline due to DURECT's implementation of necessary design and manufacturing enhancements. In connection with the execution of the agreement in November 2002, Endo purchased 1,533,742 shares of newly issued common stock of DURECT at an aggregate purchase price of approximately \$5.0 million. Under the terms of the agreement, as amended, DURECT will be responsible for CHRONOGESIC's design and development. Endo shall not be responsible for any development costs for the CHRONOGESIC development product prior to May 1, 2008. Commencing on May 1, 2008, unless the agreement is earlier terminated by Endo, Endo will fund 50% of the ongoing development costs and will

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)**

reimburse the Company for a portion of our prior development costs for the product upon the achievement of certain milestones. Development-based milestone payments made by Endo under this agreement could total up to \$52.0 million. Under the agreement, Endo has licensed exclusive promotional rights to the CHRONOGESIC product in the U.S. and Canada. Endo will be responsible for marketing, sales and distribution, including providing specialty sales representatives dedicated to supplying technical and training support for CHRONOGESIC therapy and will pay for product launch costs. The Company will be responsible for the manufacture of the CHRONOGESIC product. If commercialized, the Company will share profits from the commercialization of CHRONOGESIC in the U.S. and Canada with Endo based on the financial performance of the CHRONOGESIC product. The agreement provides each party with specified termination rights. In particular, the agreement can be terminated by Endo in the event that (i) DURECT has not delivered to Endo on or before March 31, 2008 a written notice (Notice) that a human pharmacokinetic trial had been completed with CHRONOGESIC, together with a full study report of the results of the trial or (ii) Endo, determines, in its sole discretion, to terminate the Agreement during the sixty-day period after DURECT's delivery of the notice, provided, that, in each case Endo delivers to DURECT its written notice of termination prior to April 30, 2008. The Company will not complete the requisite pharmacokinetic trial by March 31, 2008, which will give Endo the right to terminate this agreement. The Company did not receive any payments or recognize any collaborative research and development revenue in the years ended December 31, 2007, 2006 and 2005.

*TRANSDUR-Sufentanil*

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

Pursuant to the agreement, Endo was obligated to pay an upfront, nonrefundable fee of \$10.0 million. In April 2005, Endo paid the Company the \$10.0 million upfront fee. Endo is also obligated to pay to the Company additional payments of up to approximately \$35.0 million in the aggregate if predetermined regulatory and commercial milestones are achieved. In addition, Endo reimburses the Company for all qualified research and development expenses incurred for TRANSDUR-Sufentanil. If commercialized, Endo will also pay the Company product royalties based on the net sales of TRANSDUR-Sufentanil under the agreement. The Company has the right to co-promote TRANSDUR-Sufentanil under terms specified in the agreement. The agreement also contains terms and conditions customary for this type of arrangement, including representations, warranties and indemnities. The agreement shall continue in effect until terminated. The agreement provides each party with specified termination rights, including the right of each party to terminate the agreement upon material breach of the agreement by the other party. In addition, Endo shall have the right to terminate the agreement at any time without cause subject to a specified notice period and due to adverse product events, legal impediment or the issuance of a final, non-appealable court order enjoining Endo from selling TRANSDUR-Sufentanil in the U.S. and Canada as a result of an action for patent infringement by a third party, provided that in the latter instance, the Company will be required to pay Endo a termination fee ranging from \$5.0 million to \$10.0 million, depending on the date of termination.

The \$10.0 million upfront fee is recognized as revenue ratably over the term of the Company's obliged continuing involvement with Endo with respect to TRANSDUR-Sufentanil. The term of the continuing involvement has been estimated based on the product development plan pursuant to the agreement. For the years

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

ended December 31, 2007, 2006 and 2005, the Company recognized \$2.2 million, \$2.2 million and \$1.8 million, respectively in collaborative research and development revenue related to this upfront fee. Total collaborative research and development revenue recognized under this arrangement was \$4.8 million, \$4.4 million and \$7.3 million for the years ended December 31, 2007, 2006 and 2005, respectively.

***Agreement with Pain Therapeutics, Inc.***

In December 2002, the Company entered into an exclusive agreement with Pain Therapeutics, Inc. ( Pain Therapeutics ) to develop and commercialize on a worldwide basis Remoxy and other oral sustained release, abuse deterrent opioid products incorporating four specified opioid drugs, using the ORADUR technology. The agreement also provides Pain Therapeutics with the exclusive right to commercialize products developed under the agreement on a worldwide basis. In connection with the execution of the agreement, Pain Therapeutics paid the Company upfront fees of \$900,000 in December 2002 and \$100,000 in October 2003. In December 2005, the Company amended its agreement with Pain Therapeutics in order to specify its obligations with respect to the supply of key excipients for use in the licensed products. Under the agreement, as amended, the Company is responsible for formulation development, supply of selected key excipients used in the manufacture of licensed products and other specified tasks. The Company will receive additional payments if certain development and regulatory milestones are achieved. In addition, if commercialized, the Company will receive royalties for Remoxy and other licensed products which do not contain an opioid antagonist of between 6.0% to 11.5% of net sales of the product depending on sales volume. This agreement can be terminated by either party for material breach by the other party and by Pain Therapeutics without cause. Under the agreement, Pain Therapeutics reimburses the Company qualified expenses incurred by the Company in connection with the development program. The Company recognizes collaborative research and development revenue related to research and development activities for Remoxy and other development programs based on reimbursement of qualified expenses as defined in the collaborative agreement and related amendment with Pain Therapeutics. Total collaborative research and development revenue recognized under the agreements with Pain Therapeutics was \$4.9 million, \$7.5 million and \$4.9 million in 2007, 2006 and 2005, respectively.

***Agreement with Voyager Pharmaceutical Corporation***

In July 2002, the Company entered into a development and commercialization agreement with Voyager Pharmaceutical Corporation, ( Voyager ). Under the terms of the agreement, the Company will collaborate with Voyager to develop a product using the DURIN technology to provide sustained release of leuprolide based on Voyager's patented method of treatment of Alzheimer's disease. The agreement also provides Voyager with the right to commercialize the product on a worldwide basis. The Company is responsible for preclinical development, product manufacture and other specified tasks. The Company will receive payments if certain development and regulatory milestones are achieved. If commercialized, the Company will receive royalties based on product sales. This agreement can be terminated by either party for material breach by the other party. Under the agreement, Voyager reimbursed the Company qualified expenses incurred by the Company in connection with the development program for Memryte. The Company recognized collaborative research and development revenue related to research and development activities for Memryte based on reimbursement of qualified expenses as defined in the agreement, until August 2006 when the Company determined that the collectibility of amounts owed was not reasonably assured. Total collaborative research and development revenue recognized under the agreement with Voyager was \$0, \$777,000 and \$7.0 million in 2007, 2006 and 2005, respectively.

Effective January 2007, the Company entered into an amendment to the agreement with Voyager. Under the amendment, among other changes to the Agreement, the royalty rate that the Company will receive on net sales of Memryte, if commercialized, was doubled (to 10-14% of net sales after the amendment), and in addition, the

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

Company will now receive 10% of any upfront, milestone and other fees received by Voyager in the event that the product rights are sublicensed to a third party. As a part of the amendment, the Company paid Voyager \$1.0 million in cash and forgave approximately \$725,000 which was owed to us for previously provided services.

***Agreement with EpiCept Corporation***

On December 20, 2006, the Company entered into a license agreement with EpiCept Corporation ( EpiCept ) that will provide the Company with the exclusive, worldwide rights to certain of EpiCept's intellectual property for a transdermal patch containing bupivacaine for the treatment of back pain. Pursuant to the agreement, the Company paid EpiCept a \$1.0 million upfront fee in 2006 and subject to the Company's achievement of specified milestones, will pay EpiCept an additional \$9.0 million in milestone payments as well as an undisclosed royalty on net sales of any product covered by the license. The \$1.0 million fee was recognized as research and development expense at the execution of the agreement since the rights purchased had not yet reached technological feasibility and such rights also had no future alternative uses.

***Agreement with ALZA Corporation***

In April 1998, the Company entered into a development and commercialization agreement with ALZA Corporation ( ALZA ) for certain product development rights, patent rights, and other know-how relating to the DUROS system. The Company issued 5,600,000 shares of Series A-1 preferred stock, which were subsequently converted into 5,600,000 shares of common stock concurrent with our initial public offering in 2000, to ALZA in connection with this agreement and is required to pay ALZA a royalty on the net sales of products and a percentage of upfront license fees, milestone payments, or any other payments or consideration received by the Company, excluding research and development funding.

In April 2000, ALZA and the Company amended and restated their development and commercialization agreement. This amendment includes a reduction in product royalties and upfront payments to ALZA by the Company under the agreement. As consideration for these amendments, ALZA received 1,000,000 shares of the Company's common stock and, subject to conditions on exercise, a warrant to purchase 1,000,000 shares of common stock at an exercise price of \$12.00 per share. The deemed fair value of the stock and the warrant was \$13.5 million. This value was recorded as additional paid-in capital and deferred royalties and commercial rights, included as a contra-equity account in the statement of stockholders' equity, and will be amortized as royalty expense and sales and marketing expense, respectively, as associated product sales commence. This warrant expired in September 2004, which was the fourth anniversary after the warrant first became exercisable. The Company will periodically evaluate the recoverability of these amounts and assess whether any indicators of impairment have occurred. Indicators of impairment for products under the agreement may include: failure to complete product development, unfavorable outcomes from clinical trials, suspension of clinical trial activities, failure to receive approval from the FDA, and/or lack of market acceptance.

Effective October 1, 2002, the Company entered into a Third Amended and Restated Development and Commercialization Agreement with ALZA Corporation, which replaced and superseded the Second Amended and Restated Development and Commercialization Agreement entered into between ALZA and the Company effective April 28, 1999 and April 14, 2000. The agreement provides the Company with exclusive rights to develop, commercialize and manufacture products using ALZA's patented DUROS® technology in selected fields of use. Under the amended agreement, the Company's maintenance of exclusivity in these licensed fields is no longer subject to minimum annual requirements for development spending or the number of products under development by the Company.

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)**

In the years ended December 31, 2007, 2006, and 2005, the Company incurred development expenses of \$0 for work performed by ALZA.

***Patent Assignment***

On August 8, 2005, the Company entered into a Purchase Agreement and an Option Agreement with Intervet Inc. (collectively the Agreements). Under the Agreements, in addition to other covenants, rights and obligations specified to each party, the Company assigned to Intervet its entire right, title and interest to a U.S. patent, previously jointly owned by the parties, and Intervet agreed to pay the Company \$1.6 million. The Company received the payment of \$1.6 million from Intervet in August 2005 and recognized the \$1.6 million as revenue in the year ended December 31, 2005 as the Company does not have continuing obligations under the purchase agreement except for the on-going de minimus assistance the Company would provide to Intervet with respect to the maintenance of such patent. The Company did not receive any payments or recognize any revenue from patent assignments in the years ended December 31, 2007 and 2006.

**3. Acquisition of Absorbable Polymer Technologies, Inc.**

On August 15, 2003, the Company acquired Absorbable Polymer Technologies, Inc. (APT), a privately held Alabama Corporation pursuant to an Agreement and Plan of Merger among Durect Corporation, Birmingham Polymers, Inc. and APT (the Merger Agreement) for a total cost of approximately \$2.2 million including the transaction cost of approximately \$100,000. In connection with the acquisition, the Company issued an aggregate of 485,122 shares of its common stock, valued at \$1.1 million and agreed to pay the remaining purchase consideration of \$250,000, \$250,000 and \$500,000, respectively, through the issuance of additional shares of its common stock or cash in connection with the first, second and third anniversaries of the closing of the merger.

APT manufactured and sold polymer and provided analytical and product development services for third party pharmaceutical and biotechnology companies. This acquisition is intended to help the Company to gain market share in the polymers supply market and to expand custom polymer development capabilities. The purchase price was allocated to the tangible assets and identifiable intangible assets acquired based on their estimated fair value, as follows (in thousands):

|                                 |          |
|---------------------------------|----------|
| Net tangible assets acquired    | \$ 254   |
| Intangible assets acquired:     |          |
| Patents                         | 56       |
| Developed technology            | 160      |
| Goodwill                        | 1,683    |
| Total purchase price allocation | \$ 2,153 |

Tangible net assets acquired include cash, accounts receivable, inventories and fixed assets. Liabilities assumed principally include accrued expenses and notes payable. Intangible assets represent the excess of the total acquisition cost over the fair value of identifiable net assets of the business acquired. Intangible assets except goodwill are each being amortized on a straight-line basis over their estimated useful lives, which are both 7 years.

In August 2004, 2005 and 2006, the Company issued an aggregate of 184,910, 41,545 and 149,640 shares of its common stock, valued at \$250,000, \$250,000 and \$500,000, respectively, at the first, second and third anniversary of the closing of the merger to former shareholders of APT pursuant to the Merger Agreement. The 2006 issuance represents the final purchase price consideration.

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)****4. Goodwill and Intangible Assets**

Intangible assets recorded in connection with our acquisitions consist of the following (in thousands):

|                         | <b>Gross<br/>Intangibles</b> | <b>December 31, 2007<br/>Accumulated<br/>Amortization</b> | <b>Net<br/>Intangibles</b> |
|-------------------------|------------------------------|-----------------------------------------------------------|----------------------------|
| Developed technology    | \$ 3,600                     | \$ (3,540)                                                | \$ 60                      |
| Patents                 | 566                          | (446)                                                     | 120                        |
| Other intangible assets | 3,260                        | (3,260)                                                   |                            |
| Total                   | \$ 7,426                     | \$ (7,246)                                                | \$ 180                     |

|                         | <b>Gross<br/>Intangibles</b> | <b>December 31, 2006<br/>Accumulated<br/>Amortization</b> | <b>Net<br/>Intangibles</b> |
|-------------------------|------------------------------|-----------------------------------------------------------|----------------------------|
| Developed technology    | \$ 3,600                     | \$ (3,517)                                                | \$ 83                      |
| Patents                 | 466                          | (438)                                                     | 28                         |
| Other intangible assets | 3,260                        | (3,260)                                                   |                            |
| Total                   | \$ 7,326                     | \$ (7,215)                                                | \$ 111                     |

In December 2007, the Company entered a Patent Assignment Agreement and acquired from a third party a portfolio of worldwide patents relating to drug delivery technologies. The Company paid \$100,000 to this third party upon execution of the agreement. In connection with this agreement, the Company recorded \$100,000 as intangible assets on its balance sheet as of December 31, 2007 and will amortize these patents over a useful life of 7 years.

The intangible assets are being amortized on a straight-line basis over estimated useful lives ranging from four to seven years.

The net amount of intangible assets at December 31, 2007 was \$180,000, which will be amortized as follows: \$45,250 in each of the years 2008 and 2009, \$32,300 in 2010, and \$14,300 in each of the years from 2011 to 2014. Should any intangible assets become impaired, the Company will write them down to their estimated fair value.

Goodwill totaled \$6.4 million at December 31, 2007. The Company evaluates goodwill for impairment at least annually. In 2007, 2006 and 2005 goodwill was evaluated and no indicators of impairment were noted. Should goodwill become impaired, we may be required to record an impairment charge to write the goodwill down to its estimated fair value.

**5. Financial Instruments**

The carrying amount of cash and cash equivalents reported on the balance sheet approximates its fair value. Short-term and long-term investments consist of marketable debt securities. The fair values of investments are based upon quoted market prices. The carrying amounts of the Company's borrowings under its debt agreements approximate their fair values. As of December 31, 2007 and 2006, the fair value of the Company's convertible notes was \$49.1 million and \$56.8 million, respectively, compared with the carrying value of \$23.6 million and \$37.3 million, respectively. The fair value of the convertible notes was obtained through quoted market prices.



**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)**

The following is a summary of available-for-sale securities as of December 31, 2007 and 2006 (in thousands):

|                                  | <b>December 31, 2007</b>  |                            |                            | <b>Estimated<br/>Fair<br/>Value</b> |
|----------------------------------|---------------------------|----------------------------|----------------------------|-------------------------------------|
|                                  | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Gain</b> | <b>Unrealized<br/>Loss</b> |                                     |
| Money market funds               | \$ 74                     | \$                         | \$                         | \$ 74                               |
| Certificates of deposit          | 394                       |                            |                            | 394                                 |
| Commercial paper                 | 8,992                     |                            | (1)                        | 8,991                               |
| Corporate bonds and notes        | 7,948                     | 32                         |                            | 7,980                               |
| Federal agency debt securities   | 40,315                    | 19                         |                            | 40,334                              |
|                                  | \$ 57,723                 | \$ 51                      | \$ (1)                     | \$ 57,773                           |
| Reported as:                     |                           |                            |                            |                                     |
| Cash and cash equivalents        | \$ 33,338                 | \$ 9                       | \$ (1)                     | \$ 33,346                           |
| Short-term investments           | 19,688                    | 22                         |                            | 19,710                              |
| Long-term investments            | 3,677                     | 20                         |                            | 3,697                               |
| Long-term restricted investments | 1,020                     |                            |                            | 1,020                               |
|                                  | \$ 57,723                 | \$ 51                      | \$ (1)                     | \$ 57,773                           |
| <b>December 31, 2006</b>         |                           |                            |                            |                                     |
|                                  | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Gain</b> | <b>Unrealized<br/>Loss</b> | <b>Estimated<br/>Fair<br/>Value</b> |
| Money market funds               | \$ 5,669                  | \$                         | \$                         | \$ 5,669                            |
| Certificates of deposit          | 394                       |                            |                            | 394                                 |
| Commercial paper                 | 32,506                    | 5                          |                            | 32,511                              |
| Corporate bonds and notes        | 29,818                    | 6                          | (23)                       | 29,801                              |
| Federal agency debt securities   | 10,999                    |                            | (33)                       | 10,966                              |
|                                  | \$ 79,386                 | \$ 11                      | \$ (56)                    | \$ 79,341                           |
| Reported as:                     |                           |                            |                            |                                     |
| Cash and cash equivalents        | \$ 39,284                 | \$ 5                       | \$ (1)                     | \$ 39,288                           |
| Short-term investments           | 28,318                    | 6                          | (27)                       | 28,297                              |
| Long-term investments            | 10,500                    |                            | (28)                       | 10,472                              |
| Long-term restricted investments | 1,284                     |                            |                            | 1,284                               |
|                                  | \$ 79,386                 | \$ 11                      | \$ (56)                    | \$ 79,341                           |

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)**

The following is a summary of the cost and estimated fair value of available-for-sale securities at December 31, 2007, by contractual maturity (in thousands):

|                                          | 2007<br>Amortized<br>Cost | Estimated<br>Fair<br>Value |
|------------------------------------------|---------------------------|----------------------------|
| Mature in one year or less               | \$ 53,653                 | \$ 53,683                  |
| Mature after one year through five years | 4,070                     | 4,090                      |
|                                          | \$ 57,723                 | \$ 57,773                  |

The follow is a summary of unrealized losses for available-for-sale securities at December 31, 2007 (in thousands):

|                  | Unrealized Loss for<br>Less than 12 Months<br>Fair<br>Value | Unrealized<br>Loss |
|------------------|-------------------------------------------------------------|--------------------|
| Commercial paper | \$ 5,309                                                    | \$ (1)             |
|                  | \$ 5,309                                                    | \$ (1)             |

There were no securities that have unrealized loss for more than 12 months.

The follow is a summary of unrealized losses for available-for-sale securities at December 31, 2006 (in thousands):

|                                | Unrealized Loss for<br>Less than 12 Months<br>Fair<br>Value | Unrealized<br>Loss |
|--------------------------------|-------------------------------------------------------------|--------------------|
| Commercial paper               | \$ 32,506                                                   | \$                 |
| Corporate bonds and notes      | 24,818                                                      | (14)               |
| Federal agency debt securities | 5,500                                                       | (14)               |
|                                | \$ 62,824                                                   | \$ (28)            |

|  | Unrealized Loss for<br>More than 12 Months<br>Fair<br>Value | Unrealized<br>Loss |
|--|-------------------------------------------------------------|--------------------|
|--|-------------------------------------------------------------|--------------------|

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|                                |           |         |
|--------------------------------|-----------|---------|
| Corporate bonds and notes      | \$ 5,000  | \$ (9)  |
| Federal agency debt securities | 5,499     | (19)    |
|                                | \$ 10,499 | \$ (28) |

To date the Company has not recorded any impairment charges on marketable securities related to other-than-temporary declines in market value. The Company recognizes an impairment charge when the decline in the estimated fair value of a marketable security below the amortized cost is determined to be other-than-temporary. The Company considers various factors in determining whether to recognize an impairment charge, including the duration of time and the severity to which the fair value has been less than our amortized cost, any adverse

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)**

changes in the investees' financial condition and our intent and ability to hold the marketable security for a period of time sufficient to allow for any anticipated recovery in market value.

**6. Notes Receivable**

In November 2003, the Company purchased a promissory note in the amount of \$150,000 from a private company, Sinexus, Inc. and recorded the \$150,000 as part of prepaid expenses and other current assets on the Company's balance sheet as of December 31, 2003. Sinexus is a start-up venture developing site specific treatments for chronic sinusitis, an inflammatory disease affecting the paranasal sinuses. In order to provide bridge funding for Sinexus, the Company and a venture capital firm agreed to loan Sinexus \$150,000 each in convertible notes as a pre-Series A seed financing of Sinexus, Inc. The Company's investment in Sinexus represents an interest in a variable interest entity. However, the Company is not a primary beneficiary of Sinexus and the Company's maximum exposure to loss as a result of the Company's involvement with Sinexus is \$150,000.

In February 2006, the Company entered into a Note and Warrant Repurchase Agreement with Sinexus. Per the agreement, Sinexus repurchased from DURECT the note and warrant originally issued to DURECT in November 2003 at a purchase price of \$150,000. Upon the closing of this agreement, both parties agreed that Sinexus has no outstanding obligations to DURECT and the note and warrant were cancelled in their entirety. The Company recognized \$150,000 as other income which was included in interest and other income in its statement of operations in 2005.

**7. Property and Equipment**

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

|                                                | <b>December 31,</b> |             |
|------------------------------------------------|---------------------|-------------|
|                                                | <b>2007</b>         | <b>2006</b> |
| Equipment                                      | \$ 13,469           | \$ 12,404   |
| Leasehold improvement                          | 9,042               | 8,083       |
| Construction-in-progress                       | 327                 | 395         |
|                                                | 22,838              | 20,882      |
| Less accumulated depreciation and amortization | (15,180)            | (13,431)    |
| Property and equipment, net                    | \$ 7,658            | \$ 7,451    |

Depreciation expense was \$2.3 million, \$2.0 million and \$2.0 million in 2007, 2006 and 2005, respectively. At December 31, 2007 and 2006, no equipment was collateralized as security for equipment financing facilities. Depreciation expense was \$39,580, \$34,035 and \$0 in 2007, 2006 and 2005 for capital lease assets, respectively.

**8. Restricted Investments**

In July 2001, the Company deposited \$2.4 million in investment grade securities with the same institution to guarantee bonds assumed in the acquisition of SBS (see Note 10). This guarantee will be released upon the sooner of the Company's exercise of its option to call the bonds at any time, or the bond's maturity date in November 2009. From 2002 to 2007, as allowed under the guarantee agreement, a total of approximately \$1.7 million of this collateral was released from restriction following the exchange of the investment grade securities for corporate debt securities with a higher investment grade to conform with the Company's investment policy.



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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

In September 2005, the Company deposited \$329,000 in the form of a certificate of deposit with a financial institution as a letter of credit to secure a lease signed in August 2005 for the Company's office facility in Cupertino, California. The restriction on these funds will be released upon termination of the lease in December 2012.

In January 2006, the Company deposited \$61,000 in the form of a certificate of deposit with a financial institution as a letter of credit to secure a lease signed in December 2005 for capital equipment from a third party vendor for a phone system at the Cupertino facilities. The installation was completed in April 2006. The restriction on these funds will be released upon termination of the lease in January 2011.

As of December 31, 2007 and 2006, the Company had \$1.0 million and \$1.3 million, respectively, recorded as restricted investments in connection with the above items.

**9. Term Loan**

In January 2003, the Company obtained a three-year term loan with a local bank. The principal of the term loan was \$850,000 with a fixed interest rate of 4.95%. The term loan was secured by a certificate of deposit the Company placed with the same bank. The final payment on the term loan was paid in the first quarter of 2006. The Company does not have any lines of credit or available balances under this term loan.

**10. Long-term Debt and Commitments**

***Convertible Subordinated Notes due 2008***

On June 18, 2003, the Company completed a private placement of an aggregate of \$50.0 million in convertible subordinated notes (the "notes"). The notes bear interest at a fixed rate of 6.25% per annum and are due on June 15, 2008. On July 14, 2003, the initial purchaser of \$50.0 million of the notes elected to exercise its option to purchase an additional \$10.0 million in principal amount of such notes. The notes are convertible at the option of the note holders into our common stock at a conversion rate of 317.4603 shares per \$1,000 principal amount of the notes, or \$3.15 per share, subject to adjustment in certain circumstances. Interest on the notes is payable semi-annually in arrears in June and December. The Company received net proceeds of approximately \$56.7 million after deducting underwriting fees of \$3.0 million and related expenses of \$300,000. The total issuance cost of approximately \$3.3 million has been included in other long-term assets on the balance sheet and is amortized to interest expense using the effective interest rate method over the duration of the notes, which is 5 years. The notes are unsecured obligations of the Company and are subordinate to any secured debt the Company currently has or any future senior indebtedness of the Company.

In July 2005, the Company entered into an agreement with a holder of its 6.25% Convertible Subordinated Notes, due June 2008, to exchange up to \$5.0 million in principal amount of convertible notes for 317.4603 shares of common stock per \$1,000 principal amount as originally defined in the indenture, plus additional shares to compensate the note holder for the early exchange. In July and August 2005, the Company exchanged and converted approximately \$2.2 million in principal amount of its 6.25% convertible notes for an aggregate of approximately 687,000 shares of the Company's common stock issuable pursuant to the original terms of the notes as defined in the indenture, plus approximately 67,000 additional shares to compensate the note holder for the early exchange pursuant to this agreement. In accordance with SFAS No. 84, *Induced Conversions of Convertible Debt*, the Company recorded debt conversion expense of approximately \$403,000 associated with the induced conversion of this debt.

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

In September 2005, a holder of the Company's 6.25% Convertible Subordinated Notes due 2008 voluntarily converted \$500,000 in aggregate principal amount of convertible notes for 158,730 shares of common stock pursuant to the original terms of the notes as defined in the indenture.

In May 2006, a holder of \$20.0 million in principal amount of the Company's 6.25% convertible subordinated notes converted such notes into 6,349,206 shares of common stock, at the conversion rate originally set forth in the Notes. Under the terms of the Exchange Agreement between the Company and the holder, the company made a cash payment to such holder of \$2,860,000. As a result of the conversion, the Company recorded \$2,287,000 in debt conversion expense in its statement of operations in the second quarter of 2006. The debt conversion expense represents the difference between our cash payment of \$2,860,000 to the holder and the interest expense accrued on the \$20.0 million of notes converted from the last interest payment date to the date of conversion. The conversion was recorded as a reduction of \$20.0 million of convertible subordinated notes, a reduction of other long term assets of \$519,000 attributable to the related unamortized debt issuance costs and an increase of \$19.5 million to shareholder's equity.

In September and October 2007, the Company entered into privately negotiated transactions with holders of the Company's 6.25% convertible subordinated notes, pursuant to which such holders elected to convert \$13.7 million in principal amount of such notes into an aggregate of 4,361,265 shares of common stock, at the conversion rate originally set forth in the indenture for such notes. The Company made cash payments to such holders of \$981,890, which amount satisfies the future interest payments due on such notes until maturity of \$858,625 plus a small premium for early conversions.

As a result of these conversions, the Company recorded \$718,000 in debt conversion expense in its statement of operations in 2007. The debt conversion expense represents the difference between our cash payment of \$981,890 to the holders and the interest expense accrued on the \$13.7 million of notes converted from the last interest payment date to the dates of conversions. The conversions were recorded as a reduction of \$13.7 million of short-term liabilities, a reduction of other short-term assets of \$130,000 attributable to the related unamortized debt issuance costs and an increase of \$13.7 million to shareholders' equity.

As of December 31, 2007, the remaining principal balance of the Company's 6.25% Convertible Subordinated Notes due 2008 was \$23.6 million, which is due on June 15, 2008. The Company may enter into similar transactions from time to time with holders of the convertible notes if the Company is able to do so on acceptable terms and depending on capital markets conditions.

***Alabama State Industrial Development Bonds***

In conjunction with the acquisition of SBS in April 2001, the Company assumed Alabama State Industrial Development Bonds (SBS Bonds) with remaining principal payments of \$1.7 million and a current interest rate of 6.35% increasing each year up to 7.20% at maturity on November 1, 2009. As part of the acquisition agreement, the Company was required to guarantee and collateralize these bonds with a letter of credit of approximately \$2.4 million that the Company supported with investments deposited with a financial institution in July 2001. From 2002 to 2007, as allowed under the guarantee agreement, a total of approximately \$1.8 million of this collateral was released from restriction following the exchange of the investment grade securities for corporate debt securities with a higher investment grade to conform with the Company's investment policy.

Interest payments are due semi-annually and principal payments are due annually. Principal payments increase in annual increments from \$150,000 to \$240,000 over the term of the bonds until the principal is fully amortized in 2009. The Company has an option to call the SBS Bonds at any time. As of December 31, 2007, the remaining principal payments total \$465,000.

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)*****Operating Leases***

The following chart indicates the facilities that we lease, the location and size of each such facility and their designated use.

| <b>Location</b> | <b>Approximate Square Feet</b> | <b>Operation</b>                     | <b>Expiration</b>                                                          |
|-----------------|--------------------------------|--------------------------------------|----------------------------------------------------------------------------|
| Cupertino, CA   | 30,000 sq. ft.                 | Office, Laboratory and Manufacturing | Lease expires 2009 (with an option to renew for an additional five years)  |
| Cupertino, CA   | 20,000 sq. ft.                 | Office and Laboratory                | Lease expires 2009 (with an option to renew for an additional five years)  |
| Cupertino, CA   | 40,560 sq. ft.                 | Office                               | Lease expires 2012 (with an option to renew for an additional six years)   |
| Vacaville, CA   | 17,452 sq. ft.                 | Manufacturing                        | Lease expires 2008 (with an option to renew for an additional three years) |
| Pelham, AL      | 9,400 sq. ft.                  | Office, Laboratory and Manufacturing | Lease expires 2009 (with an option to renew for an additional five years)  |

Under these leases, the Company is required to pay certain maintenance expenses in addition to monthly rent. Rent expense is recognized on a straight-line basis over the lease term for leases that have scheduled rental payment increases. Rent expense under all operating leases was \$2.0 million, \$2.5 million and \$2.7 million, for the years ended December 31, 2007, 2006 and 2005, respectively.

Future minimum payments under these noncancelable leases and long-term obligations are as follows (in thousands):

| <b>Year ending December 31,</b> | <b>Bond Maturities</b> | <b>Operating Leases</b> |
|---------------------------------|------------------------|-------------------------|
| 2008                            | 225                    | 2,072                   |
| 2009                            | 240                    | 996                     |
| 2010                            |                        | 740                     |
| 2011                            |                        | 762                     |
| Thereafter                      |                        | 763                     |
|                                 | <b>\$ 465</b>          | <b>\$ 5,333</b>         |

**11. Stockholders' Equity*****Common Stock***

In October 2005, the Company filed a shelf registration statement on Form S-3 with the SEC, which will allow the Company to offer up to \$75 million of securities from time to time in one or more public offerings of our common stock. In November 2005, the Company closed a follow on public offering of 8,183,274 shares of our common stock at \$5.00 per share and received net proceeds of approximately \$38.1 million, after deducting underwriting discounts and related expenses.

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)*****Warrants***

As of December 31, 2007, we had an outstanding exercisable warrant to purchase 770 shares of common stock at \$8.50 per share. The warrant was issued in connection with an Exclusive Trademark License and Assignment Agreement. The value of the warrant was immaterial. The warrant expires in 2011.

As of December 31, 2007, shares of common stock reserved for future issuance consisted of the following:

|                                   | <b>December 31,<br/>2007</b> |
|-----------------------------------|------------------------------|
| Warrants outstanding              | 770                          |
| Stock options outstanding         | 11,481,967                   |
| Stock options available for grant | 4,671,788                    |
| Employee Stock Purchase Plan      | 392,647                      |
| Convertible subordinated notes    | 7,491,746                    |
|                                   | 24,038,918                   |

A summary of stock option activity under all stock-based compensation plans during the year ended December 31, 2007 is as follows:

|                                  | <b>Number of<br/>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price Per Share</b> | <b>Weighted<br/>Average Remaining<br/>Contractual Term<br/>(in Years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value<br/>(in millions)</b> |
|----------------------------------|------------------------------|--------------------------------------------------------------|---------------------------------------------------------------------------|------------------------------------------------------------|
| Outstanding at December 31, 2004 | 8,611,995                    | \$ 3.93                                                      |                                                                           |                                                            |
| Options granted                  | 491,102                      | \$ 4.03                                                      |                                                                           |                                                            |
| Options exercised                | (446,867)                    | \$ 1.95                                                      |                                                                           |                                                            |
| Options cancelled and forfeited  | (1,085,084)                  | \$ 4.90                                                      |                                                                           |                                                            |
| Outstanding at December 31, 2005 | 7,571,146                    | \$ 3.92                                                      |                                                                           |                                                            |
| Options granted                  | 3,778,705                    | \$ 4.88                                                      |                                                                           |                                                            |
| Options exercised                | (909,453)                    | \$ 2.24                                                      |                                                                           |                                                            |
| Options forfeited                | (738,929)                    | \$ 3.36                                                      |                                                                           |                                                            |
| Options expired                  | (182,871)                    | \$ 9.46                                                      |                                                                           |                                                            |
| Outstanding at December 31, 2006 | 9,518,598                    | \$ 4.40                                                      | 7.37                                                                      | \$ 8.8                                                     |
| Options granted                  | 2,853,346                    | \$ 4.37                                                      |                                                                           |                                                            |
| Options exercised                | (353,110)                    | \$ 2.40                                                      |                                                                           |                                                            |
| Options forfeited                | (406,052)                    | \$ 4.32                                                      |                                                                           |                                                            |
| Options expired                  | (130,815)                    | \$ 8.33                                                      |                                                                           |                                                            |
| Outstanding at December 31, 2007 | 11,481,967                   | \$ 4.41                                                      | 7.09                                                                      | \$ 26.4                                                    |

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|                                  |           |    |      |      |    |      |
|----------------------------------|-----------|----|------|------|----|------|
| Exercisable at December 31, 2007 | 5,296,113 | \$ | 4.53 | 5.72 | \$ | 13.3 |
| Vested at December 31, 2007      | 9,499,412 | \$ | 4.41 | 6.83 | \$ | 22.5 |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (i.e., the difference between the Company's closing stock price on the last trading day of 2007 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2007. This amount changes based on the fair market value of the

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

Company's common stock. Total intrinsic value of options exercised is \$890,000, \$2.1 million, and \$1.3 million for the years ended December 31, 2007, 2006 and 2005, respectively.

Since inception, the Company had recorded aggregate deferred compensation charges of \$11.2 million in connection with stock options granted to employees and directors, including \$918,000 recorded at the time of the Company's acquisition of SBS in April 2001 for the assumption of outstanding stock options granted to employees and directors of that company. The Company has amortized or reversed (due to employee terminations) approximately \$11.2 million of deferred compensation charges through December 31, 2005. Employee stock-based compensation expense, net of reversal, was \$4,000 in 2005.

Total stock-based compensation expense related to modification of employee stock option terms was \$0 in 2007 and 2006 and \$336,000 in 2005.

The weighted-average grant-date fair value of all options granted with exercise price equal to fair market value was \$3.35 in 2007, \$3.84 in 2006 and \$2.69 in 2005. There were no options granted with exercise prices lower than fair market value in 2007, 2006 and 2005.

In 2007, 2006 and 2005, the Company issued options to purchase 1,500, 3,000 and 38,800 shares of common stock to several third party consultants in exchange for services, respectively. In connection with these options to purchase common stock, the Company recorded non-cash charges of \$6,000, \$10,000 and \$205,000 in its statement of operations for the years ended December 31, 2007, 2006 and 2005. The Company has no non-cash charges related to the modification of non-employee stock options in its statement of operations for the year ended December 31, 2007, 2006 and 2005, respectively.

Expenses for non-employee stock options are recorded over the vesting period of the options, with the amount determined by the Black-Scholes option valuation method and remeasured over the vesting term.

As of December 31, 2007, the Company had five stock-based employee compensation plans, which are described below. The employee stock-based compensation cost that has been included in the statements of operations was \$6.7 million, \$4.4 million and \$591,000 for the year ended December 31, 2007, 2006 and 2005. Stock-based compensation cost capitalized as part of inventory for the year ended December 31, 2007 was \$37,000.

*Description of Stock-Based Compensation Plans*

***1998 Stock Option Plan (Incentive Stock Plan)***

In March 1998, the Company adopted the DURECT Corporation 1998 Stock Option Plan under which incentive stock options and non-statutory stock options may be granted to employees, directors of, or consultants to, the Company and its affiliates.

Options granted under the 1998 Stock Option Plan expire no later than ten years from the date of grant. Options may be granted with different vesting terms from time to time not to exceed five years from the date of grant.

The option price of an incentive stock option granted to an employee or of a nonstatutory stock option granted to any person who owns stock representing more than 10% of the total combined voting power of all classes of stock of the Company (or any parent or subsidiary) shall be no less than 110% of the fair market value per share on the date of grant. The option price of an incentive stock option granted to any other employee shall

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

be no less than 100% of the fair market value per share on the date of grant. The option price of a nonstatutory stock option that is granted to any other person shall be no less than 85% of the fair market value per share on the date of grant.

In January 2000, the Company ceased granting options from the 1998 Stock Option Plan. As of December 31, 2007, options to purchase 19,000 shares of common stock were outstanding under this plan. In addition, all of such options were exercisable and vested as of that date.

***2000 Stock Plan (Incentive Stock Plan)***

In January 2000, the Company's Board of Directors and stockholders adopted the DURECT Corporation 2000 Stock Plan, under which incentive stock options and non-statutory stock options and stock purchase rights may be granted to employees, consultants and non-employee directors. The 2000 Stock Plan was amended by written consent of the Board of Directors in March 2000 and written consent of the stockholders in August 2000.

In April 2005, the Board of Directors approved certain amendments to the 2000 Stock Plan. At the Company's annual shareholders meeting in June 2005, the shareholders approved the amendments of the 2000 Stock Plan to: (i) expand the types of awards that the Company may grant to eligible service providers under the Stock Plan to include restricted stock units, stock appreciation rights and other similar types of awards (including other awards under which recipients are not required to pay any purchase or exercise price) as well as cash awards; and (ii) include certain performance criteria that may be applied to awards granted under the Stock Plan. A total of 15,296,500 shares of common stock have been reserved for issuance under this plan.

Options granted under the 2000 Stock Plan expire no later than ten years from the date of grant. Options may be granted with different vesting terms from time to time not to exceed five years from the date of grant. The option price of an incentive stock option granted to an employee or of a nonstatutory stock option granted to any person who owns stock representing more than 10% of the total combined voting power of all classes of stock of the Company (or any parent or subsidiary) shall be no less than 110% of the fair market value per share on the date of grant. The option price of an incentive stock option granted to any other employee shall be no less than 100% of the fair market value per share on the date of grant.

As of December 31, 2007, 4,429,913 shares of common stock were available for future grant and options to purchase 10,883,689 shares of common stock were outstanding under the 2000 Stock Plan.

***2000 Directors' Stock Option Plan***

In March 2000, the Board of Directors adopted the 2000 Directors' Stock Option Plan. A total of 300,000 shares of common stock had been reserved initially for issuance under this plan. The directors' plan provides that each person who becomes a non-employee director of the Company after the effective date of this offering will be granted a non-statutory stock option to purchase 20,000 shares of common stock on the date on which the optionee first becomes a non-employee director of the Company. This plan also provides that each option granted to a new director shall vest at the rate of 33<sup>1</sup>/<sub>3</sub>% per year and each annual option of 5,000 shares shall vest in full at the end of one year.

At the Company's annual shareholders meeting in June 2002, the shareholders approved an amendment of the 2000 Directors' Stock Option Plan to: (i) increase the number of stock options granted to a non-employee director on the date which such person first becomes a director from 20,000 to 30,000 shares of common stock; (ii) increase the number of stock options granted to each non-employee director on the date of each annual

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

meeting of the stockholders after which the director remains on the Board from 5,000 to 12,000 shares of common stock; and (iii) reserve 200,000 additional shares of common stock for issuance under the Directors' Stock Option Plan so that the total number of shares reserved for issuance is 500,000.

In April 2005, the Board of Directors approved certain amendments to the 2000 Directors' Stock Option Plan. At the Company's annual shareholders meeting in June 2005, the shareholders approved the amendments of the 2000 Directors' Stock Option Plan to: (i) increase the number of shares of common stock issuable under the Director's Plan by an additional 425,000 shares, to an aggregate of 925,000 shares; (ii) increase the number of option shares issued to nonemployee directors annually in connection with their continued service on the Board (from 12,000 shares) to 20,000 shares; and (iii) modify the vesting of such annual option grants so that such shares vest completely on the day before the first anniversary of the date of grant.

As of December 31, 2007, 434,000 shares of common stock were available for future grant and options to purchase 449,000 shares of common stock were outstanding under the 2000 Director's Stock Option Plan.

***1993 Stock Option Plan of Southern BioSystems, Inc.***

In April 2001, the Company assumed the 1993 Stock Option Plan of Southern BioSystems, Inc. (1993 SBS Plan) in connection with the acquisition of SBS. Pursuant to the 1993 SBS Plan, incentive stock options may be granted to employees, and nonstatutory stock options may be granted to employees, directors, and consultants, of the Company and its affiliates. A total of 662,191 shares of common stock were reserved for issuance under this plan at the time the Company assumed the plan. Options granted under the 1993 SBS Plan expire no later than ten years from the date of grant. Options may be granted with different vesting terms from time to time not to exceed five years from the date of grant. As of December 31, 2007, there were no shares of common stock available for future grant and options to purchase 130,278 shares of common stock were outstanding under the 1993 SBS Plan.

***2000 Employee Stock Purchase Plan***

In August 2000, the Company adopted the 2000 Employee Stock Purchase Plan. This purchase plan will be implemented by a series of overlapping offering periods of approximately 24 months' duration, with new offering periods, other than the first offering period, beginning on May 1 and November 1 of each year and ending April 30 and October 31, respectively, two years later. The purchase plan allows eligible employees to purchase common stock through payroll deductions at a price equal to the lower of 85% of the fair market value of the Company's common stock at the beginning of each offering period or at the end of each purchase period. The initial offering period commenced on the effectiveness of the Company's initial public offering. A total of 1,050,000 shares of common stock have been reserved for issuance under this plan. As of December 31, 2007, 392,647 shares of common stock were available for future grant and 882,353 shares of common stock have been issued under the employee stock purchase plan.

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)***Impact of the Adoption of SFAS 123(R)*

See Note 1 for a description of our adoption of SFAS 123(R), *Share-Based Payment*, on January 1, 2006. The following table summarizes the stock-based compensation expense for stock options and the Company's employee stock purchase plan that the Company recorded in the condensed statements of operations in accordance with SFAS 123(R) for the years ended December 31, 2007 and 2006 (in thousands).

|                                     | Year ended<br>December 31, 2007 | Year ended<br>December 31, 2006 |
|-------------------------------------|---------------------------------|---------------------------------|
| Cost of revenue                     | \$ 130                          | \$ 75                           |
| Research and development            | 4,286                           | 2,885                           |
| Selling, general and administrative | 2,273                           | 1,431                           |
| Total stock-based compensation      | \$ 6,689                        | \$ 4,391                        |

As of December 31, 2007 and 2006, \$37,000 and \$ 41,000 of stock-based compensation cost was capitalized in inventory on the balance sheets, respectively.

The following table illustrates the effect on the Company's net loss and net loss per share for the year ended December 31, 2005 as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation using the Black-Scholes valuation model (in thousands) in those periods.

|                                                                                                                 | Year Ended<br>December 31, 2005 |
|-----------------------------------------------------------------------------------------------------------------|---------------------------------|
| Net loss                                                                                                        | \$ (18,128)                     |
| Add (Deduct): Stock-based employee compensation expense included in reported net loss                           | 340                             |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards | (3,470)                         |
| Pro forma net loss                                                                                              | \$ (21,258)                     |
| Net loss per share:                                                                                             |                                 |
| Basic and diluted as reported                                                                                   | \$ (0.34)                       |
| Basic and diluted pro forma                                                                                     | \$ (0.40)                       |

Because we had a net operating loss carryforward as of December 31, 2007, no excess tax benefits for the tax deductions related to stock-based compensation expense were recognized in our statement of operations. Additionally, no incremental tax benefits were recognized from stock options exercised during 2007, which would have resulted in a reclassification to reduce net cash provided by operating activities with an offsetting increase in net cash provided by financing activities.

*Determining Fair Value*

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*Valuation and Amortization Method.* The Company estimates the fair value of stock options granted using the Black-Scholes option valuation model. For options granted before January 1, 2006, the Company amortizes the fair value on an accelerated basis. For options granted on or after January 1, 2006, the Company amortizes the fair value on a straight-line basis. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods.

**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)**

**Expected Term.** The expected term of options granted represents the period of time that the options are expected to be outstanding. Based on the limited historical exercise and post-vesting termination of options granted under the Company's plans, the Company does not believe that it is able to rely on its historical employee exercise behavior to provide accurate data for estimating the Company's expected term for use in determining the fair value of these options. Therefore, as allowed by Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*, the Company has opted to use the simplified method for estimating its expected term equal to the midpoint between the vesting period and the contractual term of the stock options.

**Expected Volatility.** The Company estimates the volatility of its common stock at the date of grant based on the historical volatility of the Company's common stock, consistent with SFAS 123(R) and SAB 107.

**Risk-Free Rate.** The Company bases the risk-free rate that it uses in the Black-Scholes option valuation model on the implied yield in effect at the time of option grant on U.S. Treasury zero-coupon issues with equivalent remaining terms.

**Dividends.** The Company has never paid any cash dividends on its common stock and the Company does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero in the Black-Scholes option valuation model.

The Company used the following assumptions to estimate the fair value of options granted and shares purchased under its employee stock plans and stock purchase plan for the years ended December 31, 2007, 2006 and 2005:

|                          | 2007     | Year ended<br>December 31,<br>2006 | 2005     |
|--------------------------|----------|------------------------------------|----------|
| <b>Stock Options</b>     |          |                                    |          |
| Risk-free rate           | 3.6-5.0% | 4.3-5.1%                           | 3.7-4.4% |
| Expected dividend yield  |          |                                    |          |
| Expected term (in years) | 6.25     | 6.25                               | 3.5-4.97 |
| Volatility               | 81-89%   | 90-94%                             | 90-102%  |
| Forfeiture rate          | 14.7%    | 17.2%                              |          |

|                                     | 2007     | Year ended<br>December 31,<br>2006 | 2005     |
|-------------------------------------|----------|------------------------------------|----------|
| <b>Employee Stock Purchase Plan</b> |          |                                    |          |
| Risk-free rate                      | 3.8-5.0% | 4.7-5.1%                           | 3.4-4.4% |
| Expected dividend yield             |          |                                    |          |
| Expected term (in years)            | 1.25     | 1.25                               | 1.25     |
| Volatility                          | 50-59%   | 54-82%                             | 53-100%  |

All employee stock options under the Company's stock compensation plans were granted with exercise prices equal to the fair market value of the Company's common stock on the date of grant during the years ended December 31, 2007, 2006 and 2005. The estimated weighted average fair value of the stock options granted during the years ended December 31, 2007, 2006 and 2005 was \$3.35, \$3.84 and \$2.46 per share, respectively. The total fair value of options vested during the year ended December 31, 2007 was \$7.2 million.

There were 179,567, 194,492 and 155,744 shares granted under our employee stock purchase plan during the years ended December 31, 2007, 2006 and 2005, respectively. Included in the statement of operations for the



**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)**

year ended December 31, 2007 was \$641,000 in stock-based compensation expense related to the amortization of expenses related to shares granted under the Company's employee stock purchase plan.

As of December 31, 2007, \$9.4 million of total unrecognized compensation costs related to nonvested awards is expected to be recognized over the respective vesting terms of each award through 2011. The weighted average term of the unrecognized stock-based compensation expense is 2.47 years.

The following table summarizes information about stock options outstanding at December 31, 2007:

| Options Outstanding        |       |                                     |                                                         | Options Exercisable                      |                                     |                                          |
|----------------------------|-------|-------------------------------------|---------------------------------------------------------|------------------------------------------|-------------------------------------|------------------------------------------|
| Range of<br>Exercise Price |       | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Weighted<br>Average<br>Exercise<br>Price | Number of<br>Options<br>Exercisable | Weighted<br>Average<br>Exercise<br>Price |
|                            |       |                                     | (In years)                                              |                                          |                                     |                                          |
| \$ 0.35                    | 2.51  | 1,825,952                           | 5.4                                                     | \$ 1.95                                  | 1,353,592                           | \$ 1.94                                  |
| \$ 2.57                    | 3.20  | 1,558,632                           | 6.67                                                    | \$ 3.13                                  | 1,127,485                           | \$ 3.12                                  |
| \$ 3.22                    | 3.79  | 1,236,475                           | 7.27                                                    | \$ 3.48                                  | 652,500                             | \$ 3.39                                  |
| \$ 3.82                    | 4.24  | 385,195                             | 7.58                                                    | \$ 3.94                                  | 217,170                             | \$ 3.91                                  |
| \$ 4.34                    | 4.34  | 2,279,137                           | 9.02                                                    | \$ 4.34                                  |                                     | \$                                       |
| \$ 4.35                    | 5.26  | 906,500                             | 8.49                                                    | \$ 4.78                                  | 232,501                             | \$ 4.77                                  |
| \$ 5.27                    | 5.27  | 1,842,963                           | 7.99                                                    | \$ 5.27                                  | 459,202                             | \$ 5.27                                  |
| \$ 5.38                    | 11.13 | 1,222,113                           | 4.58                                                    | \$ 8.02                                  | 1,028,663                           | \$ 8.37                                  |
| \$11.59                    | 13.00 | 210,000                             | 3.01                                                    | \$ 11.71                                 | 210,000                             | \$ 11.71                                 |
| \$13.56                    | 13.56 | 15,000                              | 2.95                                                    | \$ 13.56                                 | 15,000                              | \$ 13.56                                 |
| \$0.35                     | 13.56 | 11,481,967                          | 7.09                                                    | \$ 4.41                                  | 5,296,113                           | \$ 4.53                                  |

The Company received \$849,000, \$2.0 million and \$874,000 in cash from option exercises under all stock-based compensation plans for the years ended December 31, 2007, 2006 and 2005, respectively.

The Black Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. The Black Scholes model requires the input of highly subjective assumptions including the expected stock price volatility. The Company's stock based awards to employees have characteristics significantly different from those of traded options. Changes in the subjective input assumptions can materially affect the fair value estimate.

Under the Black-Scholes option-pricing model, the Company historically estimated the expected life of options using its best estimate of employee exercise behavior at the time. This estimate considered the vesting period for the employee stock options and a reasonable assumption about the post-vesting holding period. In anticipation of adopting SFAS 123(R) on January 1, 2006, the Company updated this estimate to reflect more recent historical experience of employee stock option exercises and cancellations. The Company included the updated expected life of option assumption for option grants made during the fourth quarter of 2005.

For the purposes of pro forma disclosures, the estimated fair value of the stock based awards is amortized to expense over the vesting period for options and the offering period for stock purchases under the Employee Stock Purchase Plan.



**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)*****Stockholder Rights Plan***

On July 6, 2001, the Board of Directors adopted a Stockholder Rights Plan. The rights issued pursuant to the plan expire on July 6, 2011 and are exercisable ten days after a person or group either (a) announces the acquisition of 17.5% or more of the Company's outstanding common stock or (b) commences a tender offer, which would result in ownership by the person or group of 17.5% or more of the Company's outstanding common stock. Upon exercise, all rights holders except the potential acquiror will be entitled to acquire the Company's common stock at a discount. Under certain circumstances, the Company's Board of Directors may also exchange the rights (other than those owned by the acquiror or its affiliates) for the Company's common stock at an exchange ratio of one share of common stock per right. The Company is entitled to redeem the rights at any time on or before the tenth day following acquisition by a person or group of 17.5% or more of the Company's common stock.

**12. Income Taxes**

Income tax provision was \$0, \$0 and \$4,000 in 2007, 2006 and 2005. Income tax provision of \$4,000 in 2005 was due to state income taxes paid for API in Alabama in 2005.

The reconciliation of income tax expenses (benefit) at the statutory federal income tax rate of 34% to net income tax benefit included in the statement of operations for the years ended December 31, 2007, 2006 and 2005 is as follows (in thousands):

|                                                | <b>Year Ended December 31,</b> |             |             |
|------------------------------------------------|--------------------------------|-------------|-------------|
|                                                | <b>2007</b>                    | <b>2006</b> | <b>2005</b> |
| U.S. federal taxes (benefit) at statutory rate | \$ (8,275)                     | \$ (11,331) | \$ (6,162)  |
| State taxes                                    |                                |             | 4           |
| Unutilized net operating loss                  | 6,556                          | 9,956       | 5,884       |
| Non-deductible stock compensation              | 1,310                          | 1,008       |             |
| Other                                          | 409                            | 367         | 278         |
| <b>Total</b>                                   | <b>\$</b>                      | <b>\$</b>   | <b>\$ 4</b> |

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

|                                               | <b>December 31,</b> |               |
|-----------------------------------------------|---------------------|---------------|
|                                               | <b>2007</b>         | <b>2006</b>   |
| Deferred tax assets:                          |                     |               |
| Net operating loss carryforwards              | \$ 66,913           | \$ 59,009     |
| Research and other credits                    | 5,937               | 2,974         |
| Capitalized research and development expenses | 3,758               | 3,643         |
| Deferred revenue                              | 5,762               | 7,887         |
| Other                                         | 3,659               | 2,541         |
| <b>Total deferred tax assets</b>              | <b>86,027</b>       | <b>76,054</b> |
| Valuation allowance for deferred tax assets   | (86,027)            | (76,054)      |

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|                         |    |    |
|-------------------------|----|----|
| Net deferred tax assets | \$ | \$ |
|-------------------------|----|----|

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**Table of Contents****DURECT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)**

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 increased by \$10.0 million and \$11.3 million during 2007 and 2006, respectively.

As of December 31, 2007, the Company had net operating loss carryforwards for federal income tax purposes of approximately \$180.3 million, which expire in the years 2018 through 2027 and federal research and development tax credits of approximately \$3.5 million which expire at various dates beginning in 2018 through 2027, if not utilized.

As of December 31, 2007, the Company had net operating loss carryforwards for state income tax purpose of approximately \$100.0 million, which expire in the years 2008 through 2017, if not utilized, and state research and development tax credits of approximately \$3.5 million, which do not expire.

Utilization of the net operating losses may be subject to a substantial annual limitation due to federal and state ownership change limitations. The annual limitation may result in the expiration of net operating losses before utilization.

Effective January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. There was not a material impact on the Company's financial position and results of operations as a result of the adoption of the provisions of FIN 48. At January 1, 2007 and December 31, 2007, the Company had unrecognized tax benefits of approximately \$2.5 million and \$3.0 million, respectively (none of which, if recognized, would favorably affect the Company's effective tax rate). The Company does not believe there will be any material changes in its unrecognized tax positions over the next twelve months.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

|                                                              | <b>2007</b> |
|--------------------------------------------------------------|-------------|
| Balance at January 1, 2007                                   | \$ 2,462    |
| Increases (decrease) related to prior year tax positions     |             |
| Increases related to current year tax positions              | 528         |
| Settlements                                                  |             |
| Reductions due to lapse of applicable statute of limitations |             |
| Balance at December 31, 2007                                 | \$ 2,990    |

Interest and penalty costs related to unrecognized tax benefits, if any, are classified as a component of interest income and other income (expense), net in the accompanying Statements of Operations. The Company, however, did not recognize any interest and penalty expense related to unrecognized tax benefits for the year ended December 31, 2007.

The Company files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The Company is subject to U.S. federal and state income tax examination for calendar tax years ending 1998 through 2007.

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**DURECT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

**13. Unaudited Selected Quarterly Financial Data (in thousands, except per share amounts)**

|                                      | <b>First Quarter</b> |             | <b>Second Quarter</b> |             | <b>Third Quarter</b> |             | <b>Fourth Quarter</b> |             |
|--------------------------------------|----------------------|-------------|-----------------------|-------------|----------------------|-------------|-----------------------|-------------|
|                                      | <b>2007</b>          | <b>2006</b> | <b>2007</b>           | <b>2006</b> | <b>2007</b>          | <b>2006</b> | <b>2007</b>           | <b>2006</b> |
| Revenue                              | \$ 5,726             | \$ 5,211    | \$ 13,432             | \$ 6,108    | \$ 4,932             | \$ 5,134    | \$ 6,585              | \$ 5,441    |
| Net loss                             | \$ (8,767)           | \$ (6,258)  | \$ (479)              | \$ (8,735)  | \$ (7,882)           | \$ (8,583)  | \$ (7,211)            | \$ (9,751)  |
| Basic and diluted net loss per share | \$ (0.13)            | \$ (0.10)   | \$ (0.01)             | \$ (0.14)   | \$ (0.11)            | \$ (0.12)   | \$ (0.10)             | \$ (0.14)   |

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**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

Not applicable.

**Item 9A. Controls and Procedures.**

**Disclosure Controls and Procedures**

As required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15, DURECT's management, including our Chief Executive Officer and Chief Financial Officer, conducted an evaluation as of the end of the period covered by this report, of the effectiveness of DURECT's disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e) and 15d-15(e). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that DURECT's disclosure controls and procedures were effective as of the end of the period covered by this report.

**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) and 15d-15(f). Under the supervision of our Chief Executive Officer and Chief Financial Officer and with the participation of our management, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2007 based on the framework in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on that evaluation, our management concluded that our internal control over financial reporting was effective as of December 31, 2007.

The effectiveness of our internal control over financial reporting as of December 31, 2007, has been audited by Ernst & Young LLP, our independent registered public accounting firm, as stated in their report which is included below.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of DURECT Corporation

We have audited Durect Corporation's internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Durect Corporation'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, Durect Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, 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 Durect Corporation as of December 31, 2007 and 2006, and the related statements of operations, stockholders' equity, and cash flows for each of the three fiscal years in the period ended December 31, 2007 of Durect Corporation and our report dated March 10, 2008 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Palo Alto, California

March 10, 2008

**Table of Contents****Changes in Internal Control Over Financial Reporting**

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during our last fiscal quarter that have materially affected or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information.**

None

**PART III**

The definitive proxy statement for our 2008 annual meeting of stockholders, when filed, pursuant to Regulation 14A of the Securities Exchange Act of 1934, will be incorporated by reference into this Form 10-K pursuant to General Instruction G (3) of Form 10-K and will provide the information required under Part III (Items 10-14), except for the information with respect to our executive officers, which is included in Part I Executive Officers of the Registrant.

**PART IV****Item 15. Exhibits and Financial Statement Schedules.**

(a) The following documents are filed as part of this report:

(1) *Financial Statements*

See Item 8 of this Form 10-K

(2) *Financial Statement Schedules*

Schedule II Valuation and Qualifying Accounts

Schedules not listed above have been omitted because the information required to be set forth therein is not applicable or is shown in the financial statements or notes thereto.

(3) Exhibits are incorporated herein by reference or are filed in accordance with Item 601 of Regulation S-K.

| Number | Description                                                                                                            |
|--------|------------------------------------------------------------------------------------------------------------------------|
| 2.1    | Agreement and Plan of Merger dated April 18, 2001, among the Company, Target and Magnolia Acquisition Corporation (2). |
| 3.3    | Amended and Restated Certificate of Incorporation of the Company (1).                                                  |
| 3.5    | Amended and Restated Bylaws of the Company (1).                                                                        |
| 3.6    | Certificate of Designation of Rights, Preferences and Privileges of Series B-1 Preferred Stock (1).                    |

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- 3.7 Certificate of Designation of Rights, Preferences and Privileges of Series C Preferred Stock (1).
- 4.2 Second Amended and Restated Investors Rights Agreement (1).
- 4.3 Preferred Shares Rights Agreement, dated as of July 6, 2001, between the Company and EquiServe Trust Company, N.A. including the Certificate of Designation, the form of the Rights Certificate and the Summary of Rights attached thereto as Exhibits A, B and C, respectively (3).

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| <b>Number</b> | <b>Description</b>                                                                                                                                                                            |
|---------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1          | Form of Indemnification Agreement between the Company and each of its Officers and Directors (1).                                                                                             |
| 10.2          | 1998 Stock Option Plan (1).                                                                                                                                                                   |
| 10.3          | 2000 Stock Plan (1).                                                                                                                                                                          |
| 10.4          | 2000 Employee Stock Purchase Plan (1).                                                                                                                                                        |
| 10.5          | 2000 Directors Stock Option Plan (1).                                                                                                                                                         |
| 10.6**        | Second Amended and Restated Development and Commercialization Agreement between the Company and ALZA Corporation effective April 28, 1999 (1).                                                |
| 10.7**        | Product Acquisition Agreement between the Company and ALZA Corporation dated as of April 14, 2000 (1).                                                                                        |
| 10.8          | Amended and Restated Loan and Security Agreement between the Company and Silicon Valley Bank dated as of October 28, 1998 (1).                                                                |
| 10.9**        | Manufacturing and Supply Agreement between Neuro-Biometrix, Inc. and Novel Biomedical, Inc. dated as of November 24, 1997 (1).                                                                |
| 10.10**       | Master Services Agreement between the Company and Quintiles, Inc. dated as of November 1, 1999 (1).                                                                                           |
| 10.11         | Modified Net Single Tenant Lease Agreement between the Company and DeAnza Enterprises, Ltd. dated as of February 18, 1999 (1).                                                                |
| 10.12         | Sublease Amendment between the Company and Ciena Corporation dated as of November 29, 1999 and Sublease Agreement between Company and Lightera Networks, Inc. dated as of March 10, 1999 (1). |
| 10.13**       | Project Proposal between the Company and Chesapeake Biological Laboratories, Inc. dated as of October 11, 1999 (1).                                                                           |
| 10.17         | Common Stock Purchase Agreement between the Company and ALZA Corporation dated April 14, 2000 (1).                                                                                            |
| 10.18         | Warrant issued to ALZA Corporation dated April 14, 2000 (1).                                                                                                                                  |
| 10.19         | Amended and Restated Market Stand-off Agreement between the Company and ALZA Corporation dated as of April 14, 2000 (1).                                                                      |
| 10.20**       | Asset Purchase Agreement between the Company and IntraEAR, Inc. dated as of September 24, 1999 (1).                                                                                           |
| 10.21         | Warrant issued to Silicon Valley Bank dated December 16, 1999 (1).                                                                                                                            |
| 10.22         | Amendment to Second Amended and Restated Investors Rights Agreement dated as of April 14, 2000 (1).                                                                                           |
| 10.23**       | Master Agreement between the Company and Pacific Data Designs, Inc. dated as of July 6, 2000 (1).                                                                                             |
| 10.24**       | Master Services Agreement between the Company and Clinimetrics Research Associates, Inc. dated as of July 11, 2000 (1).                                                                       |
| 10.25**       | Supply Agreement between the Company and Mallinckrodt, Inc. dated as of October 1, 2000 (5).                                                                                                  |
| 10.26         | Lease between Sobrato Development Companies #850 and the Company (6).                                                                                                                         |

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| <b>Number</b> | <b>Description</b>                                                                                                                                                                                                                                                  |
|---------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.27         | Southern BioSystems, Inc. 1993 Stock Option Plan (as amended) (4).                                                                                                                                                                                                  |
| 10.28         | Southern Research Technologies, Inc. 1995 Nonqualified Stock Option Plan (as amended) (4).                                                                                                                                                                          |
| 10.29**       | Feasibility, Development and Commercialization Agreement between Southern BioSystems, Inc., an Alabama corporation and wholly-owned subsidiary of the Company (now merged into the Company), and Voyager Pharmaceutical Corporation dated as of July 22, 2002. (7). |
| 10.30**       | License & Option Agreement and Mutual Release between Southern BioSystems, Inc, an Alabama corporation and wholly-owned subsidiary of the Company (now merged into the Company), and Thorn BioScience LLC dated as of July 26, 2002 (7).                            |
| 10.31**       | Third Amended and Restated Development and Commercialization Agreement between the Company and ALZA Corporation dated as of October 1, 2002 (7).                                                                                                                    |
| 10.32**       | Development and License Agreement between the Company, Southern BioSystems, Inc, an Alabama corporation and wholly-owned subsidiary of the Company (now merged into the Company), and BioPartners, GmbH dated as of October 18, 2002.(8)                            |
| 10.33**       | Development, Commercialization and Supply License Agreement between the Company and Endo Pharmaceuticals Inc. dated as of November 8, 2002.(8)                                                                                                                      |
| 10.34**++     | Development and License Agreement between the Company, Southern BioSystems, Inc., an Alabama corporation and wholly-owned subsidiary of the Company (now merged into the Company), and Pain Therapeutics, Inc. dated as of December 19, 2002.(8)                    |
| 10.35         | Sublease between the Company and Norian Corporation with commencement date of January 1, 2004.(9)                                                                                                                                                                   |
| 10.36         | Lease between the Company and Renault & Handley Employee Investments Co. with commencement date of January 1, 2005.(9)                                                                                                                                              |
| 10.37         | Amendment to Development, Commercialization and Supply License Agreement between the Company and Endo Pharmaceuticals Inc. dated as of January 28, 2004.(9)                                                                                                         |
| 10.38         | Indenture of Lease between the Company and the Board of Trustees of the University of Alabama dated as of May 1, 2004.(10)                                                                                                                                          |
| 10.39**       | License and Commercial Agreement between the Company and NeuroSystec Corporation dated as of May 13, 2004. (10)                                                                                                                                                     |
| 10.40         | Commercial Lease between the Company and EWE, Inc. dated as of September 21, 2004.(11)                                                                                                                                                                              |
| 10.41**       | License agreement between the Company and Endo Pharmaceuticals, Inc. dated as of March 10, 2005.(12)                                                                                                                                                                |
| 10.42         | Indenture of Lease between the Company and the Board of Trustees of the University of Alabama dated as of April 25, 2005.(13)                                                                                                                                       |
| 10.43         | Third Addendum to Lease between the Company and Garaventa Properties dated as of July 8, 2005.(14)                                                                                                                                                                  |
| 10.44         | Lease between the Company and RWC, LLC dated as of September 1, 2005.(14)                                                                                                                                                                                           |
| 10.45**       | Amendment dated December 21, 2005 to Development and License Agreement dated December 19, 2002 between the Company and Pain Therapeutics, Inc.(15)                                                                                                                  |
| 10.46**       | Sucrose Acetate Isobutyrate Pharmaceutical Grade Supply Agreement between the Company and Eastman Chemical Company dated as of December 30, 2005.(15)                                                                                                               |

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| <b>Number</b> | <b>Description</b>                                                                                                               |
|---------------|----------------------------------------------------------------------------------------------------------------------------------|
| 10.47         | Indenture of Lease between the Company and the Board of Trustees of the University of Alabama dated as of October 17, 2006. (16) |
| 10.48**       | Development and License Agreement between the Company and NYCOMED Danmark ApS dated as of November 29, 2006. (16)                |
| 10.49**       | License Agreement between the Company and Epicept Corporation dated as of December 20, 2006. (16)                                |
| 12.1          | Ratio of Earnings to Fixed Charges.                                                                                              |
| 23.1          | Consent of Independent Registered Public Accounting Firm                                                                         |
| 24.1          | Power of Attorney (see signature page of this Form 10-K).                                                                        |
| 31.1          | Rule 13a-14(a) Section 302 Certification.                                                                                        |
| 31.2          | Rule 13a-14(a) Section 302 Certification.                                                                                        |
| 32.1          | Certificate pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.            |
| 32.2          | Certificate pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.            |

  

|     |                                                                                                                                                                                      |
|-----|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (1) | Incorporated by reference to our Registration Statement on Form S-1, as amended (File No. 333-35316), initially filed with the Securities and Exchange Commission on April 20, 2000. |
| (2) | Incorporated by reference to our Current Report on Form 8-K (File No. 000-31615) filed with the Securities and Exchange Commission on May 15, 2001.                                  |
| (3) | Incorporated by reference to our Registration Statement on Form 8-A (File No. 000-31615) filed with the Securities and Exchange Commission on July 10, 2001.                         |
| (4) | Incorporated by reference to our Registration Statement on Form S-8 (File No. 333-61224) filed with the Securities and Exchange Commission on May 18, 2001.                          |
| (5) | Incorporated by reference to our Annual Report on Form 10-K (File No. 000-31615) filed with the Securities and Exchange Commission on March 30, 2001.                                |
| (6) | Incorporated by reference to our Quarterly Report on Form 10-Q (File No. 000-31615) filed with the Securities and Exchange Commission on November 13, 2001.                          |
| (7) | Incorporated by reference to our Quarterly Report on Form 10-Q (File No. 000-31615) filed with the Securities and Exchange Commission on November 14, 2002.                          |
| (8) | Incorporated by reference to our Annual Report on Form 10-K (File No. 000-31615) filed with the Securities and Exchange Commission on March 14, 2003.                                |
| (9) | Incorporated by reference to our Annual Report on Form 10-K (File No. 000-31615) filed with the Securities and Exchange Commission on March 11, 2004.                                |

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- (10) Incorporated by reference to our Quarterly Report on Form 10-Q (File No. 000-31615) filed with the Securities and Exchange Commission on August 4, 2004.
- (11) Incorporated by reference to our Quarterly Report on Form 10-Q (File No. 000-31615) filed with the Securities and Exchange Commission on November 5, 2004.
- (12) Incorporated by reference to our Quarterly Report on Form 10-Q (File No. 000-31615) filed with the Securities and Exchange Commission on May 6, 2005.
- (13) Incorporated by reference to our Quarterly Report on Form 10-Q (File No. 000-31615) filed with the Securities and Exchange Commission on August 4, 2005.

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- (14) Incorporated by reference to our Quarterly Report on Form 10-Q (File No. 000-31615) filed with the Securities and Exchange Commission on October 13, 2005.
- (15) Incorporated by reference to our Annual Report on Form 10-K (File No. 000-31615) filed with the Securities and Exchange Commission on March 16, 2006.
- (16) Incorporated by reference to our Annual Report on Form 10-K (File No. 000-31615) filed with the Securities and Exchange Commission on March 15, 2007.

\*\* Confidential treatment granted with respect to certain portions of this Exhibit.

++ Refiled with additional disclosure previously treated as confidential.

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**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**

**Year Ended December 31, 2007, 2006 and 2005**

**(in thousands)**

|                                 | <b>Balance at<br/>beginning<br/>of the year</b> | <b>Provision</b> | <b>Write-<br/>Offs</b> | <b>Balance at<br/>end of<br/>the<br/>year</b> |
|---------------------------------|-------------------------------------------------|------------------|------------------------|-----------------------------------------------|
| December 31, 2007               |                                                 |                  |                        |                                               |
| Allowance for doubtful accounts | \$ 1                                            | \$ 58            | \$ (10)                | \$ 49                                         |
| December 31, 2006               |                                                 |                  |                        |                                               |
| Allowance for doubtful accounts | \$ 128                                          | \$ (36)          | \$ (91)                | \$ 1                                          |
| December 31, 2005               |                                                 |                  |                        |                                               |
| Allowance for doubtful accounts | \$ 208                                          | \$ 48            | \$ (128)               | \$ 128                                        |

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Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**DURECT CORPORATION**

By: */s/* JAMES E. BROWN  
James E. Brown

President and Chief Executive Officer

Date: March 13, 2008

**POWER OF ATTORNEY**

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints James E. Brown and Felix Theeuwes, jointly and severally, his or her attorneys-in-fact, each with the power of substitution, for him or her in any and all capacities, to sign any 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, hereby ratifying and confirming all that each of said attorneys-in-fact, or his or her substitute or substitutes may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| <b>Signature</b>                                           | <b>Title</b>                                                                     | <b>Date</b>    |
|------------------------------------------------------------|----------------------------------------------------------------------------------|----------------|
| <i>/s/</i> JAMES E. BROWN<br><br>James E. Brown            | President, Chief Executive Officer and Director<br>(Principal Executive Officer) | March 13, 2008 |
| <i>/s/</i> FELIX THEEUWES<br><br>Felix Theeuwes            | Chairman and Chief Scientific Officer                                            | March 13, 2008 |
| <i>/s/</i> MATTHEW J. HOGAN<br><br>Matthew J. Hogan        | Chief Financial Officer                                                          | March 13, 2008 |
| <i>/s/</i> SIMON X. BENITO<br><br>Simon X. Benito          | Director                                                                         | March 13, 2008 |
| <i>/s/</i> TERENCE F. BLASCHKE<br><br>Terrence F. Blaschke | Director                                                                         | March 13, 2008 |
| <i>/s/</i> MICHAEL D. CASEY<br><br>Michael D. Casey        | Director                                                                         | March 13, 2008 |

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/s/ DAVID R. HOFFMANN

Director

March 13, 2008

David R. Hoffmann

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| Signature                | Title    | Date           |
|--------------------------|----------|----------------|
| /s/ ARMAND P. NEUKERMANS | Director | March 13, 2008 |
| Armand P. Neukermans     |          |                |
| /s/ JON S. SAXE          | Director | March 13, 2008 |
| Jon S. Saxe              |          |                |