FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

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PENEDERM INC

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PENEDERM INCORPORATED
CONDENSED CONSOLIDATED BALANCE SHEETS

June 30, 1997 and December 31, 1996
(in thousands)

	June 30, 1997	December 31, 1996
	(unaudited)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 387	$ 3,062
Short-term marketable securities	8,624	2,259
Accounts receivable	1,679	276
Inventory	1,779	1,539
Prepaid expenses and other current assets	724	649
Total current assets	13,193	7,785
Marketable securities	1,000	1,099
Property and equipment, at cost, less accumulated depreciation and amortization	257	277
Intangible and other assets	1,450	1,533
Total assets	$15,900	$10,694
LIABILITIES		
Current liabilities:		
Accounts payable	$ 751	$ 1,196
Accrued liabilities	1,206	879
Total current liabilities	1,957	2,075
Long-term obligations	20	28
Total liabilities	1,977	2,103
SHAREHOLDERS' EQUITY		
Common stock, no par value	56,155	46,984
Accumulated deficit	(42,232)	(38,393)
Total stockholders' equity	13,923	8,591
Total liabilities and stockholders' equity	$15,900	$10,694

See accompanying notes.

PENEDERM INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands except per share data)
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	1997	1996	1997	1996
Revenues:				
Product sales	$ 1,643	$ 1,100	$ 4,244	$ 1,693
Licensing revenues	360	--	660	207
Total revenues	2,003	1,100	4,904	1,900
Costs and expenses:				
Cost of product sales	845	687	1,608	1,115
Research and development	1,259	1,259	2,482	3,121
Sales and marketing	1,769	425	3,932	726
General and administrative	603	697	931	1,582
Total costs and expenses	4,476	3,068	8,953	6,544
Loss from operations	(2,473)	(1,968)	(4,049)	(4,644)
Interest income, net	151	154	210	330
Net loss	$(2,322)	$(1,814)	$(3,839)	$(4,314)
Net loss per share	$ (0.29)	$ (0.25)	$ (0.49)	$ (0.59)
Number of shares used in computing net loss per share	8,112	7,257	7,848	7,256

See accompanying notes.

PENEDERM INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30,	
	1997	1996
Increase (decrease) in cash and cash equivalents		
Cash flows from operating activities:		
Net loss	$(3,839)	$(4,314)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	159	130
Increase in accounts receivable	(1,403)	(106)
Increase in inventory	(240)	(100)
Increase in prepaid expenses and other current assets	(75)	(77)
Decrease in accounts payable, accrued liabilities and rent	(118)	(10)
Increase in other assets	(2)	--
Net cash used in operating activities	(5,518)	(4,477)
Cash flows from investing activities:		
Purchases of available-for-sale securities	(7,032)	(6,908)
Maturities of available-for-sale securities	266	4,051
Sales of available-for-sale securities	500	260
Acquisition of intangible assets	--	(100)
Acquisition of fixed assets	(54)	(86)
Net cash used in investing activities	(6,320)	(2,783)
Cash flows from financing activities:		
Net proceeds from private placement stock offering	8,975	--
Proceeds from issuance of common stock	196	114
Repayment of long-term debt	(8)	(24)
Net cash provided by financing activities	9,163	90
Net decrease in cash and cash equivalents	(2,675)	(7,170)
Cash and cash equivalents at beginning of period	3,062	8,695
Cash and cash equivalents at end of period	$ 387	$1,525

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See accompanying notes.

PENEDERM INCORPORATED
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Interim Unaudited Financial Information

The accompanying interim unaudited condensed consolidated financial statements of the Company for the three and six month periods ended June 30, 1997 and 1996, have been prepared in accordance with generally accepted accounting principles for interim financial statements and include all adjustments (consisting of normal and recurring adjustments) that the Company considers necessary for a fair presentation of the operating results and cash flows for these periods. The results of operations for the interim periods are not necessarily indicative of the results to be expected for an entire year. These financial statements should be read in conjunction with the audited financial statements and notes included as part of the Company's Form 10-K for the year ended December 31, 1996.

In July 1997, the Company changed the state of its incorporation from California to Delaware.

2. Net Loss Per Share

Net loss per share is computed using the weighted average number of common shares outstanding during the period. Common stock equivalents relating to stock options are excluded from the computation as their effect is anti-dilutive.

In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128 "Earnings Per Share" (SFAS 128) which is required to be adopted in periods ending after December 15, 1997. SFAS 128 simplifies the calculation of earnings per share in most situations, excluding common stock equivalents in the computation of basic earnings per share. SFAS 128 will have no impact on

the Company's computation of loss per share in the periods ended June 30, 1997 and 1996 or in previously disclosed periods as common stock equivalents have and had been excluded due to their anti-dilutive effect.

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

Recent Events

In April 1997, Penederm announced it had entered into a second agreement with SmithKline Beecham to co-develop an undisclosed OTC product using Penederm's patented TopiCare Delivery Compounds(R) with a proprietary SmithKline Beecham formulation. Both companies will contribute scientific and technical expertise to the collaboration. SmithKline Beecham has the exclusive option to market the finished product worldwide. Penederm will receive milestone payments and royalties on the sale of products resulting from the collaboration, as well as revenues from the supply of TopiCare Delivery Compounds.

In May 1997, Penederm announced it had received regulatory approval from the Health Protection Branch of Health Canada of its topical antifungal compound, butenafine HCl 1% cream, as an over-the-counter (OTC) tinea pedis (athlete's foot) medication. Schering-Plough Healthcare Products, Inc. will market the butenafine cream in Canada under its own brand names.

In June 1997, Penederm received a Phase I Small Business Innovation Research (SBIR) grant from the National Institutes of Health National Institute on Aging to support research of Penederm's ST-630 compound as a possible treatment for two widespread skin disorders: acne and premature skin aging. ST-630 is a fluorinated derivative of Vitamin D3 that Penederm currently has in Phase II human clinical studies for the treatment of psoriasis.

Overview

Penederm is a pharmaceutical company that specializes

in developing and marketing dermatology products. Penederm recently launched Mentax(R), a once-a-day prescription topical treatment for three skin fungal conditions: tinea pedis (athlete's foot), tinea corporis (ringworm) and tinea cruris (groin fungus). Penederm also recently received FDA approval to begin marketing its Avita(TM) prescription cream product for the treatment of acne and contingent approval to begin marketing its Avita gel product upon expiration of a third party patent in January 1998. Penederm has several other pharmaceutical products for psoriasis, nail fungus and Mentax skin treatment line extensions in Phase II human clinical trials. The Company also sells its patented TopiCare Delivery Compounds for use in cosmetics and personal care products, and markets its own over-the-counter (OTC) skin care products through corporate partners.

The Company has several partnership arrangements with various pharmaceutical companies, as follows:

COMPANY	PRODUCT AREA	TERRITORY
In-License and Co-Development Agreements:		
Kaken Pharmaceutical Company Ltd. (Kaken)	Penederm in-licensed butenafine, the active ingredient incorporated in Mentax	U.S. Canada, Mexico and Latin America for skin antifungal; U.S., Canada, Europe, Mexico, Latin America, Australia & New Zealand for nail antifungal.
The Merck KGaA Group/Center Laboratories	Co-promote Akne-mycin(R) and Cloderm(TM)	U.S.
SmithKline Beecham (SmithKline)	Undisclosed OTC product	SmithKline option to market worldwide
Out-License Agreements:		
Schering-Plough HealthCare Products, Inc. (Schering-Plough)	Prescription & OTC Nail and co-promote prescription skin cream antifungal	U.S. and Canada

UCB Group of Belgium (UCB)	Prescription antifungal products	Europe, Africa and Middle East
Warner Wellcome Consumer Health Products (Warner)	OTC Dry Skin	U.S. and Canada
SmithKline Beecham (SmithKline)	OTC Consumer Products	Europe & Eastern Europe
Pierre Fabre Inc. (Pierre Fabre)	DuraScreen sunscreen	U.S.

The Company has been unprofitable since inception and expects to incur significant additional operating losses in the near future. For the period from inception through June 30, 1997, the Company incurred a cumulative net loss of $42,232,000. Penederm's sources of working capital have been equity financings, product sales to corporate partners, sales of Mentax, Avita and over-the-counter products, product license fees, sales of TopiCare Delivery Compounds and interest earned on investments.

Results of Operations

Three Months Ended June 30, 1997 and 1996

Total revenues for the three months ended June 30, 1997 of $2,003,000 increased 82% from $1,100,000 in the same period of 1996. This increase is due primarily to the initial product stocking shipments of the Company's recently launched Avita product and out-license milestone payments from corporate partners. As expected, revenues from the Company's Mentax product, which was initially launched in January of 1997, were modest in the second quarter.

The Company's cost of sales increased to $845,000 in the three months ended June 30, 1997 from $687,000 in the same period of 1996 primarily due to the 1997 launch of Avita. Gross margins improved in the second quarter of 1997 compared to the same period of 1996 due to the 1997 launch of Avita, the Company's second pharmaceutical product, which contributes higher margins than the Company's nonprescription products.

The Company's research and development expenses were $1,259,000 in both the three months ended June 30, 1997 and 1996. Research and development expenses can fluctuate based on the size and timing of the Company's clinical trial programs. The Company was conducting a large Phase III study in the second quarter of 1996 whereas several smaller Phase II studies were being conducted for the same period in 1997. Sales and marketing expenses increased 316% to $1,769,000 in the three months ended June 31, 1997 from $425,000 in the same period of 1996 due primarily to marketing and other expenses related to the product launch of Mentax in the first quarter of 1997 and preparation for the marketing launch of Avita in the third quarter and detailing support for Akne-mycin and Cloderm. General and administrative expenses decreased 13% to $603,000 in the three months ended June 30, 1997 from $697,000 in the same period of 1996. The prior year period had unusually high legal costs related to prosecuting violations of certain of the Company's patents.

Net interest income was $151,000 in the three months ended June 30, 1997 and $154,000 in the same period of 1996.

Six Months Ended June 30, 1997 and 1996

Total revenues for the six months ended June 30, 1997 of $4,904,000 increased from $1,900,000 in the same period of 1996. This increase is due primarily to the initial product stocking shipments of the Company's recently launched Mentax and Avita and out-license milestone payments from corporate partners.

The Company expects its future revenues in the near term to be derived principally from the sale of its recently approved pharmaceutical products, and for the revenues derived from OTC and cosmetic products to become less significant relative to total revenues.

The Company's cost of sales increased to $1,608,000 in the six months ended June 30, 1997 from $1,115,000 in the same period of 1996 primarily due to the 1997 launch of Mentax sales. Gross margins improved in the first six months of 1997 compared to the same period of 1996 due to the 1997 launch of Mentax and Avita, the Company's first pharmaceutical products, which contribute higher margins than the Company's nonprescription products.

The Company's research and development expenses decreased 20% to $2,482,000 in the six months ended June 30, 1997 from $3,121,000 in the same period of 1996 primarily due to the timing and size of human clinical trials. The Company was conducting a large Phase III study in the first quarter of 1996 whereas several smaller Phase II studies were being conducted for the same period in 1997. Sales and marketing expenses increased 442% to $3,932,000 in the six months ended June 30, 1997 from $726,000 in the same period of 1996 due primarily to marketing and other expenses related to the product launch of Mentax in the first quarter of 1997 and preparation for the marketing launch of Avita in the third quarter and detailing support for Akne-mycin and Cloderm. General and administrative expenses decreased 41% to $931,000 in the six months ended June 30, 1997 from $1,582,000 in the same period of 1996. The prior year period had unusually high legal costs related to prosecuting violations of certain of the Company's patents. This patent case was won by the Company resulting in the recovery of a portion of the Company's legal fees in the first quarter of 1997.

Net interest income decreased 36% to $210,000 in the six months ended June 30, 1997 from $330,000 in the same period of 1996. This decrease is primarily as a result of lower average cash balances available for investment in the six months of 1997.

The Company expects that annual revenues, and costs and expenses will continue to increase in the future, due principally to further commercialization of its recently approved pharmaceutical products. Sales and marketing expenses are expected to increase significantly from the prior year as these products are promoted in the marketplace. The Company also expects some expansion of research and development programs, increased patent and regulatory costs, expansion of regulatory, clinical and quality assurance capabilities, and increased administrative support costs. Therefore, additional operating losses are expected in the near future.

In addition, sales of a product upon initial market introduction generally include a significant amount of initial orders for inventory by wholesalers and distributors and are not necessarily indicative of actual demand for that product by patients and physicians. There can be no assurance that distributors and wholesalers will be able to forecast

demand for product accurately. Fluctuations in operating results will occur to the extent that sell through of products does not meet distributors' or wholesalers' expectations. The Company also expects that future operating results may be subject to quarterly variations that may impact cash flow from operations. Operating results for the six months ended June 30, 1997 are not necessarily indicative of future operating results.

Liquidity and Capital Resources

The Company's principal sources of capital to date have been the proceeds from public and private offerings of its equity securities, including a March 1997 private placement for which the net proceeds were approximately $9,000,000. At June 30, 1997, the Company had cash, cash equivalents and investments totaling $10,011,000.

Cash expenditures related to operating activities, the acquisition of fixed assets and repayment of long-term obligations totaled $5,580,000 in the six months ended June 30, 1997 and $4,587,000 for the same period in 1996. Operating activities were comprised of research and development, clinical trials, product sales, promotion and general administration activities. The Company also made milestone payments of $100,000 related to the in-licensing of drug compounds in the six months ended June 30, 1996. No similar milestone payments were made in the first six months of 1997. The Company expects that amounts expended historically are not indicative of future expenditures by the Company, which the Company believes will increase. The Company expects to continue to incur substantial expenditures related to the further research and development of its technologies, development of its products, acquisition of additional products and rights to drug compounds and sales and marketing.

The Company believes that existing capital resources, including the interest income earned on its invested cash balances, together with the anticipated revenues (consisting of product sales, license fees and royalties), may satisfy the Company's working capital and identified capital expenditure requirements at least through June 30, 1998. However, the Company's future capital requirements will depend on many factors, including the progress of the Company's collaborative and independent research and development programs, payments received under collaborative

agreements with other companies, if any, the results and costs of preclinical and clinical testing for the Company's products, the costs associated with and the timing of regulatory approvals, technological advances, the status of competitive products, and the commercial success of Penederm's licensing and marketing efforts. There can be no assurance that additional funds, if required, will be available to the Company on favorable terms, if at all, to permit the Company to continue with its current plan for operations.

The statements in "Management's Discussion and Analysis of Financial Condition and Results of Operations" that relate to future plans, events or performance, including statements relating to future revenue and expense levels, are forward-looking statements which involve risks and uncertainties including, but not limited to, product development and market acceptance risks, product manufacturing risks, risks associated with the establishment and management of a contract sales force, the impact of competitive products and pricing, the results of current and future licensing and other collaborative relationships, the results of financing efforts, developments regarding intellectual property rights and litigation, risks of product nonapproval or delays or post-approval reviews by the FDA or foreign regulatory authorities, and other risks identified in the Company's Securities and Exchange Commission filings. Actual results, events or performance may differ materially. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to publicly release the result of any revisions to these forward-looking statements that may be needed to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Part II: OTHER INFORMATION

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

The Company held its annual meeting of shareholders on June 16, 1997. At the meeting, the shareholders considered the items described below:

Each of the nominees for director David E. Collins, Lloyd H. Malchow, Robert F. Allnutt, William I. Bergmen, Mark J. Gabrielson, Harvey S. Sadow, Ph.D., and Gerald D. Weinstein, M.D., was elected by the affirmative vote of at least 6,227,126 shares (out of 6,460,834 shares represented at the meeting).

The shareholders voted to approve an amendment to the Penederm Incorporated Equity Incentive Plan to increase by 400,000 the number of shares reserved for issuance under the plan. The amendment was approved by a vote of 3,458,222 shares for, 1,566,896 shares against and 17,220 shares abstaining.

The shareholders voted to approve an amendment to the Penederm Incorporated Employee Stock Purchase Plan to increase by 50,000 the number of shares reserved for issuance under the plan. The amendment was approved by a vote of 4,417,761 shares for, 609,516 shares against and 15,061 shares abstaining.

The June 16, 1997 meeting of shareholders was adjourned until July 11 at which the following resolution was approved by shareholders:

The shareholders voted to approve a change in the Company's state of incorporation from California to Delaware through the merger of the Company into a newly formed Delaware corporation that is a wholly-owned subsidiary of the Company. This proposal was approved by a vote of 5,266,920 shares for, 844,645 against and 90,337 abstaining (out of 7,292,120 shares represented at the meeting).

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

2.1	Agreement and Plan of Merger between Penederm Incorporated, a California Corporation and Penederm Incorporated, a Delaware Corporation
27	Financial Data Schedule
99.1(1)	Equity Incentive Plan
99.2(1)	Employee Stock Purchase Plan

(1) Incorporated by reference to the exhibits to Penederm Registration Statement on Form S-8 (File No. 333-32689) filed on August 1, 1997.

(b) Reports on Form 8-K

On August 1, 1997, Penederm filed a current report on Form 8-K in connection with the reincorporation of the Company in Delaware.

SIGNATURES

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

PENEDERM INCORPORATED

August 14, 1997	/s/Lloyd H. Malchow
Date	Lloyd H. Malchow, President and Chief Executive Officer
August 14, 1997	/s/Michael A. Bates
Date	Michael A. Bates, Director of Finance and Administration

INDEX TO EXHIBITS

Exhibit No.	Description
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99.1(1)	Equity Incentive Plan

99.2(1) Employee Stock Purchase Plan

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(1) Incorporated by reference to the exhibits to Penederm Registration Statement on Form S-8 (File No. 333-32689) filed on August 1, 1997.

EXHIBIT 2.1

AGREEMENT AND PLAN OF MERGER
BETWEEN
PENEDERM INCORPORATED,
a California corporation
and
PENEDERM INCORPORATED,
a Delaware corporation

THIS AGREEMENT AND PLAN OF MERGER (the "Agreement") is dated as of July 30, 1997 between Penederm Incorporated, a California corporation ("Penederm California"), and Penederm Incorporated, a Delaware corporation ("Penederm Delaware"), a wholly owned subsidiary of Penederm California.

BACKGROUND

A. Penederm California is a corporation duly organized, validly existing and in good standing under the laws of the State of California and, on the date of this Agreement, has authority to issue 40,000,000 shares consisting of 30,000,000 shares of Common Stock, no par value, and 10,000,000 shares of Preferred Stock, no par value, of which 8,134,660 shares of Common Stock and no shares of Preferred Stock are issued and outstanding.

B. Penederm Delaware is a corporation duly organized, validly existing and in good standing under the laws of the State of Delaware and, on the date of this Agreement, has authority to issue 40,000,000 shares, consisting of 30,000,000 shares of Common Stock, $0.01 par value, and 10,000,000 shares of Preferred Stock, $0.01 par value, of which one share of Common Stock is issued and outstanding and owned by Penederm California and no shares of Preferred Stock are issued and outstanding.

C. The Board of Directors of each of Penederm California and Penederm Delaware have determined that it is advisable and in the best interests of each of such corporations that Penederm California merge into Penederm Delaware upon the terms and subject to the conditions set forth in this Agreement, for the purpose of effecting the reincorporation of Penederm California in the State of Delaware and have, by resolutions duly adopted, approved this Agreement and directed that it be submitted to a vote of their respective stockholders and executed by the undersigned officers.

THE PARTIES AGREE AS FOLLOWS:

ARTICLE I

DEFINITIONS

When used in this Agreement (and in any Exhibit in which such terms are not otherwise defined) the following terms shall have the following meanings:

"California Common Stock" shall mean shares of Common Stock, no par value, of Penederm California.

"California Preferred Stock" shall mean shares of Preferred Stock, no par value, of Penederm California.

"Certificate of Merger" shall mean the Certificate of Merger of Penederm California into Penederm Delaware to be filed with the Secretary of State of the State of Delaware in substantially the form attached hereto as Exhibit 2.1.

"Delaware Common Stock" shall mean shares of Common Stock, $0.01 par value, of Penederm Delaware.

"Delaware Preferred Stock" shall mean shares of Preferred Stock, $0.01 par value, of Penederm Delaware.

"Effective Time" shall mean the time when the Certificate of Merger is filed with the Secretary of State of the State of Delaware and the Merger becomes effective.

"Merger" shall mean the merger of Penederm California into Penederm Delaware.

"Shareholders' Meeting" shall mean the 1997 annual meeting of shareholders of Penederm California to approve and adopt this Agreement, among other things.

"Surviving Corporation" shall mean Penederm Delaware from and after the Effective Time.

ARTICLE II

MERGER

2.1 Merger. At the Effective Time, the Merger shall become effective under Section 252 of the Delaware General Corporation

Law and Section 1108(d) of the California General Corporation Law, and Penederm California shall merge into Penederm Delaware, the separate existence of Penederm California shall cease and Penederm Delaware shall continue in existence as the surviving corporation under the Delaware General Corporation Law.

2.2 Filings. On or prior to the Closing Date, Penederm California and Penederm Delaware shall cause:

(a) an executed counterpart of the Certificate of Merger to be filed with the Secretary of State of California; and

(b) the Certificate of Merger to be filed with the Secretary of State of Delaware. As soon as practicable after the Effective Time, the Surviving Corporation shall cause the Certificate of Merger to be filed with the County Recorder of the county in which the registered office of Penederm Delaware in the State of Delaware is located and shall cause such other local filings to be made as are required under the laws of the State of California.

2.3 Effects of the Merger. At the Effective Time:

(a) the separate existence of Penederm California shall cease and Penederm California shall be merged into Penederm Delaware;

(b) the Certificate of Incorporation of Penederm Delaware shall continue as the Certificate of Incorporation of the Surviving Corporation;

(c) the Bylaws of Penederm Delaware shall continue as the Bylaws of the Surviving Corporation;

(d) each officer and director of Penederm California in office immediately prior to the Effective Time shall serve in the same capacity as an officer or director of the Surviving Corporation immediately after the Effective Time;

(e) each share of California Common Stock outstanding immediately prior to the Effective Time shall be converted into one share of Delaware Common Stock pursuant to Article III;

(f) without further transfer, act, or deed, the separate existence of Penederm California shall cease and the Surviving Corporation shall possess all the rights, privileges, powers and franchises, and shall be subject to all the restrictions, disabilities and duties, of Penederm California; and all property, real, personal and mixed, and all debts due to Penederm California on whatever account, as well as stock subscriptions and all other things belonging to Penederm

California shall be vested in the Surviving Corporation; and all property, rights, privileges, powers and franchises, and all and every other interest of Penederm California shall be thereafter as effectually the property of the Surviving Corporation as they were of Penederm California, and the title to any real estate vested by deed or otherwise in Penederm California shall not revert or be in any way impaired by reason of the Merger; and all rights of creditors of Penederm California and all liens upon any property of Penederm California shall be preserved unimpaired and all debts, liabilities and duties of Penederm California shall attach to the Surviving Corporation and may be enforced against it to the same extent as if such debts, liabilities and duties had been incurred or contracted by it.

2.4 Further Assurances. Penederm California agrees that if, at any time after the Effective Time, the Surviving Corporation shall consider or be advised that any further deeds, assignments or assurances are necessary or desirable to vest, perfect or confirm in the Surviving Corporation title to any property or rights of Penederm California, the Surviving Corporation and its officers and directors may execute and deliver all such deeds, assignments and assurances and do all other things necessary or desirable to vest, perfect or confirm title to such property or rights in the Surviving Corporation and otherwise to carry out the purposes of this Agreement, in the name of Penederm California or otherwise.

ARTICLE III

CONVERSION OF STOCK

3.1 Conversion of Stock. At the Effective Time, the stock of Penederm California shall be converted into stock of Penederm Delaware, as follows:

(a) each share of California Common Stock issued and outstanding immediately prior to the Effective Time shall, by virtue of the Merger and without any action on the part of the holder thereof, be converted into one share of Delaware Common Stock; and

(b) each share of Delaware Common Stock issued and outstanding immediately prior to the Effective Time shall be canceled and retired and no stock shall be issued in the Merger in respect thereof.

3.2 Stock Certificates. At and after the Effective Time, all of the outstanding certificates which immediately prior to the Effective Time represented shares of California Common Stock shall be deemed for all purposes to evidence ownership of, and to

represent, shares of Delaware Common Stock into which the shares of California Common Stock formerly represented by such certificates have been converted as provided in this Agreement. The registered owner on the books and records of Penederm Delaware or its transfer agent of any outstanding stock certificate shall, until such certificate shall have been surrendered for transfer or otherwise accounted for to Penederm Delaware or its transfer agents, have and be entitled to exercise any voting and other rights with respect to, and to receive any dividends and other distributions upon, the shares of Delaware Common Stock evidenced by such outstanding certificate as provided above.

3.3 Stock Options. Each right or option to purchase shares of California Common Stock granted under the Penederm Incorporated Equity Incentive Plan, the Penederm Incorporated 1994 Nonemployee Directors Stock Option Plan, the Penederm Incorporated Employee Stock Purchase Plan, the Penederm Incorporated Employee Stock Option Plan and the Penederm Incorporated Consultant Stock Option Plan (collectively, the "Plans") which is outstanding immediately prior to the Effective Time, shall by virtue of the Merger and without any action on the part of the holder thereof, be converted into and become an option to purchase the same number of shares of Delaware Common Stock at the same option price per share, and upon the same terms and subject to the same conditions as in effect at the Effective Time. The same number of shares of Delaware Common Stock shall be reserved for purposes of said Plans as is equal to the number of shares of California Common Stock so reserved as of the Effective Time. As of the Effective Time, Penederm Delaware hereby assumes the Plans and all obligations of Penederm California under the Plans including the outstanding options or awards or portions thereof granted pursuant to the Plans.

3.4 Rights Agreement. Each right to purchase shares of California Common Stock outstanding under the Rights Agreement, dated November 20, 1996, between Penederm California and ChaseMellon Shareholder Services, LLC (the "Rights Agreement") shall become a right to purchase the same number of shares of Delaware Common Stock at the same price and on the same terms and conditions as set forth in the Rights Agreement and Penederm Delaware shall assume all rights and obligations of Penederm California under the Rights Agreement immediately as of the Effective Time.

3.5 Validity of Delaware Common Stock. All shares of Delaware Common Stock into which California Common Stock are to be converted pursuant to the Merger shall not be subject to any statutory or contractual preemptive rights, shall be validly issued, fully paid and nonassessable and shall be issued in full satisfaction of all rights pertaining to such California Common

Stock.

3.6 Rights of Former Holders. From and after the Effective Time, no holder of certificates which evidenced California Common Stock immediately prior to the Effective Time shall have any rights with respect to the shares formerly evidenced by those certificates, other than to receive the shares of Delaware Common Stock into which such California Common Stock shall have been converted pursuant to the Merger.

ARTICLE IV

GENERAL

4.1 Consents. Each of Penederm California and Penederm Delaware shall use its best efforts to obtain the consent and approval of each person (other than shareholders of Penederm California in their capacities as such) whose consent or approval shall be required in order to permit consummation of the Merger.

4.2 Governmental Authorizations. Each of Penederm California and Penederm Delaware shall cooperate in filing any necessary reports or other documents with any federal, state, local or foreign authorities having jurisdiction with respect to the Merger.

4.3 Waiver and Amendment. This Agreement may be amended by action of the Board of Directors of each of Penederm California and Penederm Delaware without action by the stockholders of the parties, except that (a) any amendment to Section 3.1, (b) any amendment changing the terms, rights, powers or preferences of the Delaware Common Stock, or (c) any amendment altering any terms of this Agreement if such alteration would adversely affect the holders of California Common Stock or Delaware Common Stock must be approved by a majority of the voting power of the outstanding California Common Stock.

4.4 Termination. This Agreement may be terminated and the Merger and other transactions provided for by this Agreement abandoned at any time prior to the Effective Time, whether before or after adoption and approval of this Agreement at the Shareholders' Meeting, by action of the Board of Directors of Penederm California if the Board determines that the consummation of the transactions contemplated by this Agreement would not, for any reason, be in the best interests of Penederm California and its shareholders.

4.5 Entire Agreement. This Agreement (including any exhibits), contains the entire agreement among the parties with respect to the Merger and supersedes all prior and concurrent

arrangements, letters of intent or understandings relating to the Merger.

4.6 Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be an original, but all of which when taken together shall constitute one and the same agreement. This Agreement shall become effective when one or more counterparts has been signed by each of the parties and delivered to each of the other parties.

4.7 Headings. The article, section and paragraph headings in this Agreement have been inserted for identification and reference and shall not by themselves determine the meaning or interpretation of any provision of this Agreement.

4.8 Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the State of Delaware and, so far as applicable, the merger provisions of the California General Corporation Law.

IN WITNESS WHEREOF, the parties have caused this Agreement to be executed as of the date first above written.

PENEDERM INCORPORATED,
a California corporation

By: /s/ John W Quigley
Title: Senior Vice President,
Research and Development

By: /s/ Richard Friedman
Title: Secretary

PENEDERM INCORPORATED,
a Delaware corporation

By: /s/ John W Quigley
Title: Senior Vice President,
Research and Development

By: /s/ Richard Friedman
Title: Secretary

EXHIBIT 2.1 TO THE AGREEMENT OF PLAN AND MERGER

CERTIFICATE OF MERGER

OF

PENEDERM INCORPORATED,
a California corporation

INTO

PENEDERM INCORPORATED,
a Delaware corporation

(UNDER SECTION 252 OF THE GENERAL
CORPORATION LAW OF THE STATE OF DELAWARE)

Penederm Incorporated, a Delaware corporation, hereby certifies that:

(1) The name and state of incorporation of each of the constituent corporations are:

(a) Penederm Incorporated, a Delaware corporation ("Penederm Delaware"); and

(b) Penederm Incorporated, a California corporation ("Penederm California").

(2) An Agreement of Merger has been approved, adopted, certified, executed and acknowledged by Penederm California and by Penederm Delaware in accordance with the provisions of subsection (c) of Section 252 of the General Corporation Law of the State of Delaware.

(3) The name of the surviving corporation is Penederm Incorporated, a Delaware corporation, which will continue its existence as the surviving corporation under its present name upon the effective date of the merger.

(4) The certificate of incorporation of Penederm Delaware shall be the certificate of incorporation of the surviving corporation after the effectiveness of the merger.

(5) The executed Agreement of Merger is on file at the principal place of business of the surviving corporation, Penederm Delaware, located at 320 Lakeside Drive, Foster City, California 94404.

(6) A copy of the Agreement of Merger will be furnished by Penederm Delaware, on request and without cost, to any stockholder of Penederm California or Penederm Delaware.

(7) The authorized capital stock of Penederm California is 30,000,000 shares of Common Stock and 10,000,000 shares of Preferred Stock.

IN WITNESS WHEREOF, Penederm Delaware has caused this Certificate of Merger to be signed by John W. Quigley, its Senior Vice President, Research and Development, on the 30th day of July, 1997.

Penederm Incorporated,
a Delaware corporation

By: _/s/ John W. Quigley_____
John W. Quigley,
Senior Vice President, Research and Development

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