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

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

For the quarterly period ended September 30, 2006

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

For the transition period from to
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Commission file Number 0-16109

A.P. PHARMA, INC.
(Exact name of registrant as specified in its charter)

Delaware	94-2875566
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

123 Saginaw Drive, Redwood City, CA 94063
(Address of principal executive offices)

(650) 366-2626
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes X No
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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.
Large accelerated filer [ ] Accelerated filer [ ]
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Non-accelerated filer [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.)
Yes [ ] No [X]
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At October 31, 2006, the number of outstanding shares of the Company's common stock, par value $.01, was 25,423,663.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements:

A.P. PHARMA, INC.

CONDENSED BALANCE SHEETS
(in thousands)

	September 30, 2006 (Unaudited)	December 31, 2005 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,769	$ 790
Marketable securities	14,304	5,019
Accounts receivable, net	75	1,519
Prepaid expenses and other	743	320
Total current assets	18,891	7,648
Property and equipment, net	953	1,164
Other long-term assets	105	157
Total assets	$ 19,949	$ 8,969
LIABILITIES & STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 357	$ 614
Accrued clinical trial expenses	988	892
Accrued disposition costs	276	248
Other accrued expenses	799	1,012
Total current liabilities	2,420	2,766
Stockholders' equity:		
Common stock	99,651	99,248
Accumulated deficit	(82,097)	(93,029)
Accumulated other comprehensive loss	(25)	(16)
Total stockholders' equity	17,529	6,203
Total liabilities and stockholders' equity	$ 19,949	$ 8,969

See accompanying notes to condensed financial statements.

A.P. PHARMA, INC.

CONDENSED STATEMENTS OF OPERATIONS (UNAUDITED)

(in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Royalties	$ --	$ 1,334	$ --	$ 3,803
Contract revenue	--	3	--	144
Total revenue	--	1,337	--	3,947
Operating expenses:				
Research & development	3,118	2,306	10,443	7,205
General & administrative	830	868	2,695	2,540
Total operating expenses	3,948	3,174	13,138	9,745
Operating loss	(3,948)	(1,837)	(13,138)	(5,798)
Interest income, net	244	74	786	221
Gain on sale of interest in royalties	--	--	23,429	--
Other expense, net	(49)	(1)	(53)	--
Income (loss) from continuing operations	(3,753)	(1,764)	11,024	(5,577)
Income (loss) from discontinued operations	(64)	20	(92)	(30)
Net income (loss)	$(3,817)	$(1,744)	$10,932	$(5,607)
Basic earnings (loss) per share:				
Income (Loss) from continuing operations	$ (0.15)	$ (0.07)	$ 0.44	$ (0.22)
Net income (loss)	$ (0.15)	$ (0.07)	$ 0.43	$ (0.22)
Diluted earnings (loss) per share:				
Income (Loss) from continuing operations	$ (0.15)	$ (0.07)	$ 0.43	$ (0.22)
Net income (loss)	$ (0.15)	$ (0.07)	$ 0.43	$ (0.22)
Weighted average common shares outstanding-basic	25,278	25,145	25,246	25,095
Weighted average common shares outstanding-diluted	25,278	25,145	25,435	25,095

See accompanying notes to condensed financial statements.

A.P. PHARMA, INC.

CONDENSED STATEMENTS OF CASH FLOWS (UNAUDITED)

(in thousands)

	For the Nine months ended September 30,	
	2006	2005
Cash flows from operating activities:		
Net income (loss)	$ 10,932	$(5,607)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Loss from discontinued operations	92	30
Loss on sale of marketable securities	1	4
Depreciation and amortization	299	190
SFAS123R stock compensation expense	240	--
Stock and stock option compensation awards to non-employees	79	89
Restricted stock awards	38	16
Amortization of premium/discount and accretion of marketable securities	(22)	43
Changes in operating assets and liabilities:		
Accounts receivable	1,388	43
Prepaid expenses and other current assets	(423)	58
Other long-term assets	56	112
Accounts payable	(257)	246
Accrued clinical trial expenses	96	(873)
Other accrued expenses	(213)	203
Net cash provided by (used in) continuing operating activities	12,306	(5,446)
Net cash provided by (used in) discontinued operations	(11)	88
Cash flows from investing activities:		
Purchases of property and equipment	(88)	(173)
Purchases of marketable securities	(14,701)	(8,113)
Maturities of marketable debt securities	1,800	8,300
Sales of marketable securities	3,628	4,439
Net cash provided by (used in) investing activities	(9,361)	4,453
Cash flows from financing activities:		
Proceeds from the exercise of stock options	11	22
Proceeds from issuance of shares under Employee Stock Purchase Plan	34	53
Proceeds from issuance of restricted stock	--	1
Net cash provided by financing activities	45	76
Net increase (decrease) in cash and cash equivalents	2,979	(829)
Cash and cash equivalents, beginning of the period	790	3,110
Cash and cash equivalents, end of the period	$ 3,769	$ 2,281

See accompanying notes to condensed financial statements.

A.P. PHARMA, INC.
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NOTES TO CONDENSED FINANCIAL STATEMENTS
- ----------------------------------
SEPTEMBER 30, 2006 and 2005 (UNAUDITED)
- ---------------------------------------

(1) Basis of Presentation

A.P. Pharma, Inc. (the "Company", "we", "our", or "us") is a specialty pharmaceutical company focused on the development of ethical (prescription) pharmaceuticals utilizing its proprietary polymer-based drug delivery systems. The Company's primary focus is the development and commercializtion of its bioerodible injectable and implantable systems under the trade name Biochronomer(TM). Initial target areas of application for the Company's drug delivery technology include anti-nausea, pain mangagement, anti-inflammation and DNA/RNAI applications.

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. All adjustments (all of which are of a normal recurring nature) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2006 are not indicative of the results that may be expected for the year ending December 31, 2006 or for any other period. The condensed balance sheet as of December 31, 2005 has been derived from the audited financial statements as of that date but it does not include all of the information and notes required by GAAP. These condensed financial statements and the notes thereto should be read in conjunction with the audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission (the "SEC") on March 31, 2006 (our "2005 10-K").

Summary of Critical Accounting Policies
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Except for the adoption of FAS 123(R) (see Stock-Based Compensation) there have been no significant changes in our critical accounting policies during the nine months ended September 30, 2006 compared to those previously disclosed in our 2005 10-K.

Use of Estimates
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The preparation of our financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in our financial statements and accompanying notes. Estimates were made relating to useful lives of fixed assets, valuation allowances, impairment of assets, accrued clinical and preclinical expenses, valuation of stock-based compensation and contingencies. Actual results could differ materially from those estimates.

Revenue Recognition
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Our revenue arrangements with multiple deliverables are divided into separate units of accounting if certain criteria are met, including whether the delivered element has stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered elements. The consideration we receive is allocated among the separate units based on their respective fair values, and the applicable revenue recognition criteria are considered separately for each of the separate units. Advance payments received in excess of amounts earned are classified as deferred revenue until earned.

* Royalties

Royalties from licensees are based on third-party sales of licensed products or technologies and recorded as earned in accordance with contract terms when third-party results can be reliably determined and collectibility is reasonably assured.

Generally, contractually required minimum royalties are recorded ratably throughout the contractual period. Royalties in excess of minimum royalties are recognized as earned when the related product is shipped to the end customer by our licensees based on information provided to us by our licensees.

* License Fees

Licensing agreements generally provide for periodic minimum payments, royalties, and/or non-refundable license fees. These licensing agreements typically require a non-refundable license fee and allow partners to sell our proprietary products in a defined field or territory for a defined period. License agreements provide for the Company to earn future revenue through royalty payments. These non-refundable license fees are initially reported as deferred revenues and recognized as revenues over the estimated life of the product to which they relate as we have continuing involvement with licensees until the related product is discontinued or the related patents expire, whichever is earlier. License fees received in connection with arrangements where we have no continuing involvement are recognized as revenue when the amounts are received or when collectibility is assured, whichever is earlier. No such fees were recorded during the nine months ended September 30, 2006.

A milestone payment is a payment made by a third party or corporate partner to us upon the achievement of a predetermined milestone as defined in a legally binding contract. Milestone payments are recognized as license fees revenue when the milestone event has occurred and we have completed all milestone related services such that the milestone payment is currently due and is non-refundable. No such fees were recorded during the nine months ended September 30, 2006.

* Contract Revenues

Contract revenues relate to research and development arrangements that generally provide for the Company to invoice research and development fees based on full-time equivalent hours for each project. Revenues from these arrangements are recognized as the related development costs are incurred. These revenues approximate the costs incurred. No such revenues were recorded during the nine months ended September 30, 2006.

Sale of Royalty Revenue

In January 2006, we completed the sale of our rights to royalties on sales of Retin-A Micro(R) and Carac(R) for up to $30 million. We received proceeds of $25 million upon the closing of the transaction and may receive up to an additional $5 million based on the satisfaction of certain predetermined milestones. The royalty interest agreement was entered into by the parties in January 2006, but the effective date of the sale of the royalty interest was October 1, 2005. The royalties recognized by the Company from October 1, 2005 through December 31, 2005 were accounted for as an offset against the $25 million gain.

Cash Equivalents and Short-term Investments

We consider all short-term investments in debt securities which have original maturities of less than three months at date of purchase to be cash equivalents. Investments which have original maturities of three months or longer are classified as marketable securities in the accompanying condensed balance sheets. Marketable securities are classified as available for sale at the time of purchase and carried at fair value. Unrealized gains or losses, if any, are recorded as other comprehensive income or loss in stockholders' equity.

Unrealized losses recorded as of September 30, 2006 were $25,000.

Accrued Disposition Costs

Costs relating to disposal of discontinued operations are reported as accrued disposition costs in the accompanying condensed balance sheets. Accrued disposition costs include severance costs and gross profit guarantees.

Concentrations of Credit Risk

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash equivalents and marketable securities. We invest excess cash in a variety of high grade short-term, interest-bearing securities. This diversification of risk is consistent with our policy to preserve principal and to maintain liquidity. In consequence, we do not believe concentrations of credit risk are an issue.

Segment and Geographic Information

Our operations are confined to a single business segment, the design and commercialization of polymer technologies for pharmaceutical and other applications. Substantially all of our revenues have been derived from domestic customers.

Stock-Based Compensation

Refer to Note 2 "Stock-Based Compensation" and Note 8 Stockholders' Equity in our 2005 10-K for further information regarding our adoption of SFAS 123(R) and our stock-based compensation arrangements, including related disclosures required upon the adoption of SFAS 123(R). On January 1, 2006, we adopted the provisions of Financial Accounting Standards Board Statement No. 123R, "Share-Based Payment" (SFAS 123R). SFAS 123R revised SFAS 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R requires companies to measure and recognize compensation expense for all employee share-based payments at fair value over the service period underlying the arrangement. Accordingly, we are required to record the grant-date or purchase-date fair value of stock options issued to employees and employee stock purchases. We have recorded the compensation expense for stock options issued to non-employees and restricted stock awards to employees and directors. Compensation related to options granted to non-employees is periodically remeasured as earned. We adopted SFAS 123R using the "modified prospective" method, whereby fair value of all previously-granted employee share-based arrangements remaining unvested at January 1, 2006, based on the grant-date value estimated in accordance with the pro forma provisions of SFAS 123, and all grants made on or after January 1, 2006, based on fair value estimated in accordance with SFAS 123(R), have been included in our determination of share-based compensation expense for the three and nine months ended September 30, 2006. We have not restated our operating results for the three and nine months ended September 30, 2005 to reflect charges for the fair value of share-based arrangements.

The fair value of each employee and director grant of options to purchase common stock is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants for the quarter ended September 30, 2006: 1) risk-free interest rate of 5.01% for stock options and 4.95% for employee stock purchase plan; 2) expected dividend yield of 0% for both stock options and employee stock purchase plan; 3) expected holding period of 6.25 years based on the simplified method provided in Staff Accounting Bulletin No. 107 for "plain vanilla options" and expected term of 1.25 years for employee stock purchase plan based on weighted-average purchase period of the plan; 4) expected volatility of 240% for stock options and 71% for employee stock purchase plan based on the Company's historical stock prices; and 5) an estimated forfeiture rate of 4.2% of the options granted based on historical data.

The SFAS 123R share-based compensation expenses recorded for awards granted under the stock option plans and employee stock purchase plan were approximately $74,000 and $240,000, net of estimated forfeitures, for the three and nine months ended September 30, 2006. The share-based compensation expense of $99,000 and $141,000 was recorded in research and development expense and general and administrative expense for the nine months ended September 30, 2006, respectively. No tax benefit was recognized related to share-based compensation expense since we have incurred operating losses and we have established a full valuation allowance to offset all the potential tax benefits associated with our deferred tax assets.

During the quarter ended September 30, 2006 we did not grant any restricted stock awards. As of September 30, 2006, we had a total of 235,000 shares of restricted stock awards granted to employees and directors, of which 135,000 shares have been vested. The compensation costs charged as operating expenses for restricted stock awards were $19,000 and $38,000 for the three and nine months ended September 30, 2006, respectively, and $8,000 and $16,000 for the three and nine months ended September 30, 2005.

During the quarter ended September 30, 2006 we granted 25,000 options to directors to purchase common stock. The following table summarizes option activity for the nine months ended September 30, 2006:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2006	2,165,966	$3.40		
Granted	214,940	$1.62		
Exercised	(1,797)	$1.55		
Expired and forfeited	(11,335)	$1.66		
Outstanding at March 31, 2006	2,367,774	$3.25	5.5	$429,453
Granted	50,000	$1.74		
Exercised	(1,090)	$1.05		
Expired and forfeited	(69,421)	$9.10		
Outstanding at June 30, 2006	2,347,263	$3.04	5.5	$239,426
Granted	25,000	$0.89		
Exercised	(6,719)	$1.07		
Expired	(161,542)	$5.15		
Forfeited	(5,448)	$1.53		
Outstanding at September 30, 2006	2,198,554	$2.87	5.48	$ 7,285
Options exercisable at September 30, 2006	1,776,054	$3.17	4.7	$ 2,251

As of September 30, 2006 there was approximately $497,741 of total unrecognized compensation expense related to nonvested stock options. This expense is expected to be recognized over a weighted-average period of 1.28 years.

Prior to January 1, 2006, we accounted for employee stock-based grants in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure". We have provided below the pro forma disclosures of the effect on net loss and net loss per share as if SFAS No. 123 had been applied in measuring compensation expense for the three and nine months ended September 30, 2005. Dollars in thousands except per share amounts.

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net loss, as reported	$(1,744)	$(5,607)
Deduct:		
Stock-based employee compensation expense determined under FAS No. 123	(92)	(251)
Pro forma net loss	$(1,836)	$(5,858)
Basic and diluted loss per share, as reported	$ (0.07)	$ (0.22)
Basic and diluted pro forma loss per share	$ (0.07)	$ (0.23)

Fair values of awards granted under the stock option plans and employee stock purchase plan were estimated at grant date using the Black-Scholes option pricing model. For pro forma disclosure, the estimated fair value of the options is amortized to expense over the vesting period of the options using the straight line method. Forfeitures have been accounted for in the period in which they occurred. The multiple option approach is used to value the purchase rights granted under the employee stock purchase plan. We used the following assumptions for the three and nine months ended September 30, 2005:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Expected life in years (from grant date):		
Stock options	5	5
Employee stock purchase plan	1.5 - 2	1.5 - 2
Interest rate:		
Stock options	4.2%	4%
Employee stock purchase plan	2.55%-3.63%	1.47%-3.63%
Volatility:		
Stock options	78%	78%
Employee stock purchase plan	84%-94%	59%-94%
Expected dividend yield:	0%	0%

Reclassifications
- -----------------

Certain amounts in the prior year's condensed financial statements have been reclassified to conform with the current presentation of the financial statements. Amortization of premium/discount and accretion of marketable securities in the prior year's quarter have been reclassified from investing activities to operating activities on the condensed statements of cash flows.

(2) Earnings (Loss) Per Share Information

Basic earnings (loss) per share is computed by dividing net income (loss) by the weighted-average number of common shares outstanding. Because the Company is in a net loss position for the three months ended September 30, 2006 and 2005 and nine months ended September 30, 2005, diluted earnings per share is also calculated using the weighted average number of common shares outstanding excluding the effect of options which are antidilutive. For the nine months ended September 30, 2006, diluted earnings per share is calculated using the weighted average number of common shares outstanding and other dilutive

securities.

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Numerator:				
Net income (loss)	$(3,817)	$(1,744)	$10,932	$(5,607)
Denominator:				
Weighted-average shares outstanding used to compute basic earnings per share	25,278	25,145	25,246	25,095
Effect of dilutive stock options, employee stock purchase and restricted stock awards	--	--	189	--
Weighted-average shares outstanding and dilutive securities used to compute diluted earnings per share	25,278	25,145	25,435	25,095

(3) Comprehensive Income (Loss)

Comprehensive income (loss) for the three and nine months ended September 30, 2006 and 2005 consists of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income (loss)	$(3,817)	$(1,744)	$10,932	$(5,607)
Unrealized gains (losses) on available-for-sale marketable securities	33	(6)	(9)	(3)
Comprehensive income (loss)	$(3,784)	$(1,750)	$10,923	$(5,610)

(4) Stockholders' Equity

During the nine months ended September 30, 2006, 108,887 shares of common stock were issued primarily through the exercise of stock options, employee stock purchases, issuance of restricted stock awards and for the payment of directors' fees.

(5) Discontinued Operations

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

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

Income (loss) from discontinued operations represents the income (loss) attributable to our Analytical Standards division that was sold to GFS Chemicals on February 13, 2003, and changes in estimates for our cosmeceutical and toiletry business that was sold to RP Scherer on July 25, 2000, as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Analytical Standards Division				
Royalties earned in excess of minimum amount recorded	$ 16	$ 29	$ 38	$ 42
Cosmeceutical and Toiletry Business				
Change in estimates for gross profit guarantees	(80)	(9)	(130)	(72)
Total loss from discontinued operations	$ (64)	$ (20)	$ (92)	$ (30)

Basic and diluted earnings (loss) per common share from discontinued operations were less than $0.01 per share for the nine months ended September 30, 2006 and 2005, respectively.

Liabilities related to the discontinued operations at September 30, 2006 in the amount of $276,000 include severance costs and accruals for gross profit guarantees. These liabilities are reported as accrued disposition costs in the accompanying condensed balance sheets.

Under the terms of the agreement with RP Scherer, we guaranteed a minimum gross profit percentage on RP Scherer's combined sales of products to Ortho Neutrogena and Dermik ("Gross Profit Guaranty"). The guaranty period commenced on July 1, 2000 and ends on the earlier of July 1, 2010 or the end of two consecutive guaranty periods where the combined gross profit on sales to Ortho and Dermik equals or exceeds the guaranteed gross profit. We expect the annual Gross Profit Guaranty payments to range from approximately $100,000 to $150,000 for the remainder of the guaranty period. As the minimum amount of Gross Profit Guaranty due is based on sales by RP Scherer and can not be estimated, no accrual has been recorded relating to sales in future periods.

Cash provided by (used in) discontinued operations primarily relates to royalty payments received from GFS Chemicals for the sale of certain products offset by a payment of $100,000 relating to the gross profit guaranty.

A summary of activity for liabilities related to discontinued operations for the nine months ended September 30, 2006 follows: (in thousands)

Accrual at December 31, 2005	$248
Additional accrual for gross profit guaranty	130
Payment for gross profit guaranty	(100)
Payment under severance agreement	(2)
Accrual at September 30, 2006	$276

(6) Subsequent Event

On October 2, 2006, we announced that we had granted an exclusive license to RHEI Pharmaceuticals to develop and sell APF530 in Greater China which includes China, Taiwan, Hong Kong and Macau. While specific license terms were not disclosed, the agreement includes an upfront payment and provisions for milestone payments and double digit percentage royalties on future net sales. APF530 is in Phase 3 clinical trial for the prevention of acute and delayed chemotherapy-induced nausea and vomiting.

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollars in thousands unless otherwise indicated)

FORWARD-LOOKING STATEMENTS

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

See Note 1 of Notes to Condensed Financial Statements. Except for the adoption of FAS 123(R), we believe that our current critical policies and estimates have not changed from those discussed in our 2005 10-K.

Results of Operations for the Three and Nine Months Ended September 30, 2006 and 2005

Our revenue has been derived principally from royalties and contract revenues. Under strategic alliance arrangements entered into with certain companies, we received non-refundable upfront fees, milestone payments and royalties based on third party product sales.

In January 2006, we completed the sale of our rights to royalties on sales of Retin-A Micro(R) and Carac(R) for up to $30 million. We received proceeds of $25 million upon the closing of the transaction and may receive up to an additional $5 million based on the satisfaction of certain predetermined milestones. The royalty interest agreement was entered into by the parties in January 2006, but the effective date of the sale of the royalty interest was October 1, 2005. The royalties recognized by the Company from October 1, 2005 through December 31, 2005 were accounted for as an offset against the $25 million gain. As a result of this transaction, royalties for the third quarter of 2006 decreased to $0 from $1.3 million in the corresponding quarter of the prior year and decreased in the first nine months of 2006 to $0 from $3.8 million in the first nine months of 2005. We will not record additional royalty revenue on sales of Retin-A Micro and Carac in future periods.

Contract revenue, which is derived from work performed under collaborative research and development arrangements, decreased from $3 to $0 in the third quarter of 2006 and decreased from $144 to $0 in the first nine months of 2006. The amount of contract revenue varies from period to period depending on the level of activity requested of us by our collaborators. Therefore we cannot predict the amount of contract revenue in future periods.

Research and development expense for the third quarter of 2006 increased by $812 from $2.3 million to $3.1 million due mainly to expenditures in the third quarter on our Phase 3 trial program for APF530, our product candidate for the prevention of chemotherapy-induced nausea and vomiting. Research and development expense for the first nine months of 2006 increased by $3.2 million from $7.2 million to $10.4 million due mainly to the preparations and initiation of our Phase 3 trial program for APF530. We expect research and development expense to increase in the last quarter of 2006 as we continue to conduct, at an accelerated pace, our Phase 3 trial program for APF530.

General and administrative expense decreased for the third quarter of 2006 by $38 from $868 to $830 and increased for the first nine months of 2006 by $155 from $2.5 million to $2.7 million due primarily to outside consultant fees. We expect general and

administrative expense for the fourth quarter of 2006 to remain relatively constant with the first three quarters of the year.

We expect our non-cash operating expenses for employee share-based compensation for the fourth quarter of 2006 to remain relatively constant with the first three quarters of the year.

Interest income, net, increased for the third quarter of 2006 by $170 to $244 from $74 and for the first nine months of 2006 by $565 from $221 to $786 due to higher interest rates earned on higher average cash, cash equivalents and marketable securities balances.

Loss from discontinued operations represents the net loss attributable to the Analytical Standards division which was sold to GFS Chemicals, Inc. in February 2003 and the cosmeceutical and toiletries business which was sold to RP Scherer Corporation in July 2000. Net loss from discontinued operations totaled $64 for the three months ended September 30, 2006, compared with a net loss of $20 in the three months ended September 30, 2005. For the nine months ended September 30, 2006, net loss from discontinued operations increased by $61 to $91 from $30 in the year-ago period.

Capital Resources and Liquidity
- ------------------------------

Cash, cash equivalents and marketable securities increased by $12.3 million to $18.1 million at September 30, 2006 from $5.8 million at December 31, 2005 due to the cash received from the sale of our interest in royalties on sales of Retin-A Micro and Carac in January 2006, partially offset by cash used in operating activities.

Net cash provided by continuing operating activities for the nine months ended September 30, 2006 was $12.3 million, compared to net cash of $5.4 million used in continuing operating activities for the nine months ended September 30, 2005. The increase in net cash provided by operating activities from 2005 to 2006 was mainly due to proceeds from the sale of our interest in royalties in January 2006.

Net cash used in investing activities for the nine months ended September 30, 2006 was $9.4 million compared to net cash of $4.5 million provided by investing activities for the nine months ended September 30, 2005. The increase in the cash used in investing activities was primarily due to the purchases of $14.7 million of marketable securities.

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

To date, we have financed our operations including technology and product research and development, primarily through income from collaborative research and development fees, the proceeds received from the sale of our Analytical Standards division, the sale of our cosmeceutical and toiletry business and the sale of our interest in royalties on sales of Retin-A Micro(R) and Carac(R), the sale of common stock in June 2004, and interest earned on short-term investments. In October 2006, we granted an exclusive license to RHEI Pharmaceuticals to develop and sell APF530 in Greater China which includes China, Taiwan, Hong Kong and Macau. While specific license terms were not disclosed, the agreement includes an upfront payment and provisions for milestone payments and double digit percentage royalties on future net sales.

We expect that existing cash, cash equivalents and marketable securities, together with interest income, receipts from the sale of our interest in royalties and other revenue-producing activities including license fees will be sufficient to meet our cash needs through the first quarter of 2007. We are actively seeking partners in the U.S. and abroad to take over the funding of the Phase 3 clinical trial of APF530, and to commercialize the product upon approval by the FDA. Also, we are currently investigating various financing options to fund our continued development of APF530 and potentially additional compounds. We may be unable to raise sufficient additional capital when we need it or to raise capital on

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

Below is a summary of fixed payments related to certain contractual obligations (in thousands). This table excludes amounts already recorded on our condensed balance sheet as current liabilities at September 30, 2006.

	Total	Less than 1 year	2 to 3 years	4 to 5 years	More than 5 years
Operating Leases	$2,367	$508	$1,053	$806	$ --

ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

Since December 31, 2005, there have been no material changes in the Company's market risk exposure.

ITEM 4. Controls and Procedures

Evaluation of disclosure controls and procedures: We carried out an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operations of our disclosure controls and procedures pursuant to Rule 13a-15(b) of the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2006, the end of period covered by this report, our disclosure controls and procedures were effective at the reasonable assurance level to alert them in a timely manner to material information relating to the Company required to be included in our Exchange Act filings.

Changes in internal controls: During the three months ended September 30, 2006, there have been no significant changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1A. Risk Factors

There have been no material changes to the risk factors set forth in the "RISK FACTORS" section of our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

ITEM 6. Exhibits

Exhibit 10.AA License Agreement, dated as of October 1, 2006, between A.P. Pharma, Inc. and RHEI PHARMACEUTICALS, INC. Confidential treatment has been requested with respect to the omitted portions of this exhibit.

Exhibit 31.1 Certification of Chief Executive Officer pursuant to Rules 13A-14(a) Promulgated under the Securities Exchange Act of 1934 as amended.

Exhibit 31.2 Certification of Chief Financial Officer pursuant to Rules 13A-14(a) Promulgated under the Securities Exchange Act of 1934 as amended.

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

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

A.P. PHARMA, INC.

Date: November 7, 2006 By: /S/ Gregory H. Turnbull

Gregory H. Turnbull
President and Chief
Executive Officer

Date: November 7, 2006 By: /S/ Stephen C. Whiteford

Stephen C. Whiteford
Vice President, Finance and
Chief Financial Officer

CONFIDENTIAL TREATMENT REQUESTED

LICENSE AGREEMENT

A.P. PHARMA, INC. ("APP")
a corporation organized under the laws of Delaware
with corporate headquarters at
123 Saginaw Drive
Redwood City, California 94063

AND:

RHEI PHARMACEUTICALS, INC. ("RHEI")
a corporation organized under the laws of Delaware
with corporate headquarters at
300 George Street
New Haven, Connecticut 06511

LICENSE AGREEMENT

THIS AGREEMENT is made as of the 1st day of October, 2006 ("Effective Date"), by and between A.P. PHARMA, INC. ("APP") and RHEI PHARMACEUTICALS, INC. ("RHEI").

RECITALS

A. APP is the owner of original processes, Patent Rights and Know How (each as defined herein) covering the Licensed Product (as defined herein);

B. RHEI is a specialty pharmaceutical company that, among other things, licenses, registers and commercializes pharmaceutical products in the Territory;

C. APP has developed the Licensed Product and has initiated clinical trials in the United States for the purpose of obtaining approval to market the Licensed Product for the treatment of patients undergoing moderately or highly emetogenic chemotherapy;

D. RHEI desires to obtain an exclusive license under APP's proprietary rights, including the Patent Rights and Know How, to develop, obtain Regulatory Approval and commercialize the Licensed Product in the Territory; and

E. APP is willing to grant such license to RHEI and also to permit RHEI to use the Data set forth on Schedule 4.2 for the purpose of obtaining Regulatory Approval of the Product.

It is therefore agreed as follows:

1. DEFINITIONS.

1.1 The terms defined in this Article 1 shall, for all purposes of this Agreement, have the following meanings:

1.2 "Active Ingredient" shall mean the chemical compound known as granisetron.

1.3 "Affiliate" shall mean any corporation or other entity that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the designated party but only for so long as such relationship exists. For the purposes of this section, "Control" shall mean ownership of at least fifty percent (or such lesser percent as may be the maximum that may be owned by foreign interests pursuant to the applicable laws of the country of incorporation) of the shares of stock entitled to vote for directors in the case of a corporation and at least fifty percent (or such lesser percent as may be the maximum that may be owned pursuant to the applicable laws of the country of domicile) of the equity or interests in profits in the case of a business entity other than a corporation.

1.4 "Applicable Permits" shall mean all permits or approvals necessary to market the Licensed Product in any country, including without limitation, permits or approvals granted by the FDA and any pricing approvals.

1.5 "Application for Regulatory Approval" means an application made to a Regulatory Authority in any country for permission to Market Licensed Product in that country, and includes without limitation a New Drug Application (an "NDA") and an Abbreviated New Drug Application (an "ANDA") submitted to the FDA or an equivalent application submitted to an equivalent Regulatory Authority in the Territory.

1.6 "Biochronomer formulation" shall mean APP's delivery system described and claimed in the Patent Rights listed on Schedule 1.24 and any and all improvements thereto that APP is legally entitled to license and related Know How and Data.

1.7 "Clinical Information" means clinical, pharmacology, toxicology, safety, efficacy, and Phase I, II and III Data set forth on Schedule 4.2 or similar information of a Party, relating to the Licensed Product.

1.8 "Commercially Reasonable Efforts" means efforts of a degree and kind, including the level of attention and care and providing of funding and manpower, consistent with the exercise of good business judgment for a company similarly situated as APP or RHEI, as the case may be, and in the case of RHEI, such efforts will in no event be less than the efforts that RHEI applies with respect to its own products (including, without limitation, in-licensed products) of similar commercial potential and stage of product life cycle.

1.9 "Competition" shall mean that one or more third parties is marketing in the Territory, for use in humans, a long-acting poly(ortho ester) formulation of the Active Ingredient for subcutaneous administration, and cannot be legally restrained from such marketing.

1.10 "Confidential Information" shall mean all proprietary materials or other information (whether or not patentable) regarding a Party's technology, products, business information or objectives, including without limitation, Data, Know-How, Clinical Information, CMC, Manufacturing and Marketing information, which is designated as confidential in writing by the disclosing Party, whether by letter or by the use of an appropriate stamp or legend, prior to or at the time any such material, know-how or other information is disclosed by the disclosing Party to the other Party. Notwithstanding the foregoing to the contrary, materials, know-how or other information which is orally, electronically, visually, or otherwise disclosed by a Party, or is disclosed in writing without an appropriate letter, stamp or legend, shall constitute Confidential Information of a Party if the disclosing Party, within 30 days after such disclosure, delivers to the other Party a written document or documents describing the materials or other information and referencing the place and date of such oral, visual, electronic, written or other disclosure and the names of the persons to whom such disclosure was made.

1.11 "Data" shall mean and include the data set forth on Schedule 4.2 and any other Clinical Information concerning the Licensed Product necessary or useful for seeking and obtaining Regulatory Approval and Applicable Permits in the Field in the United States.

1.12 "Effective Date" shall mean the date first written on page 1 of this Agreement.

1.13 "FDA" shall mean the United States Food and Drug Administration or any successor United States governmental agency performing similar functions with respect to pharmaceutical products.

1.14 "Field" shall mean any and all human applications.

1.15 "Invention" means any improvement to the Licensed Product, any new performance characteristic of the Licensed Product, any new process used to Manufacture the Licensed Product, or any step or steps in any such process.

1.16 "Know How" shall mean all APP inventions, discoveries, trade secrets, improvements and information not in the public domain, whether or not patented or patentable (but excluding Patent Rights), together with all experience, data, formulas, procedures and results, and improvements thereon, now existing or hereafter developed or acquired (by APP) during the term of and in connection with this Agreement and proprietary or licensed with right to sublicense to APP, which relate to or are useful for the development, Marketing or use of Licensed Product.

1.17 "Knowledge" or "knowledge" shall mean, with respect to either Party, the actual knowledge of its executive officers and/or managers after having taken reasonable steps to be informed of or ascertain the existence or lack thereof of any matter.

1.18 "Licensed Product" shall mean a formulation of the Active Ingredient with the Biochronomer formulation, including the formulation designated by APP as APF530.

1.19 "Manufacture" means to process, prepare, make and analyze and Manufacturing and Manufactured have a corresponding meaning.

1.20 "Market" means to promote, distribute, package, label, market, advertise, sell or offer to sell, and Marketing has a

corresponding meaning.

1.21 "NDA" shall mean a New Drug Application or equivalent application for approval to market submitted to the FDA or an equivalent regulatory agency in the Territory.

1.22 "Net Sales" shall mean the total of all amounts invoiced by RHEI and its Affiliates for Licensed Product sold to independent, unrelated third parties in the Territory in bona fide arms length transactions, less the following deductions actually allowed and taken by such third parties and not otherwise recovered by or reimbursed to RHEI or its Affiliates: (i) trade, cash and quantity discounts in such amounts as are customary in the trade; (ii) rebates (including any retroactive rebates), credits or other reimbursements actually paid; (iii) taxes on sales (such as sales or use taxes) to the extent added to the sales price and set forth separately as such in the total amount invoiced; (iv) value added taxes when included as part of the sales price and not refunded to the payor; (v) freight, insurance, and other transportation charges to the extent added to the sales price and set forth separately as such in the total amount invoiced; (vi) amounts repaid or credited by reason of rejections, defects or returns or because of retroactive price reductions; and (vii) other allowances, adjustments, reimbursements, discounts, chargebacks and rebates related to the sale of such Licensed Product that are granted to third parties, including governmental entities and managed care organizations. Net Sales shall not include sales of Licensed Product between or among RHEI and its Affiliates.

1.23 "Party" shall mean APP or RHEI, and Parties shall mean APP and RHEI.

1.24 "Patent Rights" shall mean any patent application or issued patent covering Licensed Product or any improvement to Licensed Product that are owned or otherwise controlled with right to license by APP during the term of this Agreement, in the Territory, including any addition, continuation, continuation in part, or division thereof or any substitute application thereof, any reexamination, any reissue or extension of any such patent, and any confirmation patent, registration patent revalidation patent, or patent of addition based on any such patent, any patents owned or controlled with right to license by APP that dominate any of the foregoing, and includes without limitation the patent applications set forth on Schedule 1.24.

1.25 "Regulatory Approval" shall mean the permission or consent granted by any relevant Regulatory Authority for the Marketing of Licensed Product in the Territory.

1.26 "Regulatory Authority" shall mean, in respect of any country, any government or other agency responsible for the issuance of approval to Market pharmaceutical products in or

sold from that country, including without limitation the FDA and the corresponding authorities in the Territory.

1.27 "Territory" shall mean the People's Republic of China (including without limitation Hong Kong and Macau) and Taiwan.

1.28 "US GAAP" shall mean accounting principles generally accepted in the United States of America.

1.29 "Valid Claim" shall mean a claim of an unexpired issued patent falling within Patent Rights, which claim shall not have been withdrawn, cancelled, disclaimed or held invalid by a court, tribunal, arbitrator or governmental agency of competent jurisdiction in a final or unappealed or unappealable decision.

2. PRODUCT DEVELOPMENT

2.1 APP represents and warrants to RHEI that APP has commenced the development of the Licensed Product prior to the Effective Date and that as of the Effective Date Licensed Product is undergoing Phase III clinical trials in the United States. After the Effective Date, RHEI shall use Commercially Reasonable Efforts to develop on its own or on its behalf Licensed Product in the Territory.

3. PRODUCT DEVELOPMENT COSTS

3.1 In consideration of the entering into of this Agreement by RHEI, and the agreement by RHEI to make the license and milestone payments required by Article 8 of this Agreement, and to pay the royalties required by Article 11 of this Agreement, APP agrees to carry out its obligations under this Agreement.

3.2 Any cost required to obtain Regulatory approval and Applicable Permits of the Licensed Product in the Territory

other than [***] under this Agreement shall be paid [***].

4. DISCLOSURE OF INFORMATION AND REPORTING

4.1 Within 30 days after the Effective Date, APP shall disclose and deliver to RHEI APP's existing Clinical Information. Thereafter, during the term of this Agreement, each Party shall disclose and deliver to the other Party Clinical Information within 30 days after the same shall become available, including information relating to the safety of Licensed Product as set forth in Sections 4.7-4.9 below and any regulatory problems relating thereto, all to the extent necessary or useful to enable the receiving Party to develop or Market or have Marketed the Licensed Product in accordance with its obligations under this Agreement. Clinical Information disclosed under this Section 4.1 shall be treated by the receiving Party as Confidential Information of the disclosing Party in accordance with Article 7 below.

4.2 APP shall deliver to RHEI Data, in an agreed upon form, as follows: APP shall deliver to RHEI within 30 days after the Effective Date the final report of any studies set forth in Schedule 4.2 and completed by APP on the Licensed Product and thereafter within 30 days after completion of each additional final report relating to Clinical Information. RHEI shall be responsible at its cost for all translations of any such Data.

4.3 Within 30 days after the Effective Date, the Parties shall mutually determine what other Data are judged by the Parties as necessary or useful for RHEI to commercialize the Licensed Product in the Territory. Within 30 days of such determination, APP shall disclose and deliver to RHEI such Data that are existing as of the Effective Date. Thereafter, during the term of this Agreement, APP shall disclose and deliver such Data within 30 days after it becomes available.

Records, Reports and Inspections.

4.4 APP shall maintain records in sufficient detail and in compliance with cGMP, GCP and GLP standards for such period after their completion as may be required by applicable regulations of the FDA, which records shall fully and properly reflect all work done and all results achieved by APP in the performance of its obligations under this Agreement. RHEI shall have the right to notify APP if a Regulatory Authority in the Territory requests maintenance of records that are not required by such applicable regulations of the FDA. The Parties agree to discuss and attempt to resolve any such request, provided, however, that if the Parties mutually agree to undertake additional studies or data collection or the like in order to resolve such request, the cost will be borne by RHEI.

Once in each calendar quarter each Party shall have the right to arrange for its employees and/or consultants involved in the activities contemplated hereunder to confer by telephone or to visit the other Party at its offices and laboratories during normal business hours and upon two weeks notice, and to discuss the progress of the development work, its results, and the information generated, with the technical personnel of the other Party. Until approval of the NDA or Regulatory Approval each Party shall provide to the other Party within 30 days after the end of the relevant period, semi-annual written reports of the progress and results of its development work and the information generated during the relevant reporting period.

If a Regulatory Authority in the Territory desires to conduct an inspection or audit of APP's facility with regard to a Licensed Product or this Agreement, APP shall permit such inspection and agrees to cooperate with the Regulatory Authority and RHEI during such inspection or audit. Following receipt of the inspection or audit observations of the Regulatory Authority (a copy of which the receiving Party will immediately provide to the other Party if given by the Regulatory Authority), the Parties will cooperate to prepare a response to any observation that concerns this Agreement. The Parties agree to fully cooperate in the preparation of such a response, including by providing such information and documentation in a Party's possession as may be necessary. Each Party agrees to conform its respective activities under this Agreement to any commitments made in such a response, except to the extent a Party believes in good faith that such commitments violate applicable laws.

Safety Information

4.7 During the Term of this Agreement, each Party shall promptly notify the other Party of all information required to be reported to the FDA or the Regulatory Authority in the Territory coming into its possession concerning side effects, injury, toxicity or sensitivity reaction including unexpected increased incidence and severity thereof associated with

commercial or clinical uses, studies, investigations or tests (animal or human) with the Licensed Product ("Adverse Reaction Reports"). Each Party shall transmit such Adverse Reaction Reports so that they are received by the other Party within 30 days after receipt by the transmitting Party, or such other reporting period as may be required by law. All such communications and other safety communications shall be held in confidence by each Party subject to the terms of Article 7 hereof.

4.8 RHEI agrees to share safety information, including without limitation, Adverse Reaction Reports, with APP's other licensees (if any) who agree to share such information with RHEI and to require the same obligations of its co-promotion partners (if any).

4.9 APP agrees to use reasonable efforts to secure the same provision in other Licensed Product licenses granted by APP so that safety information generated by other licensees of the Licensed Product will be shared with RHEI.

5.1 ADDITIONAL INFORMATION FOR REGULATORY APPROVAL

5.1 APP shall provide to RHEI additional information relating to the Licensed Product in its possession or control that is required to support Application for Regulatory Approval of Licensed Product in the United States that may be reasonably necessary to enable RHEI to apply for and obtain Regulatory Approval in the Territory for the Licensed Product and to Market Licensed Product in the Territory. APP shall provide such existing additional information within 30 days after the Effective Date and thereafter promptly after such information is available.

6. APPLICATION FOR REGULATORY APPROVAL

6.1 Provided that APP has complied in all material respects with its obligations under this Agreement, RHEI shall use Commercially Reasonable Efforts to file in accordance with the timelines set forth in Schedule 6.1 (as such timelines may be adjusted by mutual action of the Parties) at the cost of RHEI, and in the name of RHEI, or any Affiliate of RHEI, any Applications for Regulatory Approval required for the Licensed Product in the Territory. APP shall reasonably cooperate with RHEI in the filing of an Application for Regulatory Approval in the Territory. Notwithstanding the foregoing, APP shall have the sole right to determine when clinical trials shall be initiated in the Territory, provided that once an Application for Regulatory Approval has been accepted by the FDA, APP shall be deemed to have granted to RHEI or its Affiliates the right to initiate clinical trials in the Territory. For avoidance of doubt, upon the Effective Date, RHEI shall have the right, but not the obligation, to file an application to conduct a confirmatory clinical trial for Licensed Product with any Regulatory Authority in the Territory.

6.2 Subject only to Section 19.5, RHEI or its Affiliate shall retain ownership of each Application for Regulatory Approval in the Territory. Any Regulatory Approval, import licenses, formulary listings or other licenses or approvals for the Licensed Product in the Territory, or any agency or instrumentality thereof authorizing import and/or sale of the Licensed Product shall be issued in the name of RHEI or any Affiliate of RHEI.

7. CONFIDENTIALITY.

7.1 Each of RHEI and APP shall maintain all Confidential Information of the other Party, in confidence, and shall not at any time disclose any such information to persons other than their Affiliates, officers, employees, agents, consultants and advisers with a need to know, except where permitted by this Agreement, and only to the extent necessary for the purposes of this Agreement. RHEI and APP shall use Confidential Information of the other Party only to the extent necessary or permitted by this Agreement, or required by law, including, without limitation, as necessary in the course of seeking, enforcing or defending patent rights, obtaining approval to Market Licensed Products, in the course of any actual or potential financing or in connection with any sublicensing, alliance or other arrangement permitted under this Agreement. RHEI and APP shall take all reasonable steps to ensure that their respective Affiliates, agents, officers, employees, representatives,

consultants, advisors, permitted licensees, potential licensees and permitted sublicensees or others entitled to receive the disclosing Party's Confidential Information under this Agreement

maintain the obligations of confidence imposed on RHEI and APP by this Agreement.

7.2 Section 7.1 shall not apply to any Confidential Information that:

(a) the receiving Party can establish by written documentation was known to it at the time of its disclosure by the other Party;

(b) has been published or is otherwise within the public knowledge or is generally known to the public;

(c) has come into the public domain without any breach of this Agreement;

(d) became known or available to it from a source having the right to make such disclosure to it and without restriction on such disclosure to it;

(e) is disclosed to the public and is generally available to the public as a result of compliance with any applicable law or regulation;

(f) is disclosed as the result of publication of an application for patent relating to the Licensed Product anywhere in the world; or

(g) is independently developed as established by the receiving Party without use of the disclosing Party's Confidential Information.

7.3 Each Party acknowledges that improper use or disclosure of information of the other Party that must be kept in confidence under Section 7.1 above would cause substantial harm to the other Party (in particular in potentially barring patent protection for that Party's technology), and that such harm could not be remedied by the payment of damages alone. Accordingly, each Party will be entitled to preliminary and permanent injunctive relief and other equitable relief for any breach of this Article 7 by the other Party, without prejudice to all other remedies available at law or in equity.

8. LICENSE AND MILESTONE PAYMENT BY RHEI.

8.1 RHEI shall make the milestone payment due on the Effective Date by wire transfer to APP within 10 business days after execution of this Agreement and, thereafter, by wire transfer within 10 days after each subsequent occurrence requiring a milestone payment, in U.S. dollars as follows: [***]

9. LICENSE TO APP.

9.1 APP shall be entitled to use the Data generated by or on behalf of RHEI or its Affiliates for Licensed Product at any time after the Effective Date for the purpose of obtaining Regulatory Approval of the Licensed Product in jurisdictions outside of the Territory.

10. LICENSE OF PRODUCT.

10.1 APP hereby grants to RHEI an exclusive license in the Territory under the Patent Rights and Know How to develop, have developed, apply for and obtain Regulatory Approval, use, Market and import Licensed Product, with the right to grant sublicenses to Affiliates of the same scope as the license granted by this Agreement, (except that any Affiliate shall have no right to grant further sublicenses), to develop, have developed, apply for and obtain Regulatory Approval, use, Market and import Licensed Product in the Territory. RHEI and its Affiliates shall also have the right to grant co-promotion rights to third parties in the Territory.

10.2 APP hereby grants to RHEI the right to use the Clinical Information and Data generated by or on behalf of APP and its Affiliates (as provided in Section 4.2) for the purpose of obtaining Regulatory Approval of the Licensed Product in the Territory.

10.3 RHEI shall have the right to Market and sell Licensed Product under any trademark or trademarks that RHEI chooses and has the legal right to use, whether now or hereafter acquired or developed. At RHEI's sole discretion, RHEI shall have the right to use trademark(s) for Licensed Product which is/are filed for and owned by APP, if any, and APP hereby grants to RHEI all rights and licenses to use such APP product trademark(s) in connection with Licensed Product in the Territory. Upon the written request of APP, RHEI will, in addition to a product trademark, in any event use a line trademark proprietary to APP that is registered and owned by APP in the People's Republic of China (which may, but need not be, "Biochronomer"), which trademark shall be displayed in a prominent position (but in a size and prominence less than the primary trademark selected by RHEI) on all promotional and Marketing materials for the Licensed Product. Except as expressly set forth herein, nothing herein shall be deemed to give either party any rights to the trademarks of the other party.

10.4 RHEI shall make, or shall cause an Affiliate to make, the first commercial sale of the Licensed Product in each country in the Territory within 90 days following the grant of Regulatory Approval and any other necessary Applicable Permits, including, without limitation, pricing approval if required in that country.

[***] CERTAIN INFORMATION IN THIS EXHIBIT HAS BEEN OMITTED AND FILED SEPARATELY WITH THE COMMISSION. CONFIDENTIAL TREATMENT HAS BEEN REQUESTED WITH RESPECT TO THE OMITTED PORTIONS.

10.5 RHEI shall use Commercially Reasonable Efforts in the Marketing of the Licensed Product.

11. ROYALTIES.

11.1 In consideration for the rights and licenses granted herein, and subject to the other provisions of this Article 11 of this Agreement, RHEI shall pay to APP an earned royalty on Net Sales without reduction for any withholding tax or similar payments required to be made to a country in the Territory (which withholding tax or similar payments shall be made by RHEI and evidence of payment, including a certificate of payments, timely provided to APP) of:

(a) [***] percent of the first US [***] of Net Sales of Licensed Product in the Territory in each calendar year; and

(b) [***] percent of all Net Sales of Licensed Product in the Territory in excess of [***] in each calendar year.

(c) Beginning with the [***] calendar year following first commercial sale of the Licensed Product in the Territory, if in any calendar year earned royalties under Sections 11.1(a) and (b) above do not equal or exceed [***], RHEI agrees to pay to APP the difference between earned royalties paid and [***] or [***] percent of the earned royalties for the prior calendar year, whichever is greater.

11.2 RHEI shall pay the earned royalties required by sections 11.1 in respect of the Net Sales of the Licensed Product in each country in the Territory until the later of:

(a) the expiry of [***] years from the first commercial sale in that country of Licensed Products; or

(b) provided that Licensed Product is covered by a Valid Claim of an issued patent included in Patent Rights in that country within [***] years of the first commercial sale of Licensed Product in such country, until the Licensed Product is no longer covered by such Valid Claim in such country of sale.

11.3 If Net Sales in any year are reduced by [***] or more from the prior year's Net Sales due to Competition, as established by appropriate documentation submitted to APP, all royalties on Licensed Product shall be [***] (e.g., a [***] rate shall be reduced to [***] and an [***] rate shall be reduced to [***]) beginning in the year subsequent to documentation of such reduction in Net Sales and continuing until the earlier of (i) the calendar quarter after Competition ceases to exist, or (ii) the expiration of the obligations of RHEI to make royalty payments under Section 11.2.

11.4 Upon the expiration of the obligations of RHEI to make the royalty payments required by Section 11.1 in any country in the Territory, RHEI shall have a fully paid-up, royalty free license to develop, have developed, use, Market and import Licensed Product in that country.

Royalty Reports and Payments

11.5 Earned royalty payments hereunder shall be made within 45 days following the end of each calendar quarter, and each payment shall include royalties which shall have accrued during said calendar quarter. Such quarterly payments shall be accompanied by a report setting forth separately the Net Sales of Licensed Product sold during said calendar quarter in each country in the Territory and the calculation of earned royalties payable for such calendar quarter.

11.6 No multiple royalties shall be payable because Licensed Product, its manufacture, use or sale is or shall be covered by more than one Patent Right.

11.7 The remittance of royalties payable on Net Sales outside the United States shall be made to APP in United States dollars at the free market rate of exchange of the currency, as published in the most recent issue of the Wall Street Journal (New York edition), of the country in which the Net Sales are made on the particular date the particular United States dollars are transmitted for payment as royalties.

Records and Audits

11.8 RHEI and its Affiliates shall keep and maintain, and shall cause their co-promotion partners to keep and maintain, records of Net Sales. Such records shall be open to inspection

by APP or, in the case of their co-promotion partners, by RHEI on behalf of APP or by APP, upon reasonable advance notice at any mutually agreeable time during normal business hours within three years after the royalty period to which such records relate by an independent certified public accountant (or the equivalent in countries other than the United States) reasonably acceptable to RHEI but selected by APP. Said accountant shall have the right to examine the records kept pursuant to this Agreement and report findings of said examination of records to APP only insofar as it is necessary to evidence any error on the part of RHEI. This right of inspection shall be exercised only once with respect to each country in the Territory for any calendar year. The cost of such inspection shall be borne by APP unless the result of such examination is the determination that Net Sales in a particular country have been understated by at least 5 percent for any calendar year in which event RHEI shall bear the reasonable cost of such inspection for such country.

12. TECHNOLOGY CONSULTATION.

[***] CERTAIN INFORMATION IN THIS EXHIBIT HAS BEEN OMITTED AND FILED SEPARATELY WITH THE COMMISSION. CONFIDENTIAL TREATMENT HAS BEEN REQUESTED WITH RESPECT TO THE OMITTED PORTIONS.

12.1 APP shall provide technical consultation reasonably requested by RHEI on an as needed basis at times and places convenient to APP. APP also shall be available, at the reasonable request of RHEI, for consultation during any regulatory inspection or to assist in responding to regulatory questions that may occur during the prosecution of any Application for Regulatory Approval of, or Applicable Permit for, the Licensed Product. If APP and RHEI agree that APP should travel to the Territory for such consultation and assistance, RHEI shall pay the reasonable out-of-pocket expenses of APP for such travel.

12.2 RHEI shall use the Data, Know-How and Clinical Information transferred pursuant to this Agreement only in accordance with this Agreement and shall not use it for any other purpose.

13. SUPPLY.

13.1 APP or its designated supplier shall provide to RHEI or its Affiliates supply of the Licensed Product for clinical trials and for commercialization. The transfer price for clinical supplies and samples for regulatory purposes shall be the fully-burdened actual cost of the Licensed Product to APP computed in accordance with US GAAP but shall not exceed US [***] per individual patient dosage. The transfer price for commercial supplies of the Licensed Product shall be the lower of APP's fully burdened actual cost (computed in accordance with U.S. GAAP) of the Licensed Product plus [***] or US [***] per individual patient dosage increased by an appropriate U.S. Cost of Living Adjustment. APP shall endeavor to reduce the unit dosage price to below [***].

13.2 The Parties will negotiate in good faith the remaining provisions of the supply agreement within nine months after the Effective Date, which shall include, without limitation, that RHEI is responsible for import permits, providing product labels for primary and secondary packaging, freight and insurance for shipping Licensed Product from the site of manufacture and any import duties. The definitive supply agreement shall also include product warranties and indemnification by the Parties and provisions for a second or alternative source of supply. Notwithstanding any other provision of this Agreement, APP agrees to discuss with RHEI the grant to RHEI or its Affiliates the right to Manufacture bulk or final Licensed Product without either Party being bound to enter into such an agreement. If such agreement should be made, the transfer price of materials, if any, that may be supplied by APP shall be APP's fully-burdened actual cost (in accordance with U.S. GAAP) plus ten percent.

14. PATENTS, INFRINGEMENT.

14.1 If either party determines that any of the Patent Rights and/or Know How have been infringed by the Manufacture or Marketing in the Territory of a product containing the Active Ingredient, such Party shall give to the other Party notice of such alleged infringement, in which event RHEI may at its discretion take such steps as it may consider necessary to prosecute such infringement. RHEI may not settle any such litigation in a manner that adversely affects the rights of APP hereunder without the consent of APP. APP shall have the right, at its own expense, to be represented by counsel in any such litigation. If RHEI, after such notice, elects not to bring

suit, it shall notify APP of such election within 60 days after receipt of such notice and APP shall then have the right to bring suit at its own expense. APP shall also have the right to bring suit if RHEI fails to institute suit within 180 days from the date of the original notice of infringement.

14.2 In any litigation brought by RHEI under section 14.1, RHEI shall notify APP of the commencement of that litigation and shall have the right to use and sue in APP's name, and APP shall have the right, at its own expense, to be represented by counsel, but RHEI shall have sole control of such suit. In any such litigation, APP may elect by notice to RHEI to share equally with RHEI the costs of such litigation in exchange for the right to share equally with RHEI in any recovery of damages resulting from such litigation. Such election by APP shall be made not later than 45 days from the date such litigation is commenced. If APP does not elect to share costs of such litigation with RHEI, RHEI shall be entitled to the full recovery of any damages but the amount of the actual damages (excluding enhanced and/or punitive damages) less the costs to RHEI of the litigation shall be considered Net Sales in the year received and subject to the payment of royalties as provided in Section 11.1. RHEI may not settle any such litigation in a manner that adversely affects the rights of APP hereunder without APP's consent.

14.3 In any litigation brought by APP following an election by RHEI pursuant to section 14.1 not to bring suit, APP shall notify RHEI of the commencement of that litigation and shall have the right to use and sue in RHEI's name (if RHEI is deemed a necessary party), and RHEI shall have the right, at its own expense, to be represented by counsel, but APP shall have sole control of such suit. In any such litigation, RHEI may elect by notice to APP to share equally with APP the costs of such

litigation in exchange for the right to share equally with RHEI in any recovery of damages resulting from such litigation. Such election by RHEI shall be made not later than 45 days from the date of the commencement of any such action. If RHEI does not elect to share costs of such litigation with APP, APP shall be entitled to the full recovery of any damages. APP may not settle any such litigation in a manner that adversely affects the rights granted to RHEI under this Agreement without RHEI's consent.

14.4 In any litigation brought by one Party and naming the other Party as a party plaintiff, pursuant to Section 14.2 or 14.3 above, the litigating Party shall hold harmless and indemnify the other Party from and against any order for costs arising without fault or negligence of the non-litigating Party that may be made against such non-litigating party by reason of being named a Party plaintiff in such lawsuit.

Infringement of Third Party Patents

14.5 In the event of a final judgment in any patent infringement suit requiring RHEI to pay lump sum damages or a royalty to a non-Affiliated third party or in the event of a settlement of such suit or threatened suit consented to in writing by APP, (a) upon receipt by APP of proof of payment by RHEI of lump sum damages, the future milestone payments due to APP pursuant to Article 8 shall be reduced by one-half until the final milestone payment due to APP has been paid and after such time, if RHEI has not recovered the full amount of such lump sum payment, then the remainder shall be credited as royalty payment reductions in accordance with (b) below until the full amount of any lump sum damage payment has been recovered by RHEI; and (b) if the judgment or settlement requires royalty payments to be made, the future royalty payments due to APP pursuant to Article 11 shall be reduced by [***] of the royalty payment due to the third party, but in no case shall the royalty payment due APP be reduced by more than [***], provided that, any third party royalty payments not credited in any given year may be carried forward for credit in any future year.

15. OWNERSHIP OF INVENTIONS AND KNOW HOW.

Ownership of Intellectual Property Rights

15.1 APP shall retain its rights in and/or title to all Patent Rights which it owned or controlled prior to the Effective Date hereof.

15.2 All Inventions made by APP or by RHEI in the performance of its obligations under this Agreement shall be owned as follows:

(a) Any such Inventions relating to the Biochronomer

formulation and/or relating to the composition or manufacturing of the Licensed Product shall belong to APP and shall be included in the rights and licenses under this Agreement to RHEI in the Territory; and

(b) Any other Inventions relating to the Licensed Product in the Territory shall belong to the Party making the Invention and be licensed to RHEI in the Territory and to APP outside the Territory; provided that if any of the other Inventions are jointly made under this Agreement by APP and RHEI, the Parties shall jointly own any such Inventions and the Parties agree that each Party shall have the right to practice and exploit such joint inventions in accordance with the United States Patent Laws, except that APP's rights in any such Invention shall be included in the license under this Agreement to RHEI in the Territory and RHEI's rights in any such Invention shall be licensed by RHEI to APP outside the Territory.

15.3 The determination of inventorship for Inventions shall be made in accordance with applicable laws relating to inventorship set forth in the patent laws of the United States (Title 35, United States Code).

15.4 Each Party shall cause any inventor of any Invention employed by it to assign any and all rights that any such inventor may have in any such Invention to RHEI or to APP, as contemplated by this Agreement. Each Party shall cooperate with the other party to effectuate the provisions of this Article 15 and shall execute any documents that may reasonably be required to apply for and to obtain any patents. Each Party agrees to be named as a party, if necessary, to bring and/or maintain a lawsuit involving a patent on a jointly owned Invention.

Disclosure of Inventions

15.5 Each Party shall notify, in writing, the other Party of any Inventions made after the Effective Date and of any patent applications that it intends to file claiming Inventions made after the Effective Date that may be subject to the provisions of this Article 15, as promptly as possible, to arrange, if appropriate, for simultaneous filing of applications.

Filing and Prosecution of Patent Applications by RHEI

15.6 RHEI shall have right and the responsibility at its expense for filing, prosecuting and maintaining patents and patent applications in the Territory for all Inventions owned by RHEI. RHEI shall disclose to APP the complete texts of all such patents and patent applications filed by RHEI or its Affiliates that relate to the Licensed Product, as well as all information received concerning the institution or possible institution of any interference, opposition, re-examination, reissue, revocation, nullification, or any official proceeding involving such patent application. APP shall have the right to review all such pending applications and other proceedings in the Territory and make recommendations to RHEI concerning such applications. RHEI shall keep APP fully informed of the course of patent prosecution or other proceedings relating to any such Invention and/or Patent Rights and shall provide to APP copies of any substantive communications submitted to or received from patent offices in the Territory in sufficient time for APP to provide comments, if desired. RHEI shall give due consideration to any comments timely provided by APP.

Filing and Prosecution of Patent Applications by APP

15.7 APP shall have right and the responsibility at its expense for filing, prosecuting and maintaining patents and patent applications for all Inventions and Patent Rights controlled by APP in each country in the Territory. APP shall disclose to RHEI the complete texts of all such patents and patent applications filed by APP that relate to the Licensed Product, as well as all information received concerning the institution or possible institution of any interference, opposition, re-examination, reissue, revocation, nullification or any official proceeding involving such patent application. RHEI shall have the right to review all such pending applications and other proceedings in the Territory and make recommendations to APP concerning such applications. APP shall keep RHEI fully informed of the course of patent prosecution or other proceedings relating to any such Invention and/or Patent Rights and shall provide to RHEI copies of any substantive communications submitted to or received from patent offices in the Territory in sufficient time for RHEI to provide comments, if desired. APP shall give due consideration to any comments timely provided by RHEI.

15.8 RHEI shall have the right to assume responsibility for any patent or patent application in the Territory relating to the Licensed Product that APP intends to abandon or otherwise

cause or allow to be forfeited. APP shall give RHEI reasonable written notice prior to abandonment or other forfeiture of any such patent or patent application so as to permit RHEI to exercise its rights under this section at its own cost.

Enforcement of Intellectual Property Rights

15.9 Each Party shall report to the other any infringement or any unauthorized use or misuse of APP Patent Rights or Know How in the Territory that may come to its attention.

Filing and Prosecution of Patent Applications Jointly Owned

15.10 The Parties shall determine and agree which of them shall be responsible for filing, prosecuting and maintaining patent applications and patents on jointly owned Inventions.

16. REPRESENTATIONS, WARRANTIES AND COVENANTS.

Representations, Warranties and Covenants of APP.

16.1 APP expressly warrants and represents to RHEI that:

(a) APP owns all right, title, and interest in and to, or the exclusive right to practice in the Territory, all presently existing Patent Rights (including those listed in Schedule 1.24) and Know How relating to Licensed Product, Data and Clinical Information; APP is legally able to grant to RHEI an exclusive license to practice existing Patent Rights, Know-How, Data and Clinical Information with respect to the Licensed Product in the Territory.

(b) APP is empowered and has the right to enter into this Agreement, perform its obligations hereunder and to grant the rights and licenses provided for herein without the need for any consents or permission and without burdens, encumbrances, restraints, or limitations of any kind which could adversely affect the rights of RHEI under this Agreement;

(c) APP has not entered, and has no obligation to enter, into any arrangement or agreement that conflicts or would conflict with or adversely affects or could adversely affect, as applicable, the rights of RHEI under this Agreement;

(d) APP has no Knowledge of any patents or patent applications owned by a third party and not licensed to APP that would be infringed by the practice of the presently existing Patent Rights or Know-How, by the Manufacture or Marketing of the Licensed Product or by the use of the Data or Clinical Information in the Territory. APP has not received any claims, notices, or threats of infringement by third parties with respect to such matters;

(e) APP has no Knowledge of any claim that any third party asserts ownership rights in the Territory in any of the Patent Rights, Know How, Licensed Product, Data or Clinical Information;

(f) APP has no Knowledge that the use of any of the Patent Rights, Know-How, Data, Clinical Information, or the making, using, importing, offering for sale or selling Licensed Product, in the Territory infringes any right of any third party;

(g) APP shall file and diligently prosecute in accordance with all applicable laws national stage applications of the Patent Rights in the Territory, and maintain any patents issuing thereon;

(h) As of the Effective Date, there are no inquiries, actions or other proceedings pending before or threatened by any Regulatory Authority or other government agency with respect to any APP manufacturing facility and APP has not received any notice threatening any such inquiry, action or other proceeding. As of the Effective Date, there are no investigations pending before or threatened by any Regulatory Authority or other government agency with respect to any APP facility where Licensed Product will be manufactured and APP has not received notice threatening any such investigation During the term of this Agreement, APP shall notify RHEI promptly in writing upon learning of any such actual or threatened inquiry, action, proceeding, or investigation.

Mutual Representations and Warranties.

16.2 Each Party hereby represents and warrants to the other Party as follows:

(a) It is a corporation duly organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation. It has all requisite power and authority to carry on its business and to own and operate its properties and assets. The execution, delivery and performance of this Agreement have been duly authorized by its Board of Directors;

(b) There is no pending or, to its knowledge, threatened litigation involving it which would have any material adverse effect on this Agreement or on its ability to perform its obligations hereunder;

(c) There is no indenture, contract, or agreement to which it is a party or by which it is bound which prohibits or would prohibit the execution and delivery by it of this Agreement or the performance or observance by it of any material term or condition of this Agreement;

(d) It will use Commercially Reasonable Efforts to carry out or have carried out the development of the Licensed Product in the United States in the case of APP and in the Territory in the case of RHEI in accordance with its obligations set forth in this Agreement; or

(e) It has not been debarred or the subject of a debarment proceeding by any Regulatory Authority. It shall not use in connection with this Agreement any employee, consultant or investigator that has been debarred or the subject of debarment proceedings by any Regulatory Authority.

17. INDEMNIFICATION

Indemnification of APP.

17.1 RHEI shall indemnify and hold harmless APP and its officers, directors, employees and agents against and from any losses, damages, injuries, liabilities, claims, demands, settlement, judgments, awards, fines, penalties, taxes, fees, charges or expenses (including reasonable attorneys' fees) of APP or any of its officers, directors, employees or agents arising from or relating to:

(a) The breach or inaccuracy in any material respect of any RHEI representation or warranty contained in Article 16 of this Agreement;

(b) Any injury or alleged injury to any person (including death) or to the property of any person not a party hereto arising out of the gross negligence or intentional act or omission of RHEI or its employees or agents relating to the development by or on behalf of RHEI of the Licensed Product, labeling (except for APP's trademarks), storage, handling, shipping or Marketing of Licensed Product; or

(c) The enforcement of APP's indemnification rights hereunder.

Indemnification of RHEI.

17.2 APP shall indemnify and hold harmless RHEI and its officers, directors, employees and agents ("RHEI Indemnitee") against and from any losses, damages, injuries, liabilities, claims, demands, settlement, judgments, awards, fines, penalties, taxes, fees, charges or expenses (including reasonable attorneys' fees) of a RHEI Indemnitee or a third party arising from or relating to:

(a) The breach or inaccuracy in any material respect of any APP representation, warranty or covenant contained in Article 16 of this Agreement;

(b) Any injury or alleged injury to any person (including death) or to the property of any person not a party hereto arising out of the gross negligence or intentional act or omission of APP or its employees or agents relating to Licensed Product; or

(c) Any injury or alleged injury to any person (including death) or to the property of any person arising out of the Manufacture by or on behalf of APP of the Licensed Product; or

(d) Any claim that Licensed Product or any trademark of APP used in connection with Licensed Product in the Territory infringes any third party rights; or

(e) The enforcement of RHEI's indemnification rights hereunder.

17.3 If any indemnified Party intends to claim indemnification under this Article 16 it shall promptly notify the other Party in writing of such alleged claim. The indemnifying Party shall have the sole right to control the defense and settlement thereof except that, any such settlement shall be upon the written consent of the indemnified Party. The indemnified Party shall cooperate with the indemnifying Party and its legal representatives in the investigation of any action, claim or liability covered by this Article 17. The indemnified Party shall not, except at its own cost, voluntarily make any payment or incur any expense with respect to any claim or suit without the prior written consent of the indemnifying Party. In addition, the indemnifying Party shall be subrogated to the rights of the indemnified Party against any third party, and such indemnified Party hereby assigns to the indemnifying Party all claims, causes of action and other rights that the indemnified Party may then have against any third party, including Affiliates and co-promotion sublicensees, with respect to the claim, suit or proceeding. Conversely, and without in any way limiting the obligation of either Party to indemnify the

other Party as herein provided, to the extent that any Party shall fail to perform its indemnification obligations under Section 17.1 or Section 17.2, such Party owing a duty of indemnification hereby assigns to the indemnified Party to whom indemnification is owed all claims, cause of action and other rights that the Party owing such duty may then have against any third party, including Affiliates and sublicensees with respect to the claim, suit or proceeding.

18. TERM.

18.1 Unless sooner terminated as herein provided, this Agreement shall become effective on the Effective Date and shall continue in effect thereafter until it is terminated in accordance with the terms hereof.

19. EXPIRY AND TERMINATION.

19.1 Unless earlier terminated pursuant to Section 19.2 below, this Agreement shall not expire. Upon the expiration of the payment term for the license grant in all countries as set forth in Article 11, RHEI shall have a fully paid up, perpetual and non terminable exclusive license in the Territory for the Licensed Product.

19.2 At any time during the Term of this Agreement, either Party may terminate this Agreement forthwith for cause, as "Cause" is described below, by giving written notice to the other party. "Cause" for termination by one party of this Agreement shall be deemed to exist (i) if the other Party is in material breach or default in the performance or observance of any of the provisions of this Agreement applicable to it, and such breach or default is not cured within 60 days (or 30 days in the case of failure to make royalty or other payments due hereunder) after the giving of written notice by the Party specifying such breach or default, or (ii) if, with respect to the other Party:

(a) (i) a voluntary case under any applicable bankruptcy, insolvency or other similar law now or hereafter in effect shall be instituted by such Party, or such Party shall consent to the entry of any order for relief in an involuntary case under any such law; (ii) a general assignment for the benefit of creditors shall be made by such Party; (iii) such Party shall consent to the appointment of or possession by a receiver, liquidation, trustee, custodian, sequestrator or similar official of the property of such Party or of any substantial part of its property; or (iv) such Party shall adopt a directors resolution in furtherance of any of the foregoing actions specified in this subsection (a); or

(b) a decree or order for relief by a court of competent jurisdiction shall be entered in respect of such Party in an involuntary case under any applicable bankruptcy, insolvency or other similar law now or hereafter in effect, or appointing a receiver, liquidator, trustee, sequestrator or other similar official of such Party to wind up or liquidate its affairs, and any such decree or order shall remain unstayed or undischarged and in effect for a period of 60 days.

19.3 RHEI may terminate this Agreement at will, in whole or in part, upon 60 day written notice to APP in which event RHEI shall remain liable for all of its obligations hereunder that have accrued by the end of such 60-day period.

19.4 All rights and licenses granted under or pursuant to this Agreement are, and shall otherwise be deemed to be, for the purposes of Section 365(n) of Title 11, U.S. Code ("Bankruptcy Code") license rights to "intellectual property" as defined under Section 101(60) of the Bankruptcy Code. The parties agree that RHEI, as a licensee of such rights under this Agreement, shall retain and may fully exercise all of its rights and elections under the Bankruptcy Code in the event of the bankruptcy of APP.

19.5 Upon termination by APP for Cause or by RHEI pursuant to Section 19.3, RHEI shall, at the request of APP, assign to APP RHEI's Regulatory Approval or Application for Regulatory Approval for the Licensed Product in each country in the Territory; and shall assign to APP RHEI's interest in any Inventions (including Joint Inventions) relating to the Licensed Product.

19.6 Upon termination of this Agreement by APP pursuant to Section 19.2, the licenses granted to RHEI under this Agreement shall terminate. Notwithstanding such termination, and subject to the terms and conditions of this Agreement, RHEI may dispose of, by sale or otherwise in the Territory, any remaining inventory of Licensed Product that RHEI may have in its possession or control on the date of termination.

19.7 Upon termination of this Agreement by RHEI pursuant to Section 19.2 above, the rights and licenses granted hereunder to

[***] CERTAIN INFORMATION IN THIS EXHIBIT HAS BEEN OMITTED AND FILED SEPARATELY WITH THE COMMISSION. CONFIDENTIAL TREATMENT HAS BEEN REQUESTED WITH RESPECT TO THE OMITTED PORTIONS.

RHEI in the Territory shall continue in fall force and effect and (i) any future milestone payments to APP pursuant to Section 8 shall be cancelled and (ii) royalty obligations on future Net Sales pursuant to Section 11 shall be reduced by [***] as of the termination date and such obligations shall expire [***] after the date of first commercial sale. Upon such termination, APP shall consent to having its contract manufacturer supply Licensed Product directly to RHEI, and RHEI shall have the obligation to continue to pay for such supply and to make full payment of all its obligations hereunder that shall have accrued as of such termination date.

19.8 Termination shall not release RHEI or APP from any obligations or liabilities that matured prior to termination, including without limitation the obligations of RHEI to make any payments owing at the time of termination through the date of termination. If the terms of this Agreement expressly state that a right or obligation shall survive expiration or termination of this Agreement, such right or obligation shall survive expiration or termination to the degree necessary to allow complete fulfillment or discharge of the right or obligation. Unless otherwise provided to the contrary, the provisions of Articles 1, 7, 15, 17 and 20 and Sections 19.4, 19.5, 19.6 and 19.7 of this Agreement shall survive the expiration or termination of this Agreement.

19.9 Except as otherwise provided in this Agreement, in the event of termination or expiration, each of APP and RHEI shall retain ownership of the ideas, Inventions, discoveries, developments, designs, trademarks, trade secrets, improvements, know how, process, procedures, techniques, formulae, computer programs, drawings, technology(ies) and intellectual and industrial property accorded to each under the terms of this Agreement.

20. PUBLICITY.

20.1 Neither Party will originate any publicity, news release, public comment or other public announcement, written or oral, or relating to this Agreement, without the written consent of the other Party, except for an initial agreed upon and jointly issued press release on execution of this Agreement and such further announcements which, in accordance with the advice of legal counsel to the party making such announcement, is required by law. The Party making any announcement which is required by law will, unless prohibited by law, give the other party an opportunity to review the form and content of such announcement and comment before it is made. Either Party shall have the right to make such filings with governmental agencies as to the contents and existence of this Agreement as it shall reasonably deem necessary or appropriate.

21. ASSIGNABILITY.

21.1 This Agreement may be assigned by either Party to an Affiliate or as part of the sale by either Party of all of its business to which this Agreement may be a part without the consent of the other Party; provided, however, that neither Party shall assign this Agreement to an Affiliate or any third party that is not reasonably capable of performing all of its obligations under this Agreement and that has not agreed in writing to be bound by all of the terms and conditions of this Agreement. This Agreement may not otherwise be assigned by either Party without the prior written consent of the other Party, which consent shall not be unreasonably withheld.

21.2 No assignment permitted by this Article 21 shall serve to release either Party from liability for the performance of its obligations hereunder.

22. NOTICES.

22.1 All notifications, demands, approvals and communications required to be made under this Agreement shall be given in writing and shall be effective on the date of delivery if personally delivered, sent by facsimile, if followed by prepaid air express or delivered by courier service addressed as set forth below. The Parties hereto shall have the right to notify each other of changes of address during the Term of this Agreement.

A.P. Pharma, Inc.
123 Saginaw Drive
Redwood City, California 94063
Attention: President
Facsimile: (650) 365-9452

With a copy to:

Heller Ehrman LLP
275 Middlefield Road
Menlo Park, California 94025
Attention: Julian N. Stern
Facsimile: (650) 324-0638

RHEI Pharmaceuticals, Inc.
300 George Street
Suite 530
New Haven, Connecticut 06511
Attention: CEO
Facsimile: (203) 624-7433

With a copy to:

Jones Day
222 East 41st Street
New York, New York 10017
Attention: Ann L. Gisolfi
Facsimile: (212) 755-7306

23. FORCE MAJEURE.

23.1 In the event of any failure or delay in the performance by a Party of any provision of this Agreement due to acts beyond the reasonable control of such Party (such as, for example, fire, explosion, strike or other difficulty with workmen, shortage of transportation equipment, accident, act of God, or compliance with or other action taken to carry out the intent or purpose of any law or regulation, or an order or judgment of any court of competent jurisdiction, whether interim, temporary, interlocutory or permanent), then such Party shall have such additional time to perform as shall be reasonably necessary under the circumstances. In the event of such failure or delay, the affected Party will use its diligent efforts, consonant with sound business judgment and to the extent permitted by law, to correct such failure or delay as expeditiously as possible.

24. MISCELLANEOUS.

24.1 The parties acknowledge and agree that: (a) each Party and its representatives have reviewed and negotiated the terms and provisions of this Agreement and have contributed to its revision; and (b) the terms and provisions of this Agreement will be construed fairly as to each Party hereto and not in favor of or against either Party regardless of which Party was generally responsible for the preparation or drafting of this Agreement. Unless the context of this Agreement otherwise requires: (i) words of any gender include each other gender; (ii) words using the singular or plural number also include the plural or singular number, respectively; (iii) the terms "hereof", "herein", "hereby", and derivative or similar words refer to this entire Agreement; (iv) the terms "Article", "Section", "Exhibit", "Schedule", or "clause" refer to the specified Article, Section, Exhibit, Schedule, or clause of this Agreement; (v) "or" is disjunctive but not necessarily exclusive; and (vi) the term "including" or "includes" means "including without limitation" or "includes without limitation". Whenever this Agreement refers to a number of days, such number shall refer to calendar days unless business days are specified. Business Days, whether or not capitalized, means any day except Saturday and Sunday on which commercial banking institutions in New York are open for business.

24.2 This Agreement and the confidential disclosure agreement entered into by the Parties on May 7, 2006 define the full extent of the legally enforceable undertakings of the parties hereto. No promise or representation, written or oral, which is not set forth explicitly in this Agreement or the said confidential disclosure agreement is intended by either Party to be legally binding. Both Parties acknowledge that in deciding to enter into this Agreement and to consummate the transaction contemplated hereby neither has relied upon any statements or representations, written or oral, other than those explicitly set forth in this Agreement.

24.3 It is the desire and intent of the Parties that the provisions of this Agreement shall be enforced to the extent permissible under the laws and public policies applied in each jurisdiction in which enforcement is sought. Accordingly, if any particular provision of this Agreement which substantially affects the commercial basis of this Agreement shall be

determined to be invalid or unenforceable, such provision shall be amended as hereinafter provided to delete therefrom or revise the portion thus determined to be invalid or unenforceable. Such amendment shall apply only with respect to the operation of such provision of this Agreement in the particular jurisdiction for which such determination is made, provided no unfairness results. In such event, the Parties agree to use reasonable efforts to agree on substitute provisions, which, while valid, will achieve as closely as possible the same economic effects or commercial basis as the invalid provisions, and this Agreement otherwise shall continue in full force and effect. If the Parties cannot agree to such revision within 60 days after such invalidity or unenforceability is established, the matter may be submitted by either party to arbitration as provided in this Agreement to finalize such revision.

24.4 The waiver by a Party of any single default or breach or succession of defaults or breaches by the other shall not deprive either party of any right under this Agreement arising out of any subsequent default or breach.

24.5 All matters affecting the interpretation, validity, and performance of this Agreement shall be governed by the laws of the State of California without regard to that state's conflict of laws rules or principles.

24.6 Nothing in this Agreement authorizes either Party to act as agent for the other Party as to any matter. The relationship between APP and RHEI is that of independent contractors.

24.7 Except if a Party reasonably determines that it must seek a preliminary injunction, temporary restraining order or other provisional relief, any and all disputes between the Parties relating in any way to the entering into of this Agreement and/or the validity, construction, meaning, enforceability, or performance of this Agreement or any of its provisions, or the intent of the parties in entering into this Agreement, or any of its provisions arising under this Agreement, except for any disputes relating to the provisions of Articles 14, 17 and 19, shall be settled by binding arbitration. Such arbitration shall be conducted at San Francisco, California, if RHEI is the instigating Party and at New Haven, Connecticut, if APP is the instigating Party, in accordance with the rules then pertaining of the American Arbitration Association with a panel of three arbitrators. (Each Party shall select one arbitrator and the two selected arbitrators shall select the third arbitrator. If the two selected arbitrators cannot agree on a third arbitrator then the American Arbitration Association shall select said arbitrator from the National Panel of Arbitrators.) Reasonable discovery as determined by the Arbitrators shall apply to the arbitration proceeding. The law of the State of California shall apply to the arbitration proceedings. Judgment upon the award rendered by the arbitrators may be entered in any court having jurisdiction thereof. The successful Party in such arbitration, in addition to all other relief provided, shall be entitled to an award of all its reasonable costs and expenses including attorney costs. Both Parties agree to waive, and the Arbitrators shall have no right to award, punitive damages in connection with an arbitration proceeding hereunder.

24.8 All rights and obligations of the Parties are subject to compliance with United States and foreign export regulations and such other United States and foreign laws and regulations as may be applicable, and to obtaining all necessary approvals required by applicable agencies of the governments of the United States and foreign jurisdictions.

24.9 This Agreement may be executed in counterparts, each of which shall be deemed an original, but both of which together shall constitute one and the same instrument.

IN WITNESS WHEREOF, the undersigned have caused this Agreement to be duly executed by their duly authorized officers on the date first above written.

A.P. PHARMA, INC.

By: /S/ Michael O'Connell

Title: President

RHEI PHARMACEUTICALS, INC.

By: /S/ Scott B. Kozak

Title: V.P. Commercial Operations

Schedule 1.24

Patent Rights

APP Case No.	COUNTRY FILED	Patents or Application Serial Numbers
10008-7184 CIP	PCT * Taiwan	PCT/US2005/035117 94133844
10008-7208	United States	11/433,834 (Filed May 12, 2006)
10008-7209	United States	60/786,548 (Filed March 27, 2006)

* PCT Application designated 170 countries, including China.

Schedule 4.2

Data

Nonclinical Data - final study reports for:

* Single dose toxicology studies in dog and rat (Note 1)
* 28-day repeat dose toxicology studies in dog and rat (Note 1)
* Genotoxicity studies (Ames, mouse lymphoma and mouse micronucleus) (Note 1)
* 90-day repeat dose toxicology studies in dog and rat
* Segment II reproductive toxicology studies in rat and rabbit (Note 1)
* ADME study of radiolabeled polymer in rat
* Other studies carried out by APP that are determined to be necessary for or carried out in support of Licensed Product approval in the Field in the United States.

Clinical Data - final study reports for:

* Phase I study in normal volunteers (Note 1)
* Phase II study in patients undergoing chemotherapy (Note 1)
* Phase III pivotal study: three-arm blinded, placebo-controlled study of APF530 250 mg, APF530 500 mg and Aloxi in patients undergoing moderately or highly emetogenic chemotherapy
* Other studies carried out by APP that are determined to be necessary for or carried out in support of Licensed Product approval in the Field in the U.S.

CMC Data

* Results of release and stability tests for Licensed Product lots supplied to RHEI.
* Other CMC data that the Parties agree are necessary or useful for RHEI to commercialize APF530 in the Territory

Regulatory Data

* Cross-reference rights to APP's US IND and APP's US NDA as required for regulatory approval in the Territory

Marketing Data

* Final reports of market research conducted by APP (Note 1)

Note 1: These reports are complete as of the Effective Date

[***] CERTAIN INFORMATION IN THIS EXHIBIT HAS BEEN OMITTED AND FILED SEPARATELY WITH THE COMMISSION. CONFIDENTIAL TREATMENT HAS BEEN REQUESTED WITH RESPECT TO THE OMITTED PORTIONS.

Schedule 6.1

Timing and Sequence of Events for

Development and Commercialization of APF530 in China

[***]

All increments of time on the timeline are in months

Actual Dates after Application to Conduct Confirmatory Trials Dependent upon US NDA Filing

(Footnote continued)

Exhibit 31.1

SECTION 302 CERTIFICATIONS

Certifications:

I, Gregory H. Turnbull, certify that:

1. I have reviewed this quarterly report on Form 10-Q of A.P. Pharma, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant is made known to us by others, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which could be reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2006

/s/ Gregory H. Turnbull
- ----------
Gregory H. Turnbull
President and Chief Executive Officer

Exhibit 31.2

SECTION 302 CERTIFICATIONS

Certifications:

I, Stephen C. Whiteford, certify that:

1. I have reviewed this quarterly report on Form 10-Q of A.P. Pharma, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant is made known to us by others, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which could be reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2006

/s/ Stephen C. Whiteford
- ------------------------
Stephen C. Whiteford
Chief Financial Officer

Exhibit 32

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

In connection with the Quarterly Report of A.P. Pharma, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Gregory H. Turnbull, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Gregory H. Turnbull
Gregory H. Turnbull,
Chief Executive Officer

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

In connection with the Quarterly Report of A.P. Pharma, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Stephen C. Whiteford, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Stephen C. Whiteford
Stephen C. Whiteford,
Chief Financial Officer