

AEOLUS PHARMACEUTICALS, INC.  
Form 10-Q  
August 13, 2010

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2010.

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934  
for the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number  
0-50481

AEOLUS PHARMACEUTICALS, INC.  
(Exact Name of Registrant as Specified in Its Charter)

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

56-1953785  
(I.R.S. Employer  
Identification No.)

26361 Crown Valley Parkway, Ste. 150  
Mission Viejo, California  
(Address of Principal Executive Offices)

92691  
(Zip Code)

(Registrant's Telephone Number, Including Area Code)  
949-481-9825

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  NO

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  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Outstanding as of

Edgar Filing: AEOLUS PHARMACEUTICALS, INC. - Form 10-Q

| Class                                   | August 13, 2010   |
|---|-------------------|
| Common Stock, par value \$.01 per share | 59,925,249 shares |

1

---

AEOLUS PHARMACEUTICALS, INC.  
FORM 10-Q  
For the Quarter Ended June 30, 2010  
Table of Contents

|                                      |  | Page |
|--------------------------------------|--|------|
| <b>PART I. FINANCIAL INFORMATION</b> |  |      |
| Item 1.                              | Financial Statements   | 3    |
|                                      | Statement Regarding Financial Information  | 3    |
|                                      | Condensed Consolidated Balance Sheets as of June 30, 2010 (unaudited) and September 30, 2009                                 | 4    |
|                                      | Condensed Consolidated Statements of Operations for the Three Months and Nine Months ended June 30, 2010 and 2009(unaudited) | 5    |
|                                      | Condensed Consolidated Statements of Cash Flows for the Nine Months ended June 30, 2010 and 2009 (unaudited)                 | 6    |
|                                      | Notes to Condensed Consolidated Financial Statements   | 7    |
| Item 2.                              | Management's Discussion and Analysis of Financial Condition and Results of Operations  | 14   |
| Item 3.                              | Quantitative and Qualitative Disclosures About Market Risk   | 17   |
| Item 4.                              | Controls and Procedures  | 17   |
| <b>PART II. OTHER INFORMATION</b>    |  |      |
| Item 1.                              | Legal Proceedings  | 18   |
| Item 1A.                             | Risk Factors   | 18   |
| Item 2.                              | Unregistered Sales of Equity Securities and Use of Proceeds  | 18   |
| Item 3.                              | Defaults Upon Senior Securities  | 18   |
| Item 4.                              | Removed and Reserved   | 18   |
| Item 5.                              | Other Information  | 18   |

|         |          |    |
|---------|----------|----|
| Item 6. | Exhibits | 18 |
|---------|----------|----|

|            |  |    |
|------------|--|----|
| SIGNATURES |  | 19 |
|------------|--|----|

AEOLUS PHARMACEUTICALS, INC.

PART I - FINANCIAL INFORMATION

ITEM 1. Financial Statements.

Statement Regarding Financial Information

The condensed consolidated financial statements of Aeolus Pharmaceuticals, Inc. and its wholly-owned subsidiary, Aeolus Sciences, Inc. (collectively the “Company”), included herein have been prepared by management, without audit (except for the Consolidated Balance Sheet as of September 30, 2009), pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information normally included in the consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States has been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to make the information presented not misleading. The Company recommends that you read the consolidated financial statements included herein in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended September 30, 2009, filed with the SEC on December 28, 2009.

## AEOLUS PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS  
(In thousands, except shares and per share data)

|  | June 30,<br>2010<br>(Unaudited) | September 30,<br>2009 |
|--|---------------------------------|-----------------------|
| <b>ASSETS</b>  |                                 |                       |
| Current assets:  |                                 |                       |
| Cash and cash equivalents  | \$ 457                          | \$ 646                |
| Prepays and other current assets   | 50                              | 133                   |
| Total current assets   | 507                             | 779                   |
| Investment in CPEC, LLC  | 32                              | 32                    |
| Total assets   | \$ 539                          | \$ 811                |
| <b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>   |                                 |                       |
| Current liabilities:   |                                 |                       |
| Accounts payable and accrued expenses  | \$ 330                          | \$ 774                |
| Short-term note payable  | 645                             | 0                     |
| Total current liabilities  | 975                             | 774                   |
| Non-current liabilities:   |                                 |                       |
| Warrant liability  | 14,708                          | 0                     |
| Senior convertible note  | 0                               | 600                   |
| Long-term note payable   | 0                               | 594                   |
| Total liabilities  | \$ 15,683                       | \$ 1,968              |
| Stockholders' deficit:   |                                 |                       |
| Preferred stock, \$.01 par value per share, 10,000,000 shares authorized:  |                                 |                       |
| Series B nonredeemable convertible preferred stock, 600,000 shares authorized; 475,087 shares issued and outstanding at June 30, 2010 and September 30, 2009 | 5                               | 5                     |
| Common stock, \$.01 par value per share, 200,000,000 shares authorized;  |                                 |                       |
| 48,224,320 shares issued and outstanding at June 30, 2010 and 37,563,392 shares issued and outstanding at September 30, 2009                                 | 482                             | 376                   |
| Additional paid-in capital   | 154,192                         | 159,657               |
| Accumulated deficit  | (169,823)                       | (161,195)             |
| Total stockholders' deficit  | (15,144)                        | (1,157)               |
| Total liabilities and stockholders' deficit  | \$ 539                          | \$ 811                |

The accompanying notes are integral part of these unaudited condensed consolidated financial statements.



AEOLUS PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)  
(In thousands, except per share data)

|   | Three Months Ended<br>June 30, |           | Nine Months Ended<br>June 30, |            |
|---|--------------------------------|-----------|-------------------------------|------------|
|   | 2010                           | 2009      | 2010                          | 2009       |
| <b>Revenue</b>  |                                |           |                               |            |
| Grant income  | \$ -                           | \$ -      | \$ -                          | \$ -       |
| <b>Costs and expenses:</b>  |                                |           |                               |            |
| Research and development  | 275                            | 130       | 885                           | 469        |
| General and administrative  | 475                            | 315       | 1,337                         | 903        |
| Total costs and expenses  | 750                            | 445       | 2,222                         | 1,372      |
| Loss from operations  | (750)                          | (445)     | (2,222)                       | (1,372)    |
| Interest (expense), net   | (17)                           | (114)     | (860)                         | (322)      |
| Other income (expense), net   | (3,856)                        | 133       | (9,899)                       | 144        |
| Net loss  | \$ (4,623)                     | \$ (426)  | \$ (12,981)                   | \$ (1,550) |
| <b>Net loss per weighted share attributable to common stockholders:</b> |                                |           |                               |            |
| Basic and diluted   | \$ (0.10)                      | \$ (0.01) | \$ (0.27)                     | \$ (0.05)  |
| <b>Weighted average common shares outstanding:</b>                      |                                |           |                               |            |
| Basic and diluted   | 48,244                         | 37,468    | 47,652                        | 33,865     |

The accompanying notes are integral part of these unaudited condensed consolidated financial statements.

## AEOLUS PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)  
(In thousands)

|  | Nine Months Ended<br>June 30, |                 |
|--|-------------------------------|-----------------|
|  | 2010                          | 2009            |
| <b>Cash flows from operating activities:</b>                                       |                               |                 |
| Net loss   | \$ (12,981)                   | \$ (1,550)      |
| <b>Adjustments to reconcile net loss to net cash used in operating activities:</b> |                               |                 |
| Noncash compensation   | 407                           | 193             |
| Change in fair value of warrants   | 3,686                         | -               |
| Change in fair value of trading securities   | -                             | (49)            |
| Noncash consulting expense   | 14                            | 25              |
| Loss on sale of investments  | -                             | (133)           |
| Noncash interest and warrant costs   | 7,020                         | 366             |
| <b>Change in assets and liabilities:</b>   |                               |                 |
| Prepays and other assets   | 90                            | 5               |
| Accounts payable and accrued expenses  | (31)                          | (247)           |
| <b>Net cash used in operating activities</b>                                       | <b>(1,795)</b>                | <b>(1,390)</b>  |
| <b>Cash flows from investing activities:</b>                                       |                               |                 |
| (Purchases) sales of investments and marketable securities                         | (7)                           | 751             |
| <b>Net cash (used by) provided by investing activities</b>                         | <b>(7)</b>                    | <b>751</b>      |
| <b>Cash flows from financing activities:</b>                                       |                               |                 |
| Repayment of short term note payable   | -                             | (368)           |
| Proceeds from short term note payable  | -                             | 3               |
| Proceeds from the issuance of common stock and warrants                            | 1,650                         | 1,500           |
| Proceeds from exercise of warrants   | 17                            | -               |
| Proceeds from issuance of Senior Convertible Notes                                 | -                             | 375             |
| Costs related to the issuance of common stock and warrants                         | (54)                          | (91)            |
| <b>Net cash provided by financing activities</b>                                   | <b>1,613</b>                  | <b>1,419</b>    |
| <b>Net (decrease) increase in cash and cash equivalents</b>                        | <b>(189)</b>                  | <b>780</b>      |
| <b>Cash and cash equivalents at beginning of period</b>                            | <b>646</b>                    | <b>399</b>      |
| <b>Cash and cash equivalents, end of period</b>                                    | <b>\$ 457</b>                 | <b>\$ 1,179</b> |

AEOLUS PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

A. Organization and Business and Basis of Presentation

Aeolus Pharmaceuticals, Inc. is a biopharmaceutical company that is developing a new class of catalytic antioxidant compounds as a medical countermeasure against biological, chemical and radiological weapons as well as for diseases and disorders of the central nervous system, respiratory system, autoimmune system and oncology. The Company's initial target indications are as a protective agent against the effects of acute radiation syndrome, sulfur mustard gas exposure and chlorine gas exposure. The Company has reported positive safety results from two Phase I clinical trials of AEOL 10150, our lead drug candidate, with no serious adverse events noted.

Funding of the research on the Company's lead compound, AEOL 10150 for use as a medical countermeasure comes from a number of sources. Development of the compound for lung effects of acute radiation exposure has largely been funded by Aeolus through programs at the University of Maryland and Duke University. In December 2009, the Company was informed by the Biologic Advanced Research and Development Authority (BARDA) that it had been chosen to submit a full proposal for funding of its Lung ARS program from its current stage to FDA approval, based on a summary "white paper" submitted earlier in 2009 by the Company.

Since March of 2009, AEOL 10150 has also been under development as a medical countermeasure for the GI effects of Acute Radiation Syndrome (GI-ARS). The GI-ARS program has been completely funded to date by the National Institutes of Health-National Institute of Allergy and Infectious Disease (NIH-NIAID). Additional NIH-NIAID funded studies of AEOL 10150 in GI-ARS are expected to begin before the end of the fiscal year.

For the past two years, AEOL 10150 has been the subject of research and development as a countermeasure for mustard and chlorine gas exposure through funding by NIH CounterACT. In May of 2010, the Company submitted white papers to BARDA proposing long-term funding of 10150 as both a chlorine and mustard gas countermeasure from the current stages of development to FDA Approval. A response to the white papers is expected before the end of the fiscal year. In any event, funding of the chlorine and mustard gas programs is expected to continue through the NIH CounterACT program.

The Company has a second compound, AEOL 11207, which has been the subject of research and development as a treatment for Parkinson's Disease and Epilepsy. Currently, this research work is being funded through grants to Dr. Manisha Patel at the University of Colorado from the Michael J. Fox Foundation and Citizens United for Research in Epilepsy (CURE).

The "Company" or "Aeolus" refers collectively to Aeolus Pharmaceuticals, Inc., a Delaware corporation ("Aeolus"), and its wholly owned subsidiary, Aeolus Sciences, Inc., a Delaware corporation. As of June 30, 2010, Aeolus also owned a 35.0% interest in CPEC LLC, a Delaware limited liability company ("CPEC"). The Company's primary operations are located in Mission Viejo, California.

All significant intercompany activity has been eliminated in the preparation of the condensed consolidated financial statements. The unaudited condensed consolidated financial statements have been prepared in accordance with the requirements of Form 10-Q and Rule 10-01 of Regulation S-X. Some information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations. In the opinion of management, the accompanying unaudited consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations and cash flows of the Company. The consolidated balance sheet at September 30, 2009 was derived from the Company's audited financial statements

included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2009. The unaudited condensed consolidated financial statements included herein should be read in conjunction with the audited consolidated financial statements and the notes thereto included in that Annual Report on Form 10-K and in the Company's other SEC filings. Results for the interim period are not necessarily indicative of the results for any other period.

**B. Liquidity**

The Company has incurred significant losses from operations of approximately \$2,222,000 and \$1,372,000, and cash outflows from operations of approximately \$1,795,000 and \$1,390,000, for the nine months ended June 30, 2010 and for the nine months ended June 30, 2009, respectively. The Company expects to incur additional losses and negative cash flow from operations during the remainder of fiscal year 2010 and for several more years.

On July 30, 2010, the Company announced the exercise of its "Put Option" with Xmark Funds, under which the Company raised \$1.65 million. In addition, on August 12, 2010, the Company completed a common stock and warrant financing for \$1 million, with the option to call another \$1 million during the first quarter of fiscal 2011. The proceeds from these financings are expected to enable the Company to continue operations into the first half of fiscal 2012 (see subsequent events).

If the Company is unable to obtain additional financing to fund operations beyond the first half of fiscal year 2012, it will need to eliminate some or all of its activities, merge with another company, sell some or all of its assets to another company, or cease operations entirely. There can be no assurance that the Company will be able to obtain additional financing on favorable terms or at all, or that the Company will be able to merge with another Company or sell any or all of its assets.

C. Net Loss Per Common Share

The Company computes basic net loss per weighted average share attributable to common stockholders using the weighted average number of shares of common stock outstanding during the period. The Company computes diluted net income (loss) per weighted average share attributable to common stockholders using the weighted average number of shares of common and dilutive potential common shares outstanding during the period. Potential common shares consist of stock options, convertible debt, warrants and convertible preferred stock using the treasury stock method and are excluded if their effect is anti-dilutive. Diluted weighted average common shares excluded incremental shares of approximately 59,925,249 for the nine months ended June 30, 2010 issuable upon the exercise or conversion of convertible debt, stock options to purchase common stock, convertible preferred stock and warrants to purchase common stock. These shares were excluded due to their anti-dilutive effect as a result of the Company's net loss for the nine months ended June 30, 2010. Diluted weighted average common shares included incremental shares issuable upon conversion of the Senior Convertible Notes but excluded incremental shares of approximately 36,585,000, for the nine months ended June 30, 2009 due to their anti-dilutive effect as a result of the Company's net loss for the nine months ended June 30, 2009.

D. Warrant Liability

On October 1, 2009, the Company adopted new accounting guidance originally referred to as Emerging Issues Task Force 07-5, recently codified by FASB to be ASC 815. The new guidance revised existing guidance for determining whether an Instrument (or Embedded Feature) is indexed to an entity's own stock. Equity-linked instruments (or embedded features) that otherwise meet the definition of a derivative are not accounted for as derivatives if certain criteria are met, one of which is that the instrument (or embedded feature) must be indexed to the entity's own stock. The Company applied the new guidance to outstanding instruments as of October 1, 2009. The fair value of the warrants affected by the new guidance at the dates of issuance totaled \$8,282,000 and was initially recorded as a component of additional paid-in capital. Upon adoption of the new guidance, the Company recorded a decrease to the opening balance of additional-paid-in capital of \$8,142,000 and recorded a decrease to accumulated deficit totaling \$4,353,000, representing the decrease in the fair value of the warrants from the date of issuance to October 1, 2009. The fair value of the warrants at October 1, 2009 of \$3,789,000 was classified as a liability in the balance sheet as of that date.

Future increases or decreases in fair value of the warrants will be included as a component of other income (expenses) in the accompanying statement of operations for the respective period. As of June 30, 2010, the liability for warrants increased to approximately \$14,708,000, resulting in an additional charge to the statements of operations for the three months and nine months ended June 30, 2010 of approximately \$3,856,000 and \$9,899,000, respectively. The warrant liability and revaluations have not and will not have any impact on the Company's working capital, liquidity, or business operations.

E. Note Payable

Senior Convertible Notes to Related Parties

On August 1, 2008, the Company entered into a Securities Purchase Agreement (the "SCN Purchase Agreement") with three accredited institutional investors (the "Investors") pursuant to which the Company agreed to sell to the

Investors units comprised of senior unsecured convertible notes of the Company (the "Notes"), in an aggregate principal amount of up to \$5,000,000, which shall bear interest at a rate of 7% per year and mature on the 30-month anniversary of their date of issuance, and warrants to purchase up to an aggregate of 10,000,000 additional shares of Common Stock (the "Warrant Shares"), each with an initial exercise price of \$0.50 per share, subject to adjustment pursuant to the warrants (the "Warrants") (collectively the "SCN Financing"). Each unit (collectively, the "Units") is comprised of \$1,000 in Note principal and Warrants to purchase up to 2,000 shares of the Company's common stock, par value \$0.01 per share (the "Common Stock"), and has a purchase price of \$1,000.

On August 1, 2008, the Company sold and issued to the Investors 500 Units comprised of Notes in the aggregate principal amount of \$500,000 and Warrants to purchase up to 1,000,000 shares of Common Stock for an aggregate purchase price of \$500,000 (the "Financing").

On each of September 4, 2008, October 1, 2008, November 3, 2008 and December 1, 2008, the Company sold and issued to the Investors 125 Units comprised of Notes in the aggregate principal amount of \$125,000 and Warrants to purchase up to 250,000 shares of Common Stock for an aggregate purchase price of \$125,000 (the "Subsequent Financings").

The Notes issued in the Financing and the Subsequent Financings had an initial conversion price of \$0.35 per share, subject to adjustment pursuant to the Notes. In addition, the Investors had the option to purchase up to an additional 4,000 Units, in one or more closings (each, an "Election Closing") at their sole option at any time on or before December 31, 2013.

Interest on the Notes accrued at the rate of 7.0% per annum from the date of issuance, and was payable semi-annually, on January 31 and July 31 of each year. Interest was payable, at the Company's sole election, in cash or shares of Common Stock, to holders of Notes on the record date for such interest payments, with the record dates being each January 15 and July 15 immediately preceding an interest payment date. The effective interest rate of the Note including the effect of the amortization of the embedded conversion feature and the note discount is 39.4 percent.

The net proceeds to the Company from the sale of 1,000 Units in the Financing and Subsequent Financing, after deducting for expenses, were approximately \$844,000. The Company used the net proceeds to fund the development of AEOL 10150 and to fund ongoing operations of the Company. Offering costs of the private placement were \$156,000 and were allocated to the Notes and Warrants based upon their respective fair values. The offering costs attributed to the Notes in the amount of \$100,000 were capitalized as Debt Issuance Costs. The Debt Issuance Costs were amortized over the life of the Notes in the Financing.

In connection with a financing that occurred on October 6, 2009 and is more fully described in Note F – Stockholders' Equity, the holders of the Notes agreed to convert all \$1,000,000 of the Company's Notes into Common Stock at a conversion rate of \$0.35 per share and to exchange their remaining option to purchase an additional \$4,000,000 in Notes for warrants to purchase up to 14,285,714 shares of Common Stock with an initial exercise price of \$0.28 per share, subject to adjustment pursuant to the warrants (the "Note Warrants").

On December 24, 2009, the "Company entered into an amendment (the "Amendment") to the Securities Purchase and Exchange Agreement dated October 6, 2009 (the "October 2009 Purchase Agreement") pursuant to which the Company agreed to lower the conversion price of the Notes from \$0.35 per share to \$0.28 per share and as a result, issued an additional 714,286 shares of the Company's Common Stock. The Amendment was executed to resolve a misunderstanding regarding one of the financing terms in the October 6, 2009 financing between the Company and the investors in the financing. The Company did not receive any proceeds from the issuance. As a result of the amendment and issuance of the additional shares, the Company recorded a charge of \$343,000 in the Statement of Operations as interest expense for the value of the shares issued on the date of issuance.

Affiliates of Xmark Opportunity Partners, LLC were the sole investors in the SCN Financing. Together with its affiliates, Xmark Opportunity Partners, LLC beneficially owned approximately 52% of the Company's outstanding common stock prior to the Financing. Xmark Opportunity Partners, LLC is the sole manager of Goodnow Capital, L.L.C. and possesses sole power to vote and direct the disposition of all securities of the Company held by Goodnow. Goodnow has the right to designate up to two directors for election to the Company's Board of Directors, pursuant to the terms of a purchase agreement between Goodnow and the Company. David C. Cavalier, a current Director of the Company, and Managing Partner of XMark Opportunity Partners LLC, is President of Goodnow. The transaction was evaluated by Management and the Board of Directors for fairness to ensure the terms were reasonable given the related party nature of the SCN Financing by providing an option for non-related party investors to participate in the transaction.

#### Elan Note Payable

In August 2002, Aeolus borrowed from Elan Corporation, plc. ("Elan") \$638,000. The note payable accrued interest at 10% compounded semi-annually. The note was convertible at the option of Elan into shares of the Company's Series B non-voting convertible preferred stock ("Series B Stock") at a rate of \$43.27 per share. The original note matured on December 21, 2006. However, in February 2007, the Company and Elan terminated the note, the Company paid \$300,000 in cash to Elan, Elan forgave \$225,000 of the note payable and Elan and the Company entered into a new two-year note payable in the amount of \$453,000 under substantially the same terms as the original note. In February 2009, the Company and Elan agreed to amend the note payable to extend the maturity date of the convertible promissory note from February 7, 2009 to February 7, 2011 and increased the interest rate of the convertible promissory note from 10% to 11% effective February 7, 2009. As of the date of the Amendment, an aggregate of

\$553,000 in principal and interest was outstanding under the convertible promissory note. In the event of an event of default under the convertible promissory note, Elan may demand immediate payment of all amounts outstanding under the note. For purposes of the note, an event of default includes, among other items, a default in the payment of the note principal or interest when due and payable, an uncured breach by the Company of its obligations to Elan pursuant the agreements under which the convertible promissory note was issued, an inability of the Company to pay its debts in the normal course of business, the cessation of business activities by the Company (other than as a result of a merger or consolidation with a third party) without Elan's prior written consent and the appointment of a liquidator, receiver, administrator, examiner, trustee or similar officer of the Company or over all or substantially all of its assets under the law.

During the term of the note payable, Elan has the option to convert the note into shares of Series B Preferred Stock at a rate of \$9.00 per share. Upon the maturity of the note payable, Aeolus has the option to repay the note either in cash or in shares of Series B Stock and warrants having a then fair market value of the amount due; provided that the fair market value used for calculating the number of shares to be issued will not be less than \$13.00 per share. As of June 30, 2010, the outstanding balance, including interest, on the note payable to Elan was approximately \$645,000.

## F. Stockholders' Equity

On October 6, 2009, the Company entered into the October 2009 Purchase Agreement with several accredited institutional investors (the "October 2009 Investors") pursuant to which the Company sold and issued to the October 2009 Investors in a private placement an aggregate of 5,892,857 units (the "Units"), comprised of an aggregate of 5,892,857 shares of Common Stock (the "Shares") and warrants to purchase up to an aggregate of 11,785,714 additional shares of Common Stock (the "October 2009 Warrants"), with an initial exercise price of \$0.28 per share, subject to adjustment pursuant to the October 2009 Warrants, with each Unit representing one share of Common Stock and a October 2009 Warrant to purchase two shares of Common Stock, at a purchase price of \$0.28 per Unit for aggregate gross proceeds of \$1,650,000 (collectively, the "October 2009 Financing"). The October 2009 Warrants are exercisable for a seven year period from their date of issuance; contain a "cashless exercise" feature that allows the holder to exercise the October 2009 Warrants without a cash payment to the Company under certain circumstances; contain a dividend participation right which allows the holder to receive any cash dividends paid on the Common Stock without exercising the October 2009 Warrant and contain a provision that provides for the reduction of the exercise price to \$0.01 in the event of any such payment of cash dividends by the Company or upon a change of control and contain anti-dilution provisions in the event of a stock dividend or split, dividend payment or other issuance, reorganization, recapitalization or similar event.

The Company also granted to the October 2009 Investors the option to acquire, collectively, up to an additional 5,892,857 additional Units (the "Additional Units"), comprised of an aggregate of 5,892,857 shares of Common Stock and warrants to purchase up to an aggregate of 11,785,714 additional shares of common stock at the per Additional Unit purchase price of \$0.28 (the "Call Option"). In addition, the October 2009 Investors granted to the Company the option to require these October 2009 Investors, severally and not jointly, to acquire up to 5,892,857 Additional Units, less any Additional Units acquired under the Call Option, at the per Additional Unit purchase price of \$0.28 (the "Put Option"). The Call Option was exercisable at any time, and from time to time, on or prior to June 30, 2010. The Put Option was exercisable at any time from June 30, 2010 to July 30, 2010. On July 30, 2010, the Company exercised the full Put Option and received \$1.65 million in cash and issued 5,892,857 common shares and 11,785,714 warrants to the October 2009 Investors (see Subsequent Events).

In addition, the October 2009 Investors agreed to convert all \$1,000,000 of the Company's Senior Convertible Notes issued in 2008 (the "Notes") into Common Stock at a conversion rate of \$0.35 per share (the "Conversion Shares"), which was subsequently lowered to \$0.28 as discussed below and to exchange their remaining option to purchase an additional \$4,000,000 in Senior Convertible Notes for warrants to purchase up to 14,285,714 shares of Common Stock in substantially the same of form and terms of the October 2009 Warrants issued in the October 2009 Financing, including an initial exercise price of \$0.28 per share, subject to adjustment pursuant to the warrants (the "Note Warrants"). As consideration for the October 2009 Investors to convert the Notes, the Company agreed to exchange warrants to purchase up to 2,000,000 shares of Common Stock issued to the October 2009 Investors in connection with the sale of the Notes, warrants to purchase up to 2,150,000 shares of Common Stock issued to the October 2009 Investors and one of their affiliates in connection with a financing completed in November 2005 and warrants to purchase up to 13,392,857 shares of Common Stock issued to the October 2009 Investors in connection with a financing completed in March 2009 (collectively, the "Prior Warrants") for warrants to purchase up to 17,542,857 shares of Common Stock in substantially the same form and terms of the October 2009 Warrants issued in the October 2009 Financing, including an initial exercise price of \$0.28 per share, subject to adjustment pursuant to the warrants (the "Exchange Warrants") (collectively, the "Conversion").

In connection with the October 2009 Financing and the Conversion, the Company also entered into a Registration Rights Agreement (the "October 2009 Rights Agreement") with the Investors. In addition, the Investors agreed to terminate the Company's Registration Rights Agreements dated November 21, 2005 and March 30, 2009. Pursuant to the October 2009 Rights Agreement, the Company agreed to file one or more registration statements (collectively, the "Registration Statements") with the Securities and Exchange Commission (the "SEC") covering the resale of the Shares,

the Conversion Shares and all shares of common stock issuable upon exercise of the Warrants, the Note Warrants and the Exchange Warrants (collectively, the “Registrable Securities”) upon demand of the holders of a majority of the Registrable Securities (a “Demand Registration”). Such holders have the right to two Demand Registrations, subject to certain exceptions. In the event the holders exercise their right to a Demand Registration, the Company has agreed to file a Registration Statement to register the resale of the Registrable Securities within a certain number of days after the request and to use commercially reasonable efforts to cause the Registration Statement to be declared effective by the SEC as soon as practicable after the filing thereof. The Company also agreed to use its commercially reasonable efforts to keep the Registration Statements effective for a specified period.

The net proceeds to the Company from the October 2009 Financing, after deducting for expenses, were approximately \$1.6 million. The Company intends to use the net proceeds from the Financing to finance animal efficacy studies in Acute Radiation Syndrome, the development of AEOL 10150 and ongoing operations of the Company.

The fair value of the October 2009 Warrants, the Note Warrants and the Exchange Warrants was estimated to be \$10,585,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 93%; risk free interest rate of 2.9%; and an expected life of seven years. The fair value of the Prior Warrants cancelled on October 6, 2009 was \$3,352,000. The proceeds from the October 2009 Financing were allocated based upon the relative fair values of the October 2009 Warrants and the Shares. Due to the anti-dilution provisions of the October 2009 Warrants, the Note Warrants and the Exchange Warrants, these warrants were deemed to be a liability under current accounting guidance and as a result the warrant liability was increased by \$7,233,000 of which \$6,213,000 was recorded as a charge to the Statement of Operations and \$1,020,000 of proceeds from the October 2009 Financing was allocated to the value of the October 2009 Warrants.

Affiliates of Xmark Opportunity Partners, LLC are the sole investors in the Financing and, together with the Company, are the sole participants in the Conversion. Together with its affiliates, Xmark Opportunity Partners, LLC beneficially owned approximately 71% of the Company's outstanding common stock prior to the Financing and the Conversion. Xmark Opportunity Partners, LLC is the sole manager of Goodnow Capital, L.L.C. and possesses sole power to vote and direct the disposition of all securities of the Company held by Goodnow. Goodnow has the right to designate up to two directors for election to the Company's Board of Directors pursuant to the terms of a purchase agreement between Goodnow and the Company. David C. Cavalier, a current employee, Director and Chairman of the Board of the Company, and Managing Partner of XMark Opportunity Partners LLC, is President of Goodnow.

On December 24, 2009, the Company entered into an amendment (the "Amendment") to the October 2009 Purchase Agreement pursuant to which the Company agreed to lower the conversion price of the Notes from \$0.35 per share to \$0.28 per share and as a result, issued to the investors in the Company's October 2009 Financing an additional 714,286 shares of the Company's Common Stock upon conversion of the Notes (the "Issuance"). The Agreement was executed to resolve a misunderstanding regarding one of the Financing terms between the Company and the investors in the Financing. The Company did not receive any proceeds from the Issuance. The fair value of the common stock on the date of issuance was \$343,000 and was charged to the Statement of Operations as interest expense.

On March 30, 2009, Aeolus entered into a Securities Purchase Agreement (the "Purchase Agreement") with two accredited institutional investors (the "March 2009 Investors") pursuant to which the Company sold and issued to the March 2009 Investors in a private placement an aggregate of 5,357,143 units (the "March 2009 Units"), comprised of an aggregate of 5,357,143 shares of Common Stock of the Company (the "Shares") and warrants to purchase up to an aggregate of 13,392,857 additional shares of Common Stock (the "March 2009 Warrants"), with an initial exercise price of \$0.35 per share, subject to adjustment pursuant to the March 2009 Warrants, with each March 2009 Unit representing one share of Common Stock and a March 2009 Warrant to purchase two-and-one-half shares of Common Stock, at a purchase price of \$0.28 per March 2009 Unit for aggregate gross proceeds of \$1,500,000 (collectively, the "March 2009 Financing"). The March 2009 Warrants are exercisable for a five year period from their date of issuance; contain a "cashless exercise" feature that allows the holder to exercise the March 2009 Warrants without a cash payment to the Company under certain circumstances; contain a dividend participation right which allows the holder to receive any cash dividends paid on the Common Stock without exercising the March 2009 Warrant and contain a provision that provides for the reduction of the exercise price to \$0.01 in the event of any such payment of cash dividends by the Company; and contain standard anti-dilution provisions that provide for the adjustment of the exercise price and the number of shares of common stock that can be purchased in the event of a financing at a price per share below the exercise price, a stock dividend or split, dividend payment or other issuance, reorganization, recapitalization or similar event.

The fair value of the March 2009 Warrants was estimated to be \$4,129,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; risk free interest rate of 1.7%; expected volatility of 164%; and an expected life of five years.

Offering costs of the March 2009 Financing were \$91,000 resulting in net proceeds to the Company of approximately \$1.4 million. The Company intends to use the net proceeds from the March 2009 Financing to finance the development of AEOL 10150 and to fund ongoing operations of the Company. Affiliates of Xmark Opportunity Partners, LLC were the sole investors in the Financing.

As a result of the March 2009 Financing, the Company was required to lower the exercise price of 4,687,000 warrants previously issued in November 2005 and May 2007 to \$0.28 per share, the purchase price of the March 2009 Units issued in the March 2009 Financing. As a result of the change in the exercise price, these warrants were revalued resulting in an increase in the value of \$38,000 which was charged to the statement of operations during the second quarter of fiscal year 2009.

In connection with the SCN Financing, Aeolus issued warrants to purchase 2,000,000 shares at an exercise price of \$0.50 per share with a five year term. The fair value of the warrants issued on August 1, 2008 was estimated to be \$282,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 128% risk free interest rate of 3.2%; and an expected life of five years. The fair value of the warrants issued on September 4, 2008 was estimated to be \$53,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 130% risk free interest rate of 3.0%; and an expected life of five years. The fair value of the warrants issued on October 1, 2008 was estimated to be \$93,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 133% risk free interest rate of 2.9%; and an expected life of five years. The fair value of the warrants issued on November 3, 2008 was estimated to be \$76,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 139% risk free interest rate of 2.7%; and an expected life of five years. The fair value of the warrants issued on December 1, 2008 was estimated to be \$75,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 138% risk free interest rate of 1.7%; and an expected life of five years.

In addition, as a result of the SCN Financing, the Company was required to lower the exercise price of 4,687,000 warrants previously issued in the November 2005 Financing and in the 2007 Financing to \$0.35 per share, the conversion price of the Notes issued in the SCN Financing. As a result of the change in the exercise price, these warrants were revalued resulting in an increase in the value of \$118,000 which was charged to the statement of operations during the fourth quarter of fiscal year 2008.

As of June 30, 2010, warrants to purchase 53,440,953 shares of common stock were outstanding. Details of the warrants for common stock outstanding at June 30, 2010 were as follows:

| Number of Shares | Exercise Price | Expiration Date |
|------------------|----------------|-----------------|
| 350,000          | \$ 0.28        | November 2010   |
| 2,126,668        | \$ 0.28        | May 2012        |
| 43,614,285       | \$ 0.28        | October 2016    |
| 20,000           | \$ 0.39        | September 2014  |
| 50,000           | \$ 0.35        | May 2011        |
| 15,000           | \$ 0.50        | September 2014  |
| 15,000           | \$ 0.60        | September 2014  |
| 7,000,000        | \$ 0.75        | June 2011       |
| 50,000           | \$ 1.00        | May 2011        |
| 50,000           | \$ 1.50        | May 2011        |
| 50,000           | \$ 2.00        | May 2011        |
| 50,000           | \$ 2.50        | May 2011        |
| 50,000           | \$ 0.38        | April 2020      |
| 53,440,953       | \$ 0.35        |                 |

Below is a summary of warrant activity for the nine months ended June 30, 2010:

|                          | Number of Shares | Exercise Price | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|--------------------------|------------------|----------------|--|---------------------------|
| Outstanding at 9/30/2009 | 27,379,525       | \$ 0.46        | 3.25   | \$ 1,051,248              |
| Granted                  | 43,664,285       | \$ 0.28        | 6.27   | \$ 5,234,714              |
| Exercised                | (60,000)         | \$ 0.28        | 1.89   | \$ 9,000                  |
| Expired or Canceled      | (17,542,857)     | \$ 0.36        | 3.27   | \$ 927,643                |
| Forfeited                |                  | \$ 0.00        |  | \$ 0                      |
| Vested RSAs              |                  |                |  |                           |
| Outstanding at 6/30/2010 | 53,440,953       | \$ 0.35        | 5.33   | \$ 5,532,114              |

As discussed previously, the Warrants expiring in November 2010, May 2012 and October 2016 are deemed to be liabilities and as such are carried at their fair value as a liability on the Balance Sheet.

#### G. Stock-Based Compensation

Below is a summary of stock option activity for the nine months ended June 30:



|                          | Number of<br>Shares | Exercise<br>Price | Weighted Average<br>Remaining<br>Contractual<br>Term (in years) | Aggregate<br>Intrinsic<br>Value |
|--------------------------|---------------------|-------------------|---|---------------------------------|
| Outstanding at 9/30/2009 | 6,175,015           | \$ 1.58           | 6.96  | \$ 137,913                      |
| Granted                  | 185,000             | \$ 0.35           | 9.53  | \$ 8,825                        |
| Exercised                |                     | \$ 0.00           | 0.00  | \$ 0                            |
| Expired or Canceled      | (1,200)             | \$ 51.25          | 0.00  | \$ 0                            |
| Forfeited                | (421,250)           | \$ 0.62           |   | \$ 4,500                        |
| Vested (RSAs)            |                     |                   |   |                                 |
| Outstanding at 6/30/2010 | 5,937,565           | \$ 1.60           | 6.24  | \$ 163,775                      |

For the nine months ended June 30, 2010 and 2009, all stock options were issued with an exercise price at or above the fair market value of the Company's common stock on the date of grant.

The details of stock options for the nine months ended June 30, 2010 were as follows:

| Range of<br>Exercise Prices | Options Outstanding                          |                                       |   | Options Exercisable                          |                                       |         |
|-----------------------------|--|---------------------------------------|---|--|---------------------------------------|---------|
|                             | Number<br>Outstanding<br>at<br>June 30, 2010 | Weighted<br>Average Exercise<br>Price | Weighted Average<br>Remaining<br>Contractual Life | Number<br>Exercisable at<br>June<br>30, 2010 | Weighted<br>Average Exercise<br>Price |         |
| \$ 0.29-0.32                | 1,526,250                                    | \$ 0.30                               | 8.72  | 1,509,583                                    | \$ 0.30                               |         |
| \$ 0.33-0.45                | 903,500                                      | \$ 0.39                               | 8.82  | 784,545                                      | \$ 0.39                               |         |
| \$ 0.55-0.75                | 768,111                                      | \$ 0.65                               | 6.41  | 768,111                                      | \$ 0.65                               |         |
| \$ 0.78-0.90                | 794,335                                      | \$ 0.87                               | 5.91  | 794,335                                      | \$ 0.87                               |         |
| \$ 0.91-1.50                | 1,382,019                                    | \$ 1.46                               | 3.25  | 1,382,019                                    | \$ 1.46                               |         |
|                             | 1.52   | 2,500                                 | \$ 1.52   | 4.25   | 2,500                                 | \$ 1.52 |
| \$ 1.55-2.10                | 211,750                                      | \$ 1.85                               | 4.22  | 211,750                                      | \$ 1.85                               |         |
| \$ 2.50-11.50               | 188,624                                      | \$ 4.95                               | 3.27  | 188,624                                      | \$ 4.95                               |         |
| \$ 12.85-20.00              | 79,754                                       | \$ 15.10                              | 1.09  | 79,754                                       | \$ 15.10                              |         |
| \$ 22.50-51.25              | 80,722                                       | \$ 36.75                              | 0.15  | 80,722                                       | \$ 36.75                              |         |
| \$ 0.29-51.25               | 5,937,565                                    | \$ 1.60                               | 6.23  | 5,801,943                                    | \$ 1.63                               |         |

Stock-based compensation expense recognized in the statement of operations is as follows (in thousands):

|  | For the three months<br>ended June 30, |      | For the nine months ended<br>June 30, |      |
|--|--|------|---------------------------------------|------|
|  | 2010                                   | 2009 | 2010                                  | 2009 |
| Research and<br>Development Expenses   | 8                                      | 11   | 41                                    | 34   |
| General and<br>Administrative Expenses | 79                                     | 71   | 366                                   | 159  |
|  | 87                                     | 82   | 407                                   | 193  |

The total deferred compensation expense for outstanding and unvested stock options for the nine months ended June 30, 2010 was approximately \$32,000. The weighted average remaining recognition period for the total deferred compensation expense is approximately six months. The fair value of the options associated with the above compensation expense was determined at the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions:

|                         | For the nine months<br>ended June 30 |                |
|-------------------------|--------------------------------------|----------------|
|                         | 2010                                 | 2009           |
| Dividend yield          | 0%                                   | 0%             |
| Expected volatility     | 95% -<br>96%                         | 96% -<br>209%  |
| Risk-free interest rate | 3.3% -<br>3.5%                       | 2.6% -<br>3.8% |
| Expected term           | 10 years                             | 10 years       |

## H. Commitments

The Company has acquired assets still in development and entered into research and development arrangements with third parties that may require milestone and royalty payments to the third party contingent upon the occurrence of certain future events linked to the success of the asset in development. Milestone payments may be required, contingent upon the successful achievement of an important point in the development life-cycle of the pharmaceutical product (e.g., approval of the product for marketing by a regulatory agency). If required by the arrangement, the Company may have to make royalty payments based upon a percentage of the sales of the pharmaceutical product in the event that regulatory approval for marketing is obtained.

These arrangements may be material individually, and in the unlikely event that milestones for multiple products covered by these arrangements were reached in the same period, the aggregate charge to expense could be material to the results of operations in any one period. In addition, these arrangements often give Aeolus the discretion to unilaterally terminate development of the product, which would allow Aeolus to avoid making the contingent payments; however, Aeolus is unlikely to cease development if the compound successfully achieves clinical testing objectives.

## I. Subsequent Events

On July 30, 2010, the Company exercised the "Put Option" granted by the Investors to the Company in the October 2009 financing. As a result of the exercise, the Company received \$1.65 million in gross proceeds from the investors in exchange for 5,892,857 additional Units (the "Additional Units"), comprised of an aggregate of 5,892,857 shares of Common Stock and warrants to purchase up to an aggregate of 11,785,714 additional shares of common stock at a purchase price of \$0.28. Cash proceeds from the put exercise are expected to be \$1.63 million after legal costs associated with the exercise and subsequent issuance of stock and warrants.

On July 30, 2010, the Company and Mr. John McManus amended and restated Mr. McManus' employment agreement, dated July 14, 2006, with the Company. Under the Amended and Restated Employment Agreement (the "Restated Agreement"), Mr. McManus will continue to serve as President, Chief Executive Officer and Chief Operating Officer of the Company. Pursuant to the agreement, Mr. McManus will be paid \$20,850 a month. However, in the event, on or prior to June 30, 2011, the Company (i) enters into one or more binding agreements for the sale and issuance of equity of the Company in one or more financings, (ii) enters into one or more binding partnership, licensing, collaboration, development or similar agreements, or (iii) is awarded one or more grants or contracts, all of which taken together collectively entitle the Company to receive gross proceeds of at least \$10,000,000 (the "Threshold Amount") (excluding any proceeds received from the Investors or any affiliate thereof), Mr. McManus' salary shall be increased to \$33,333 per month, effective as of the date of such agreement or award, when combined with all prior agreements or awards, entitles the Company to the Threshold Amount.

On August 12, 2010, the Company announced an additional financing with existing investors. Under the terms of the August 2010 Financing agreement, Aeolus received \$1 million in gross proceeds in exchange for the issuance of 2.5 million shares of common stock and warrants to purchase up to 1,875,000 shares at an exercise price of \$0.50 per share. The Company also granted to the August 2010 Investors the option to acquire, collectively, up to an additional 2,500,000 Additional Units, comprised of an aggregate of 2,500,000 shares of Common Stock and warrants to purchase up to an aggregate of 1,875,000 additional shares of common stock at an exercise price of \$0.50 (the "Call Option"). In addition, the August 2010 Investors granted to the Company the option to require these August 2010 Investors, severally and not jointly, to acquire up to 2,500,000 Additional Units, less any Additional Units acquired under the Call Option, at the per Additional Unit purchase price of \$0.40 (the "Put Option"). The Call Option is exercisable at any time, and from time to time, on or prior to December 31, 2010. The Put Option is exercisable at any time from November 30, 2010 to December 30, 2010. However, the Investors shall have the right to terminate the Put Option if they reasonably determine that a material adverse event, condition or circumstance has occurred with

respect to the prospects of the Company's AEOL 10150 drug candidate for acute radiation syndrome; provided that the Company's failure to receive a grant or financing shall not, by itself, constitute a material adverse event, condition or circumstance with respect thereto.

Management has evaluated for subsequent events through the date these financial statements were filed and determined that no other material subsequent events have occurred.

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

### Introduction

Unless otherwise noted, the terms "we," "our" or "us" refer collectively to Aeolus Pharmaceuticals, Inc. and our wholly owned subsidiary, Aeolus Sciences, Inc.

This report contains, in addition to historical information, statements by us with respect to expectations about our business and future results which are “forward-looking” statements under the Private Securities Litigation Reform Act of 1995. These statements and other statements made elsewhere by us or by our representatives, which are identified or qualified by words such as “likely,” “will,” “suggests,” “expects,” “might,” “believe,” “could,” “should,” “may,” “estimates,” “predict,” “continue,” “would,” “anticipates,” “plans,” or similar expressions, are based on a number of assumptions that are subject to risks and uncertainties. Such statements include, but are not limited to, those relating to Aeolus’ product candidates, as well as its proprietary technologies and uncertainties and other factors that may cause Aeolus’ actual results to be materially different from historical results or from any results expressed or implied by such forward-looking statements. Important factors that could cause results to differ include risks associated with uncertainties of progress and timing of clinical trials, scientific testing, obtaining regulatory approval, the need to obtain funding for pre-clinical and clinical trials and operations, the scope and validity of intellectual property protection for Aeolus’ product candidates, proprietary technologies and their uses, new accounting and SEC requirements and competition from other biopharmaceutical companies. Certain of these factors and others are more fully described in Aeolus’ filings with the SEC, including, but not limited to, Aeolus’ Annual Report on Form 10-K for the fiscal year ended September 30, 2009. All forward-looking statements are based on information available as of the date hereof, and we do not assume any obligation to update such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof.

#### Operations Summary

We are developing a new class of catalytic antioxidant compounds as a medical countermeasure against biological, chemical and radiological weapons as well as for diseases and disorders of the central nervous system, respiratory system, autoimmune system and oncology. Our initial target indications are as a protective agent against the effects of acute radiation syndrome, sulfur mustard gas exposure and chlorine gas exposure. We have reported positive safety results from two Phase I clinical trials of AEOL 10150, our lead drug candidate, with no serious adverse events noted.

On May 12, 2010, the Company was notified by Chemical Biological Medical Systems that it had not been awarded a contract for development of AEOL 10150 as a countermeasure for GI-Acute Radiation System. Development of the compound for GI-ARS continues and continues to be funded by the National Institutes of Health (NIH) – National Institutes of Allergies and Immunological Disorders (NIAID). The decision by CBMS does not have a financial impact on the Company as funding from CBMS was not considered as a component of Aeolus’ programs for budgeting purposes. Review of the Company’s proposal for a contract with the Biologic Advanced Research and Development Authority (BARDA) for development of AEOL 10150 in Lung ARS continues.

We do not have any revenue, other than grant income, and therefore we must rely on public or private equity offerings, debt financings, collaboration arrangements or grants to finance our operations.

#### Need for Additional Funds

With the financings announced in July and August 2010 (see subsequent events), we believe we have adequate financial resources to fund our operations into the first half of fiscal year 2012. In order to fund on-going operating cash requirements beyond the first half of fiscal year 2012, or to accelerate or expand our programs, however, we may need to raise significant additional funds. Our need for additional financing is discussed under “Liquidity and Capital Resources”, and is updated in Subsequent Events.

#### Results of Operations

Three months ended June 30, 2010 versus three months ended June 30 2009

We had a net loss of approximately \$4,623,000 for the three months ended June 30, 2010, versus a net loss of approximately \$426,000 for the three months ended June 30, 2009. Of the loss for the three months ended June 30, 2010, approximately \$3,856,000 of the loss was due to the impact of changes to the fair value of warrants under accounting rules.

Research and development (“R&D”) expenses increased about \$145,000, or 112%, to \$275,000 for the three months ended June 30, 2010 from approximately \$130,000 for the three months ended June 30, 2009. R&D expenses were higher during the three months ended June 30, 2010 versus June 30, 2009 due to an increase in Lung ARS related research activities. Preclinical fees increased about \$52,000 over the comparable period in 2009 due to increased animal study activity to support the Company’s ARS development program. The Company currently has eight studies in progress: the study of its drug candidates as a potential countermeasure against the effects of sulfur mustard gas on the lung and skin, as a protectant against the effects of radiation on the lungs and on the gastro-intestinal tract, as a countermeasure against the effects of chlorine gas, as a potential treatment for epilepsy and for the potential treatment for Parkinson’s disease.

R&D expenses for our antioxidant program have totaled approximately \$36,407,000 from inception through June 30, 2010. Because of the uncertainty of our research and development and clinical studies, we are unable to predict the level of spending and the anticipated program completion date, if any.

General and administrative (“G&A”) expenses increased about \$160,000, or 51%, to approximately \$475,000 for the three months ended June 30, 2010 from approximately \$315,000 for the three months ended June 30, 2009. Salaries and wages increased by about \$38,000 due to the hiring of a new employee during the first quarter of fiscal 2010. Investor relations expenses increased by \$48,000, due to increased IR-related activities performed by outside consultants, and legal fees increased by \$43,000.

We incurred interest expense of approximately \$17,000 for the three months ended June 30, 2010 compared to interest expense of about \$114,000 for the three months ended June 30, 2009. The decrease in interest expense is primarily the result of the conversion of a note payable to equity.

As disclosed previously, certain of the Company’s warrants to purchase common stock were deemed to be a liability upon adoption of a new accounting pronouncement on October 1, 2009. Subsequent changes to the fair market value resulted in an offsetting charge on the statements of operations of about \$3,856,000 for the three month period ended June 30, 2010. The warrant liability and revaluations have not and will not have any impact on the Company’s working capital, liquidity, or business operations.

Nine months ended June 30, 2010 versus nine months ended June 30, 2009

We had a net loss of approximately \$12,981,000 for the nine months ended June 30, 2010, versus a net loss of approximately \$1,550,000 for the nine months ended June 30, 2009. The loss for the first nine months of 2010 included \$9,899,000 in non-cash charges for change in fair value of warrants.

Research and development (“R&D”) expenses increased by about \$416,000, or 89%, to approximately \$885,000 for the nine months ended June 30, 2010 from about \$469,000 for the nine months ended June 30, 2009. R&D expenses were higher during the nine months ended June 30, 2010 versus June 30, 2009 due to an increase in research activities to support the Company’s Lung ARS development program and the retention of a consultant to assist in the writing of proposals for government funding described in the discussion of three months results. For the nine months ended June 30, 2010, consultant expenses increased by about \$186,000 due to costs associated with the aforementioned consultant. Preclinical fees increased about \$187,000 over the comparable period in 2009 due to increased animal studies to support the Company’s ARS development program. The Company currently has eight studies in progress: the study of its drug candidates as a potential countermeasure against the effects of sulfur mustard gas on the lung and skin, as a protestant against the effects of radiation on the lungs and on the gastro-intestinal tract, as a countermeasure against the effects of chlorine gas, as a potential treatment for epilepsy and for the potential treatment for Parkinson’s disease.

General and administrative (“G&A”) expenses increased approximately \$434,000, or 48%, to approximately \$1,337,000 for the nine months ended June 30, 2010 from about \$903,000 for the nine months ended June 30, 2009. Salaries and wages increased by about \$100,000 due to the hiring of a new employee during the first quarter of fiscal 2010. Consulting stock expense increased by about \$207,000 as a result of a higher level of grant activity to employees, consultants, and directors. Investor relations expenses increased by \$80,000, due to increased IR-related activities performed by outside consultants, and legal fees increased by \$87,000.

We incurred interest expense of approximately \$860,000 for the nine months ended June 30, 2010 compared to interest expense of about \$322,000 for the nine months ended June 30, 2009. The expense in the nine month period ended June 30, 2010 reflects about \$826,000 incurred in the first quarter of fiscal year 2010, mostly due to charges as a result of the conversion of the Senior Convertible Notes on October 6, 2009. In the second and third quarters of 2010, interest expense dropped significantly principally due to the conversion of the aforementioned note payable to equity (and the recognition of the related non-legal fees in the first quarter).

As previously disclosed, certain of the Company's warrants to purchase common stock were deemed to be a liability upon adoption of a new accounting pronouncement on October 1, 2009. Subsequent changes to the fair market value resulted in an offsetting charge on the statements of operations of about \$9,899,000 for the nine month period ended June 30, 2010. The warrant liability and revaluations have not and will not have any impact on the Company's working capital, liquidity, or business operations.

#### Liquidity and Capital Resources

We do not have any revenue and therefore we rely on investors, grants, collaborations and licensing of our compounds to finance our operations. At June 30, 2010, we had approximately \$457,000 of cash and cash equivalents, a decrease of \$189,000 from September 30, 2009. The decrease in cash was primarily due to the funding of expenses from operations, which was more than the \$1.6 million in net proceeds from the October 2009 Financing. We believe we have adequate financial resources to conduct operations into the first quarter of fiscal year 2012, but in order to fund on-going operating cash requirements beyond that point, or to further accelerate or expand our programs, we need to raise significant additional funds (see Subsequent Events).

We incurred significant losses from operations of approximately \$2,222,000 and \$1,372,000, and cash outflows from operations of approximately \$1,795,000 and \$1,390,000, for the nine months ended June 30, 2010 and for the nine months ended June 30, 2009, respectively. Our ongoing future cash requirements will depend on numerous factors, particularly the progress of our catalytic antioxidant program and clinical trials and our ability to negotiate and complete collaborative agreements or out-licensing arrangements. In order to help fund our on-going operating cash requirements, we intend to seek new collaborations for our antioxidant research program that include initial cash payments and on-going research support. In addition, we might sell additional shares of our stock and/or convertible debentures and explore other strategic and financial alternatives, including a merger with another company, the sale of stock and/or debt, the establishment of new collaborations for current research programs, that include initial cash payments and ongoing research support and the out-licensing of our compounds for development by a third party.

There are significant uncertainties as to our ability to access potential sources of capital. We may not be able to enter into any collaboration on terms acceptable to us, or at all, due to conditions in the pharmaceutical industry or in the economy in general or based on the prospects of our catalytic antioxidant program. Even if we are successful in obtaining collaboration for our antioxidant program, we may have to relinquish rights to technologies, product candidates or markets that we might otherwise develop ourselves. These same risks apply to any attempt to out-license our compounds.

Similarly, due to market conditions, the illiquid nature of our stock and other possible limitations on equity offerings, we may not be able to sell additional securities or raise other funds on terms acceptable to us, if at all. Any additional equity financing, if available, would likely result in substantial dilution to existing stockholders.

Our forecast of the period of time through which our financial resources will be adequate to support our operations is forward-looking information, and actual results could vary.

#### Off-Balance Sheet Commitments

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

#### ITEM 3. Quantitative and Qualitative Disclosures About Market Risk.

Our exposure to market risk is presently limited to the interest rate sensitivity of our cash and cash equivalents, which is affected by changes in the general level of U.S. interest rates. However, we believe that we are not subject to any material market risk exposure and do not expect that changes in interest rates would have a material effect upon our financial position. A hypothetical 10% change in interest rates would not have a material effect on our Statement of Operations or Cash Flows for the nine months ended June 30, 2010. We do not have any foreign currency or other derivative financial instruments. Our debt bears interest at a fixed rate.

#### ITEM 4. Controls and Procedures.

##### Evaluation of Disclosure Controls and Procedures

As defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 as amended, our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed by, or under the supervision of, our principal executive and principal financial officer and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, internal

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

#### Management's Report on Internal Control over Financial Reporting

As required by Securities and Exchange Commission Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer. Our management assessed the effectiveness of our internal control over financial reporting as of June 30, 2010. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based upon its assessment, management concluded that, as of June 30, 2010, our internal control over financial reporting was not effective due to a material weakness existing with respect to the segregation of duties.

A "material weakness," as defined by the Standards of the Public Company Accounting Oversight Board (PCAOB) is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. This material weakness has not resulted in an adjustment or misstatements to the financial statements.

Management has determined that given the Company's size, level of operations and financial resources, it is not practicable for the Company to eliminate the segregation of controls weakness and therefore management has established mitigating controls to minimize the impact of the lack of segregation of duties. To address this material weakness, the Company engaged an executive search firm to conduct a search for a full time Chief Financial Officer. The Company is continuing a search process for a new Chief Financial Officer and expects to hire a new Chief Financial Officer by the end of September 2010. Additionally, our Audit Committee has taken an active role in reviewing and discussing the identified material weakness with our auditors and senior management. Our management and the Audit Committee will actively monitor the implementation and effectiveness of the remediation measures taken by our financial management.

#### Changes in Internal Control over Financial Reporting

Except as noted above, there have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) during the quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1. Legal Proceedings.

None.

### ITEM 1A. Risk Factors.

None.

### ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

### ITEM 3. Defaults Upon Senior Securities.

None.

### ITEM 4. Removed and Reserved.

N/A.

### ITEM 5. Other Information.

None.

### ITEM 6. Exhibits

| Exhibit # | Description  |
|-----------|--|
| 31.1      | Certification of the Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a). |

- 31.2 Certification of the Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a).
- 32.1 Certification by the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. §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.

AEOLUS PHARMACEUTICALS, INC.

Date: August 13, 2010

By: /s/ John L. McManus  
John L. McManus  
President and Chief Executive Officer  
(Principal Executive Officer)  
Chief Financial Officer, Treasurer and Secretary  
(Principal Financial and Accounting Officer)