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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2004

OR

[ ] TRANSACTION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO_____

COMMISSION FILE NUMBER 1-10113

HALSEY DRUG CO., INC.
(Exact name of registrant as specified in its charter)

NEW YORK	11-0853640
(State or other Jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

616 N. NORTH COURT, SUITE 120 PALATINE, ILLINOIS	60067
(Address of Principal Executive Offices)	(Zip Code)

(847) 705-7709
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes [ ] No [X]

As of May 14, 2004 the registrant had 21,601,704 shares of Common Stock, $.01 par value, outstanding.

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HALSEY DRUG CO., INC. & SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HALSEY DRUG CO., INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	UNAUDITED MARCH 31, 2004	DECEMBER 31, 2003
	(IN THOUSANDS)	
ASSETS		
CURRENT ASSETS		
Cash	$ 7,282	$ 942
Accounts Receivable - trade, net of allowances for doubtful accounts of $414 and $428 at March 31, 2004 and December 31, 2003, respectively	66	467
Inventories	-	312
Prepaid expenses and other current assets	132	401
Total current assets	7,480	2,122
PROPERTY, PLANT & EQUIPMENT, NET	3,152	3,394
DEFERRED PRIVATE OFFERING COSTS, net of accumulated amortization of $424 and $318 at March 31, 2004 and December 31, 2003, respectively	882	714
OTHER ASSETS AND DEPOSITS	64	392
TOTAL ASSETS	$ 11,578	$ 6,622

The accompanying notes are an integral part of these statements

HALSEY DRUG CO., INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	UNAUDITED MARCH 31, 2004	DECEMBER 31, 2003
	(IN THOUSANDS, EXCEPT	PER SHARE DATA)
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
CURRENT LIABILITIES		
CONVERTIBLE SUBORDINATED DEBENTURES	$ 12,313	$ -
Less: debt discount	(8,464)	-
	3,849	-
Current maturities of notes payable and capital lease obligations	27	45
Accounts payable	272	1,895
Accrued interest	1,993	1,544
Accrued expenses	1,352	2,108
Deferred asset proceeds	2,000	-
Department of Justice Settlement	-	300
Total current liabilities	9,493	5,892
TERM NOTE PAYABLE	5,000	21,401
BRIDGE LOANS	-	2,000
Less: debt discount	-	(568)
	-	1,432
CONVERTIBLE SUBORDINATED DEBENTURES	86,632	86,632
Less: debt discount	(50,565)	(56,893)
	36,067	29,739
CAPITAL LEASE OBLIGATIONS	92	92
DEPARTMENT OF JUSTICE SETTLEMENT	-	133
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY (DEFICIT)		
Common stock - $.01 par value; authorized 80,000,000 shares; issued and outstanding, 21,601,704 shares at March 31, 2004 and December 31, 2003	216	216
Additional paid-in capital	169,575	157,262
Accumulated deficit	(208,865)	(209,545)
STOCKHOLDERS' DEFICIT	(39,074)	(52,067)
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 11,578	$ 6,622

The accompanying notes are an integral part of these statements

HALSEY DRUG CO., INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	THREE MONTHS ENDED MARCH 31	
	2004	2003
	(IN THOUSANDS, EXCEPT SHARE DATA)	
Net product revenues	$ 628	$ 1,526
Cost of manufacturing	1,253	2,873
Research and development	238	329
Selling, general and administrative expenses	1,221	1,711
Loss from operations	(2,084)	(3,387)
Other income (expense)		
Interest expense	(958)	(1,433)
Interest income	7	17
Amortization of deferred debt discount and private offering costs	(10,843)	(5,767)
Gain on sale of assets	1,754	-
Gain on debt restructuring	12,401	-
Other	403	(5)
NET INCOME (LOSS)	$ 680	$ (10,575)
Earnings (loss) per share		
Basic	$ .03	$ (0.50)
Diluted	$ .00	$ (0.50)
Weighted average shares outstanding		
Basic	21,601,704	21,035,323
Diluted	278,020,203	21,035,323

The accompanying notes are an integral part of these statements

HALSEY DRUG CO., INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	THREE MONTHS ENDED MARCH 31	
	2004	2003
	(IN THOUSANDS)	
Cash flows from operating activities		
Net income (loss)	$ 680	$(10,575)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	192	199
Amortization of deferred debt discount and private offering costs	10,843	5,767
Amortization of deferred product acquisition costs	205	14
Debentures and stock issued for interest	-	600
Loss on disposal of assets	47	5
Gain on restructure of debt	(12,401)	-
Changes in assets and liabilities		
Accounts receivable	252	(634)
Inventories	312	265
Prepaid expenses and other current assets	251	(290)
Other assets and deposits	124	18
Accounts payable	(1,610)	(912)
Accrued expenses	1,642	351
Total adjustments	(143)	5,383
Net cash provide by (used in) operating activities	537	(5,192)
Cash flows from investing activities		
Capital expenditures	(9)	(451)
Net cash used in investing activities	(9)	(451)
Cash flows from financing activities		
Payments on notes payable and capital lease obligations	(4,019)	(10)
Issuance of debentures	10,264	-
Payments to Department of Justice	(433)	(80)
Net cash provided by (used in) financing activities	5,812	(90)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	6,340	(5,733)
Cash and cash equivalents at beginning of period	942	9,211
Cash and cash equivalents at end of period	$ 7,282	$ 3,478

Cash paid for interest was $47 during the quarter ended March 31, 2004.

The accompanying notes are an integral part of these statements

SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES FOR THE QUARTER ENDED MARCH 31, 2004:

1. The Company's Convertible Subordinated Debentures contained beneficial conversation features, which were valued at $12,313,000.

2. The Company has repaid $166,000 of indebtedness in the form of product deliveries.

3. Bridge Loans of $2,000,000 and accrued interest of $49,000 were converted into like amounts of Convertible Subordinated Debentures.

The accompanying notes are an integral part of these statements

HALSEY DRUG CO., INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT)

THREE MONTHS ENDED MARCH 31, 2004

(IN THOUSANDS, EXCEPT SHARE DATA)

(UNAUDITED)

	COMMON STOCK $.01 PAR VALUE		ADDITIONAL PAID-IN	ACCUMULATED	
	SHARES	AMOUNT	CAPITAL	DEFICIT	TOTAL
Balance January 1, 2004.....	21,601,704	$ 216	$ 157,262	$ (209,545)	$ (52,067)
Net income for the three months ended March 31, 2004.....				680	680
Beneficial conversion features in connection with issuance of debentures.....			12,313		12,313
Balance at March 31, 2004.....	21,601,704	$ 216	$ 169,575	$ (208,865)	$ (39,074)

The accompanying notes are an integral part of these statements

HALSEY DRUG CO., INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Halsey Drug Co., Inc. and subsidiaries (the "Company") have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accrual adjustments, considered necessary to present fairly the financial position, results of operations and changes in cash flows for the three months ended March 31, 2004, assuming that the Company will continue as a going concern, have been made. The results of operations for the three month period ended March 31, 2004 are not necessarily indicative of the results that may be expected for the full year ended December 31, 2004. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto for the year ended December 31, 2003 included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission.

At March 31, 2004 the Company had cash and cash equivalents of $7,282,000 as compared to $942,000 at December 31, 2003. The Company had working capital deficit at March 31, 2004 of $2,013,000 and an accumulated deficit of $208,865,000. The Company had an operating loss of $2,084,000 during the three months ended March 31, 2004.

In the fourth quarter of 2003 and first quarter of 2004, the Company restructured it operations, as more fully describe in Note 2, and substantially ceased the manufacturing of the Company's generic finished dosage pharmaceutical products and distribution of those products by the Company's subsidiary, Axiom Pharmaceutical Corporation ("Axiom"). All manufacturing operations of Axiom ceased on January 30, 2004.

As restructured, the Company is engaged in the development of proprietary opioid abuse deterrent formulation technology (the "ADF Technology") the manufacture, packaging and stability testing of clinical trial supplies of finished products utilizing the ADF Technology, the evaluation of such products in appropriate clinical trials, the development and scale up of novel active pharmaceutical ingredient ("API") opioid synthesis technologies (the "Opioid Synthesis Technology") , and the prosecution of the Company's application to the Drug Enforcement Administration ("DEA") for a registration to import narcotic raw materials ("NRMs"). The Company proposes to enter into license agreements with strategic partners providing that such licensees will further develop abuse deterrent formulation finished dosage products, file for regulatory approval with the U.S. Food and Drug Administration ("FDA") and other regulatory authorities and commercialize such products. The Company intends to manufacture commercial quantities of such products for sale by the Company's licensees.

NOTE 2 - LIQUIDITY MATTERS

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. At December 31, 2003, the Company had cash and cash equivalents of $942,000, working capital deficit of approximately $3,770,000 and a stockholders' deficit of approximately $52,067,000. The Company incurred a loss from operations of approximately $17,244,000 and a net loss of approximately $48,455,000 during the year ended December 31, 2003. At March 31, 2004, the Company had cash and cash equivalents of $7,282,000, a working capital deficit of $2,014,000 and an accumulated deficit of $208,865,000. The Company incurred operating losses of $2,084,000 during the three months ended March 31, 2004. Historically, the Company has incurred significant losses

from operations and until such time as the research and development efforts are commercialized, for which no assurance can be given, the Company will continue to incur operating losses. These factors, among others, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans with respect to these matters follow:

On November 6, 2003, the Company publicly announced its restructuring plan to focus its efforts on research and development related to certain proprietary finished dosage products and APIs. In making its determination the Board of Directors considered, among other factors, the Company's ability and time required to generate positive cash flow and income from the operation of the Company's finished dosage manufacturing, packaging, labeling and distribution facilities located in Congers, New York (collectively, the "Congers Facilities") in the manufacture and distribution of finished dosage generic products pursuant to abbreviated new drug applications ("ANDAs").

The Company incurred losses of $48.5 million in 2003, $59.6 million in 2002 and $12.6 million in 2001. The Board determined that near term sales of the Company's finished dosage generic products would likely result in continued financial losses in view of the highly competitive market environment, low market pricing, declining market size for its existing generic products and the lack of timely new generic product launches. Based on this analysis and other factors, the Board concluded that the Company restructure its operations by closing or divesting the Congers Facilities and reducing certain activities at its Culver Facility. The plan targeted a reduction in workforce of approximately 70 employees at the Congers Facilities, 25 employees at the Culver, Indiana facility (the "Culver Facility") and 5 employees in Rockford, Illinois.

In implementing the restructuring plan at the Culver Facility, the reduction in work force involved approximately 25 employees engaged in or supporting the manufacture of doxycycline hyclate and doxycycline monohydrate APIs which were converted to finished dosage products at the Congers Facilities. With the closure of the Congers Facilities the APIs manufactured at the Culver Facility were not required. The Culver Facility work force reduction was substantially completed by December 31, 2003.

In implementing the restructuring plan at the Rockford, Illinois administrative office facility, the Company terminated its Rockford office lease agreement and relocated the administrative functions to Palatine, Illinois. This process was completed on February 29, 2004 resulting in a reduction in work force of 5 employees.

In implementing the restructuring of operations at the Congers Facilities, the reduction in work force involved essentially all of the employees at the site. Finished generic product manufacturing operations substantially ceased on January 30, 2004. Packaging and labeling operations ceased approximately February 12, 2004 and quality assurance and related support activities ceased on approximately February 27, 2004. Such dates also mark the substantial completion of the reduction in work force of approximately 70 employees engaged in these activities at the Congers Facilities. From approximately March 1, 2004 to March 19, 2004 a small logistics, maintenance and warehouse staff prepared the Congers Facilities for sale to IVAX Pharmaceuticals as discussed below.

In implementing the restructuring adopted by the Board, the Company has transitioned to a single vertically integrated operations site located in Culver, Indiana. The Company's strategy and key activities to be conducted at the Culver Facility are as follows:

- Development of the Company's ADF Technology for use in orally administered opioid finished dosage products.

- Manufacture and quality assurance release of clinical trial supplies of certain finished dosage form products utilizing the ADF Technology.

- Evaluation of certain finished dosage products utilizing the ADF Technology in clinical trials.

- Scale-up and manufacture of commercial quantities of certain products utilizing the ADF Technology for sale by the Company's licensees.

- Research, development and scale up of the Company's novel Opioid Synthesis Technologies.

- Prosecution of the Company's application to the DEA to for registration to import NRMs for use in the production of opioid API's utilizing the Company's Opioid Synthesis Technologies.

- Negotiating and executing license and development agreements with strategic pharmaceutical company partners providing that such licensees will further develop certain finished dosage products utilizing the ADF Technology, file for regulatory approval with the FDA and other regulatory authorities and commercialize such products.

As of December 31, 2003, the Company has recorded aggregate restructuring expenses of approximately $3,280,000 consisting of an impairment charge of $1,673,000 against property, plant and equipment, an impairment charge of $1,354,000 against inventory (charged against cost of sales), and $253,000 of other costs. All restructuring costs have been reserved for at December 31, 2003.

On February 6, 2004, the Company consummated a private offering of convertible senior secured debentures (the "2004 Debentures") in the aggregate principal amount of approximately $12.3 million (the "2004 Debenture Offering"). The 2004 Debentures were issued by the Company pursuant to a certain Debenture and Share Purchase Agreement dated as of February 6, 2004 (the "2004 Purchase Agreement") by and among the Company, Care Capital, Essex, Galen and each of the purchasers listed on the signature page thereto. Of the approximate $12.3 million in debentures issued on February 6, 2004 under the 2004 Debenture Offering, approximately $2.0 million of 2004 Debentures were issued in exchange for the surrender of a like amount of principal plus accrued and unpaid interest under the Company's 2002 Debentures issued to Care Capital, Essex and Galen during November and December, 2003 pursuant to the Letter of Support. As the conversion price of such debentures was less than the fair market value of the Company's common stock on the date of issue, beneficial conversion features were determined to exist. The Company recorded approximately $12.3 million of debt discount limited to the face amount of the new debt, which is being amortized over the life of the debt, which matures July 31, 2004, subject to extension to October 31, 2004. During the three months ended March 31, 2004, the Company recognized approximately $3.8 million of amortization expense from this transaction.

On April 14, 2004, the Company completed an additional closing under the 2004 Purchase Agreement pursuant to which the Company issued additional 2004 Debentures in the aggregate principal amount of $579,000, bringing the aggregate principal amount of 2004 Debentures issued by the Company under the 2004 Purchase Agreement to $12.879 million. As the conversion price of such debentures was less than the fair market value of the Company's common stock on the date of issue, beneficial conversion features were determined to exist. The Company recorded approximately $0.6 million of debt discount limited to the face amount of the new debt, which will be amortized over the life of the debt, which matures July 31, 2004, subject to extension to October 31, 2004.

The 2004 Purchase Agreement further provides that the Company may issue additional 2004 Debentures in the principal amount of up to approximately $1.1 million on or prior to June 5, 2004, provided that the aggregate principal amount of 2004 Debentures issued pursuant to the 2004 Purchase Agreement shall not exceed $14.0 million without the consent of the holders of 60% of the principal amount of the 2004 Debentures then held by Care Capital, Essex and Galen.

The 2004 Debentures, issued at par, bear interest at the rate of 1.62% per annum, the short-term Applicable Federal Rate on the date of issuance. The 2004 Debentures are secured by a lien on all assets of the Company. In addition, each of Houba, Inc. and Axiom Pharmaceutical Corporation, each a wholly-owned subsidiary of the Company, has executed in favor of the 2004 Debenture holders, an unconditional agreement of guaranty of the Company's obligations under the 2004 Purchase Agreement. Each guaranty is secured by all assets of such subsidiary. In addition, the Company has pledged the stock of each such subsidiary to the holders of the 2004 Debentures to further secure its obligations under the 2004 Purchase Agreement.

In accordance with the terms of an Amended and Restated Subordination Agreement dated as of February 6, 2004 between the Company, the holders of the 2004 Debentures and the holders of the Company's other outstanding debentures, the liens on the Company's and its subsidiary's assets as well as the payment priority of the 2004 Debentures are (i) subordinate to the Company's lien and payment obligations in favor of Watson Pharmaceuticals under the Watson Term Loan Agreement, and (ii) senior to the Company's lien and payment obligations in favor of the holders of the Company's other outstanding debentures in the aggregate principal amount of approximately $87.7 million.

The 2004 Debentures (including the principal amount plus interest accrued at the date of conversion) will convert automatically into the Company's Series A convertible preferred stock (the "Series A Preferred") immediately following the Company's receipt of shareholder approval at its next shareholders' meeting to restate the Company's Certificate of Incorporation (the "Charter Amendment") to authorize the Series A Preferred and the Junior Preferred Shares (as described below) and the filing of the Charter Amendment with the Office of the New York Department of State (the date of such filing, the "Charter Amendment Filing Date"), as provided in the 2004 Purchase Agreement. The 2004 Debentures will convert into Series A Preferred at a price per share (the "Series A Conversion Price") of $0.6425, representing the average of the closing bid and asked prices of the Company's Common Stock for the twenty (20) trading days ending February 4, 2004, as reported by the Over-the-Counter ("OTC") Bulletin Board. The Series A Conversion Price is subject to adjustment, from time to time, to equal the consideration per share received by the Company for its Common Stock, or the conversion/exercise price per share of the Company's Common Stock issuable under rights or options for the purchase of, or stock or other securities convertible into, Common Stock ("Convertible Securities"), if lower than the then applicable Series A Conversion Price.

Based on the $0.6425 Series A Conversion Price of the Series A Shares and estimating the interest accrual under the 2004 Debentures prior to the Charter Amendment Filing Date, the 2004 Debentures with an aggregate principal amount of $14.0 million would be convertible into an aggregate of approximately 22 million Series A Preferred shares.

In general, the Series A Preferred shares have a liquidation preference equal to five (5) times the initial $0.6425 Series A Conversion Price (the "Series A Liquidation Preference"). In addition, the Series A Preferred shares are convertible into the Company's Common Stock, with each Series A Preferred share convertible into the number of shares of Common Stock obtained by dividing (i) the Series A Liquidation Preference, by (ii) the $0.6425 Series A Conversion Price, as such conversion price may be adjusted, from time to time, pursuant to the dilution protections of such shares. Without limiting the Series A Liquidation Preference, the holders of Series A Preferred shares also have the right to participate with the holders of the Company's Common Stock upon the occurrence of a liquidation event, including the Company's merger, sale of all or substantially all of its assets or a change of control transaction, on an as-converted basis (but for these purposes only, assuming the Series A Preferred shares to be convertible into only thirty percent (30%) of the shares of Common Stock into which they are otherwise then convertible). The holders of Series A Preferred shares also have the right to vote as part of a single class with all holders of the Company's voting securities on all matters to be voted on by such security holders. Each holder of Series A Preferred shares will have such number of votes as shall equal the number of votes he would have had if such holder converted all Series A Preferred shares held by such holder into shares of Common Stock immediately prior to the record date relating to such vote.

The 2004 Purchase Agreement provides that each of Care Capital, Essex and Galen (collectively, the "Lead 2004 Investors") has the right to designate for nomination one member of the Company's Board of Directors, and that the Lead Investors collectively may designate one additional member of the Board (collectively, the Designees"). The Purchase Agreement further provides that the Designees, if so requested by such Designee in his sole discretion, shall be appointed to the any Committee of the Board of Directors. The Designees of Care Capital, Essex and Galen are Messrs. Karabelas, Thangjaraj and Wesson, respectively, each of whom are current Board members. Effective as of the closing of the 2004 Purchase Agreement, the Lead 2004 Investors may collectively nominate one additional Designee to the Board. The Company has agreed to nominate and appoint to the Board of Directors, subject to shareholder approval, one designee of each of Care Capital, Essex and Galen, and one collective designee of the Lead 2004 Investors, for so long as each holds a minimum of 50% of the Series A Preferred shares initially issued to such party (or at least 50% of

the shares of Common Stock issuable upon conversion of the Series A Preferred shares).

As of February 6, 2004, the date of the initial closing of the 2004 Purchase Agreement, the Company had issued and outstanding an aggregate of approximately $87.7 million in principal amount of 5% convertible senior secured debentures maturing March 31, 2006 issued pursuant to three separate Debenture Purchase Agreements dated March 10, 1998, as amended (the "1998 Debentures"), May 26, 1999, as amended (the "1999 Debentures") and December 20, 2002 (the "2002 Debentures"), respectively. The 1998 Debentures, 1999 Debentures and 2002 Debentures are referred to collectively as the "1998-2002 Debentures". After giving effect to the Company's issuance of additional 5% convertible senior secured debentures in satisfaction of interest payments on the 1998-2002 Debentures, as of February 6, 2004, the 1998-2002 Debentures were convertible into an aggregate of approximately 190.4 million shares of the Company's Common Stock.

Simultaneous with the execution of the 2004 Purchase Agreement, and as a condition to the initial closing of the 2004 Purchase Agreement, the Company, the 2004 Debenture Investor Group and each of the holders of the 1998-2002 Debentures executed a certain Debenture Conversion Agreement, dated as of February 6, 2004 (the "Conversion Agreement"). In accordance with the terms of the Conversion Agreement, each holder of the 2004 Debentures agreed to convert the 2004 Debentures held by such holder into the Company's Series A Preferred shares and each holder of 1998-2002 Debentures agreed to convert the 1998-2002 Debentures held by such holder into the Company's Series B convertible preferred stock (the "Series B Preferred") and/or Series C-1, C-2 and/or C-3 convertible preferred stock (collectively, the "Series C Preferred"). The Series C Preferred Shares together with the Series B Preferred Shares are herein referred to as, the "Junior Preferred Shares", and the Junior Preferred Shares together with the Series A Preferred, are collectively referred to as the "Preferred Stock". The Conversion Agreement provides, among other things, for the automatic conversion of the 2004 Debentures and the 1998-2002 Debentures (collectively, the "Outstanding Debentures") into the appropriate class of Preferred Stock immediately following the Company's receipt of shareholder approval to the Charter Amendment authorizing the creation of the Preferred Stock and the filing of the Charter Amendment with the Office of the New York Department of State.

Under the Conversion Agreement, the holders of approximately $6.7 million in principal amount of 2002 Debentures issued during 2003 will convert such 2002 Debentures (plus accrued and unpaid interest) into Series B Preferred Shares. Of the remaining approximate $81.0 million in principal amount of the 1998-2002 Debentures, approximately $31.6 million is comprised of 1998 Debentures, approximately $21.8 million is comprised of 1999 Debentures and approximately $27.6 million is comprised of 2002 Debentures. The 1998 Debentures will be converted into Series C-1 Preferred shares. The 1999 Debentures will be converted into Series C-2 Preferred shares. The remaining balance of the 2002 Debentures shall be converted into Series C-3 Preferred shares.

The number of Junior Preferred Shares to be received by each holder of 1998-2002 Debentures is based on the respective prices at which the 1998-2002 Debentures were convertible into Common Stock. The 2002 Debentures issued in 2003 have a conversion price of $0.3420 per share. The 1998 Debentures, 1999 Debentures and the remaining balance of the 2002 Debentures have conversion prices of $0.5776, $0.5993 and $0.3481 per share, respectively. Based on the respective conversion prices of the 1998-2002 Debentures, and estimating the interest accrual on the 1998-2002 Debentures prior to the Charter Amendment Filing Date, the 1998-2002 Debentures are convertible into an aggregate of approximately 20.0 million Series B Preferred shares, 56.5 million Series C-1 Preferred shares, 37.5 million Series C-2 Preferred shares and 80.9 million Series C-3 Preferred shares.

In general, the Junior Preferred Shares have a liquidation preference equal to one (1) time the principal amount plus accrued and unpaid interest of the 1998-2002 Debentures converted into Junior Preferred Shares The liquidation preference of the Series B Preferred has priority over, and will be satisfied prior to, the liquidation preference of the Series C Preferred. The liquidation preference for each class of the Junior Preferred Shares is equal to the conversion prices of such shares. The Junior Preferred Shares are convertible into the Company's Common Stock, with each Junior Preferred Share convertible into one share of Common Stock. The holders of the Junior Preferred Shares have the right to vote as part of the single class with all holders of the Company's Common Stock and the holders of the Series A Preferred on all matters to be voted on by such stockholders, with each holder of Junior Preferred Shares having such

number of votes as shall equal the number of votes he would have had if such holder had converted all Junior Preferred Shares held by such holder into Common Stock immediately prior to the record date relating to such vote.

The Company was a party to a certain loan agreement with Watson Pharmaceuticals ("Watson") pursuant to which Watson made term loans to the Company (the "Watson Term Loan Agreement") in the aggregate principal amount of $21.4 million as evidenced by two promissory notes (the "Watson Notes"). It was a condition to the completion of the 2004 Debenture Offering that simultaneous with the closing of the 2004 Purchase Agreement, the Company shall have paid Watson the sum of approximately $4.3 million (which amount was funded from the proceeds of the 2004 Debenture Offering) and conveyed to Watson certain Company assets in consideration for Watson's forgiveness of approximately $16.4 million of indebtedness under the Watson Notes. As part of such transaction, the Watson Notes were amended to extend the maturity date of such notes from March 31, 2006 to June 30, 2007, to provide for satisfaction of future interest payments under the Watson Notes in the form of the Company's Common Stock, to reduce the principal amount of the Watson Notes from $21.4 million to $5.0 million, and to provide for the forbearance from the exercise of rights and remedies upon the occurrence of certain events of default under the Watson Notes (the Watson Notes as so amended, the "Amended and Restated Watson Note"). Simultaneous with the issuance of the Amended and Restated Watson Note, each of the Lead 2004 Investors and the other investors in the 2004 Debentures as of February 6, 2004 (collectively, the "Watson Note Purchasers") purchased the Amended and Restated Note from Watson in consideration for a payment to Watson of $1.0 million.

In addition to Watson's forgiveness of approximately $16.4 million under the Watson Notes, as additional consideration for the Company's payment to Watson of approximately $4.3 million and the Company's conveyance of certain Company assets, all current supply agreements between the Company and Watson were cancelled and Watson waived the dilution protections contained in the Common Stock purchase warrant dated December 20, 2002 exercisable for approximately 10.7 million shares of the Company's Common Stock previously issued by the Company to Watson, to the extent such dilution protections were triggered by the transactions provided in the 2004 Debenture Offering.

The Amended and Restated Watson Note in the principal amount of $5.0 million as purchased by the Watson Note Purchasers is secured by a first lien on all of the Company's and its subsidiaries' assets, senior to the lien securing the Outstanding Debentures and all other Company indebtedness, carries a floating rate of interest equal to the prime rate plus 4.5% that is payable quarterly in shares of the Company's common stock, and matures on June 30, 2007.

As part of the restructuring of the Company's operations, in February, 2004, the Company sold certain non-revenue generating abbreviated new drug applications ("ANDAs"). Additionally, on March 19, 2004, the Company and its wholly-owned subsidiary, Axiom Pharmaceutical Corporation, entered into an Asset Purchase Agreement with IVAX Pharmaceuticals New York LLC ("IVAX"). Pursuant to the Purchase Agreement, the Company and Axiom agreed to sell to IVAX substantially all of the Company's assets used in the operation of the Company's former manufacturing and packaging locations in Congers, New York. Shareholder approval is necessary to complete this transaction and will be sought of the Company's next annual meeting of shareholders. The cash proceeds received from this Purchase Agreement have been recorded as deferred asset proceeds on the Company's balance sheet until shareholder approval is received. After giving effect to the payment of legal and other professional fees relating to these assets divestment transactions, the Company estimates that it will realize aggregate net proceeds of approximately $4.3 million from such transactions.

The development and commercialization of APIs and finished dosage products incorporating the Company's Opioid Synthesis Technologies and ADF Technology are subject to various factors, many of which are outside the Company's control. For instance, only a portion of such technologies have been tested in laboratory settings, none have been tested in clinical settings, and all of such technologies will need to be successfully scaled up to be commercially viable, of which no assurance can be given. Additionally, the Company must satisfy, and continue to maintain compliance with, the DEA's and FDA's requirements for the maintenance of its controlled substances manufacturing registrations. The process of seeking a DEA registration to import NRMs and contesting opposition proceedings, and the continuing development of the Company's Opioid Synthesis Technologies and ADF Technology are intended to continue through 2004. The Company is currently unable to provide any assurance that

such technologies will be commercially viable, that the patent application associated with the ADF Technology will issue, or if such patent issues that the claims granted will be sufficiently broad to provide economic value. Additionally no assurance can be given that the Company will succeed in obtaining the DEA registration to import NRMs. The Company is committing substantially all of its resources, and available capital to the development of the Opioid Synthesis Technologies and ADF Technology. The failure of the Company to successfully develop the ADF Technology will have a material adverse effect on the Company's operations and financial condition. The Company's cash flow and limited sources of available financing make it uncertain that the Company will have sufficient capital to continue to fund operations or to otherwise complete the development of the Opioid Synthesis and ADF Technologies, to obtain required DEA and FDA approvals and to fund the capital improvements necessary for the manufacture of APIs and finished dosage products incorporating such technologies.

In view of the matters described above, recoverability of a major portion of the recorded asset amounts shown in the accompanying consolidated balance sheets is dependent upon continued operations of the Company, which in turn are dependent upon the Company's ability to meet its financing requirements on a continuing basis, to maintain present financing, and to succeed in its future operations. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

NOTE 3 - NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued Financial Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN No. 46"), which addresses consolidation by business enterprises of variable interest entities (VIEs). In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. A variable interest entity often holds financial assets, including loans or receivables, real estate or other property. A variable interest entity may be essentially passive or it may engage in activities on behalf of another company. Until now, a company generally has included another entity in its consolidated financial statements only if it controlled the entity through voting interests. FIN No. 46 changes that by requiring a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. The accounting provisions and disclosure requirements of FIN No. 46 are effective immediately for VIEs created or acquired after January 31, 2003, and are effective for the Company's interim period ending March 31, 2004, for VIEs created prior to February 1, 2003. In December 2003, the FASB published a revision to FIN No. 46 ("FIN No. 46R") to clarify some of the provisions of the interpretation and to defer the effective date of implementation for certain entities. Under the guidance of FIN No. 46R, public companies that have interests in VIE's that are commonly referred to as special purpose entities are required to apply the provisions of FIN No. 46R for periods ending after December 15, 2003. A public company that does not have any interests in special purpose entities but does have a variable interest in a VIE created before February 1, 2003, must apply the provisions of FIN No. 46R by the end of the first interim or annual reporting period ending after March 14, 2004. During the quarter ended March 31, 2004 the Company adopted the provisions of FIN No. 46R. Adoption of FIN No. 46R did not have a material effect on the Company's financial statements.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," ("SFAS No. 149"), which amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 except for the provisions that were cleared by the FASB in prior pronouncements. The adoption of SFAS No. 149 did not have a material impact on the Company's financial position or results of operations.

In May 2003, the FASB issued "SFAS No. 150", "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS No. 150"). This statement establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. In accordance with the standard, financial instruments that embody obligations for the issuer are required to be classified as liabilities. This Statement shall be effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 did not have a material impact

on the Company's financial position or results of operations.

NOTE 4 - RECLASSIFICATIONS

Certain reclassifications have been made to the prior years' amounts to conform to the current year's presentation.

NOTE 5 - EARNINGS (LOSS) PER SHARE

Basic earnings per share is computed by dividing net income (loss) by the weighted average common shares outstanding during the period. Diluted earnings per share is based on the treasury stock method and is computed by dividing net income by the weighted average common shares and common share equivalents outstanding during the periods presented assuming the exercise of all in-the-money stock options. Common share equivalents have been excluded where their inclusion would be anti-dilutive. A reconciliation of the numerator and denominators of basic and diluted earnings per share for the Quarters ended March 31, 2004 and March 31, 2003 consisted of the following (in thousands except per share amount):

QUARTER ENDED MARCH 31,	2004	2003
NUMERATOR:		
Net income (loss)	$ 680	$(10,575)
DENOMINATOR:		
Basic weighted average shares outstanding	21,602	21,035
Convertible debentures	249,479	-
Warrants	6,939	-
Stock options	-	-
Diluted weighted average shares outstanding	278,020	21,035
Basic earnings per share	$ .03	$ (.50)
Diluted earnings per share	$ .00	$ (.50)

For the quarter ended March 31, 2004, stock options and warrants to purchase 3.4 million and 9.7 million common shares respectively, were outstanding but not included in the computation of diluted earnings per share because the exercise prices were greater than the average market price of the common shares. For the Quarter ended March 31, 2003, approximately 199,850,000 of outstanding warrants, options, and the effect of convertible debentures and convertible bridge loans outstanding, have been excluded from the computation of diluted earnings per share as they would be antidilutive to the reported net loss.

NOTE 6 - INVENTORIES

Inventories consist of the following:

	MARCH 31, 2004	DECEMBER 31, 2003
	(IN THOUSANDS)	
Finished Goods.....	$ 705	$ 357
Work in Process.....	198	953
Raw Materials.....	211	356
	1,114	1,666
Less impairment reserve.....	(1,114)	(1,354)
	$ -	$ 312

NOTE 7 - ACCRUED EXPENSES

Accrued expenses are summarized as follows:

	MARCH 31, 2004	DECEMBER 31, 2003
	(IN THOUSANDS)	
Payroll, Payroll Taxes and Benefits	$ 232	$ 468
Professional and Director Fees	200	536
Property and Sales Taxes	147	142
Other	773	962
	$ 1,352	$ 2,108

NOTE 8 - CONVERTIBLE SUBORDINATED DEBENTURES

Convertible Subordinated Debentures consist of the following:

	MARCH 31, 2004	DECEMBER 31, 2003
	(IN THOUSANDS)	
1998 Debentures	$ 31,212	$ 31,212
1999 Debentures	21,485	21,485
2002 Debentures	27,303	27,303
2003 Debentures	6,632	6,632
2004 Debentures	12,313	--
	98,945	86,632
Less: Debt discount	(59,029)	(56,893)
	39,916	29,739
Less: Current maturities, net	(3,849)	--
	$ 36,067	$ 29,739

During the three months ended March 31, 2003, the Company issued $600,000 in new debentures as payment of accrued interest in the same amount of these debentures. Such debentures are convertible into 645,161 shares of the Company's common stock at a conversion price of $0.93.

Related-Party Transactions

Certain of the 1998 Debentures and 1999 Debentures are held a member of the Company's management and Board of Directors. The aggregate principal amount of such debentures was approximately $173,000 at March 31, 2004 and December 31, 2003, respectively. Interest expense on these debentures was approximately $2,200 and $4,600 for the quarters ended March 31, 2004 and 2003, respectively.

Indemnification

Each of the purchase agreements for the Company's 1998 Debentures, 1999 Debentures, 2002 Debentures, 2003 Debentures and Bridge Loans, and 2004 Debentures contain provisions by which the Company is obligated to indemnify the purchasers of the debentures for any losses, claims, damages, liabilities, obligations, penalties, awards, judgments, expenses or disbursements arising out of or resulting from the breach of any representation, warranty or agreement of the Company related to the purchase of the debentures and bridge loans. These indemnification obligations do not include a limit on maximum potential future payments, nor are there any recourse provisions or collateral that may offset the cost. As of March 31, 2004, the Company does not believe that any liability has been incurred as a result of these indemnification obligations.

NOTE 9 - TERM NOTE PAYABLE

In connection with various strategic alliance transactions between the Company and Watson completed in 2001, Watson advanced $17,500,000 to the Company under the Watson Term Loan. The loan was secured by a first lien on all of the Company's assets, senior to the lien securing all other Company indebtedness, and carried a floating rate of interest equal to prime plus two percent and had an original maturity date of March 31, 2004. As part of the Company's 2002 Debenture Offering, the Watson Term Loan was amended to (1) extend the maturity date to March 31, 2006, (2) increase the interest rate to prime plus four and one half percent and (3) increase the principal amount to $21,401,331 to reflect the inclusion of the Company's payment obligations under the Core Products Supply Agreement between Watson and the Company. In consideration of the amendment to the Watson Term Loan, the Company issued to Watson a common stock purchase warrant ("Watson Warrant") exercisable for 10,700,665 shares of the Company's common stock at an exercise price of $0.34 per share. The warrant has a term expiring December 31, 2009. The fair value of the Watson Warrant on the date of grant, as calculated using the Black-Scholes option-pricing model, of $11,985,745 was charged to earnings on the date of grant as a loss on the extinguishment of debt. As of December 31, 2003, Watson had advanced $21,401,331 to the Company under the Watson Term Loan and the interest rate was 8.5%.

In satisfaction of a condition to the completion of the 2004 Debenture Offering, simultaneous with the closing of the 2004 Purchase Agreement, the Company paid Watson the sum of approximately $4.3 million (which amount was funded from the proceeds of the 2004 Debenture Offering) and conveyed to Watson certain Company assets in consideration for Watson's forgiveness of approximately $16.4 million of indebtedness under the Watson Notes. As part of such transaction, the Watson Notes were amended to extend the maturity date of such notes from March 31, 2006 to June 30, 2007, to provide for satisfaction of future quarterly interest payments under the Watson Notes in the form of the Company's Common Stock, to reduce the principal amount of the Watson Notes from $21.4 million to $5.0 million, and to provide for the forbearance from the exercise of rights and remedies upon the occurrence of certain events of default under the Watson Notes (the Watson Notes as so amended, the "Amended and Restated Watson Note"). Simultaneous with the issuance of the Amended and Restated Watson Note, each of the Lead 2004 Investors and the other investors in the 2004 Debentures as of February 6, 2004 (collectively, the "Watson Note Purchasers") purchased the Amended and Restated Note from Watson in consideration for a payment to Watson of $1,000,000.

In addition to Watson's forgiveness of approximately $16.4 million under the Watson Notes, as additional consideration for the Company's payment to Watson of approximately $4.3 million and the Company's conveyance of certain Company assets, all current supply agreements between the Company and Watson were cancelled and Watson waived the dilution protections contained in the Watson Warrant, to the extent such dilution protections were triggered by the transactions provided in the 2004 Debenture Offering.

The Amended and Restated Watson Note in the principal amount of $5.0 million as purchased by the Watson Note Purchasers is secured by a first lien on all of the Company's and its subsidiaries' assets, senior to the lien securing the Outstanding Debentures and all other Company indebtedness, carries a floating rate of interest equal to the prime rate plus 4.5% and matures on June 30, 2007. The interest rate at March 31, 2004 was 8.50%.

NOTE 10 - INCOME TAXES

The Company has not provided for any tax expense during the the three months ended March 31, 2004, as a result of utilizing net operating loss carry forwards not previously provided for. Historically, the Company has incurred significant losses from operations and until such time as the research and development efforts are commercialized, for which no assurance can be given, the Company will continue to incur operating losses.

NOTE 11 - STOCK-BASED COMPENSATION

The Company accounts for stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations ("APB No. 25") and has adopted the disclosure provisions of Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation -- Transition and Disclosure, an amendment of FASB Statement No. 123." Under APB No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. Accordingly, no compensation expense has been recognized in the consolidated financial statements in connection with employee stock option grants.

The following table illustrates the effect on net income and earnings per share had the Company applied the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation.

	THREE MONTHS ENDED MARCH 31, 2004	2003
	(IN THOUSANDS, EXCEPT PER SHARE DATA)	
Net income (loss), as reported	$ 680	$ (10,575)
Deduct: Total stock-based employee compensation expense determined under fair value-based method for all awards	(64)	(194)
Pro forma net income (loss)	$ 616	$ (10,769)
Basic EPS -- as reported	$ .03	$ (0.50)
Basic EPS -- pro forma	$ .03	$ (0.51)
Diluted EPS -- as reported	$ .00	$ (0.50)
Diluted EPS -- pro forma	$ .00	$ (0.51)

Pro forma compensation expense may not be indicative of future disclosures because they do not take into effect pro forma compensation expense related to grants before 1995. For purposes of estimating the fair value of each option on the date of grant, the Company utilized the Black-Scholes option-pricing model.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

NOTE 11 - COMMITMENTS AND CONTINGENCIES

U.S. Department of Justice Settlement

On June 21, 1993, the Company entered into a Plea Agreement with the U.S. Department of Justice (the "DOJ") to resolve the DOJ's investigation into the manufacturing and record keeping practices of the Company's Brooklyn, New York plant. The Plea Agreement required the Company to pay a fine of $2,500,000 over five years in quarterly installments of $125,000, commencing on or about September 15, 1993.

As of February 28, 1998, the Company was in default of the payment terms of the Plea Agreement and had made payments aggregating $350,000. On May 8, 1998, the Company and the DOJ signed the Letter Agreement serving to amend the Plea Agreement relating to the terms of the Company's satisfaction of the fine assessed under the Plea Agreement. Specifically, the Letter Agreement provided that the Company will satisfy the remaining $2,150,000 of the fine through the monthly payments of $25,000 commencing June 1, 1998, plus interest on such outstanding balance (at the rate calculated pursuant to 28 U.S.C. Section 1961 (5.319%). Such payment schedule provide for the full satisfaction of the DOJ fine in July 2005. The Letter Agreement also provides certain restrictions on the payment of salary or compensation to any individual in excess of certain amounts without the written consent of the DOJ. In addition, the Letter Agreement requires the repayment of the outstanding fine to the extent of 25% of the Company's after-tax profit or 25% of the net proceeds received by the Company on any sale of a capital asset for a sum in excess of $10,000, if not invested in another capital asset. At December 31, 2003, the Company was current in its payment obligations, with a remaining obligation of $433,000. In February 2004, the Company fully satisfied its obligation to the DOJ.

Employment Contracts

During April 2004, the Company entered into an employment agreement with a new officer/employee of the Company. The agreement provides for, among other things: (i) an annual base salary of $260,000, and (ii) an aggregate of 3,000,000 options to purchase the Company's stock at an exercise price of $0.13 per common share that vest 1,000,000 option shares on October 1, 2004 and the balance thereafter at a rate of 333,333 per calendar quarter, beginning January 1, 2005 with an exercise term expiring in ten years. The stock option is subject to the shareholders approval to modify the Company's 1998 Stock Option Plan to (i) increase the number of shares reserved for issuance and (ii) authorize issuance of stock options having an exercise price less than fair market value of the common stock of the Company on the date of issuance. The employment agreement term is for a two year period which automatically renews for successive one-year periods unless either the Company or the employee provides 90 days' notice of non-renewal.

During August 2003, the Company entered into an employment agreement with a new officer/employee of the Company. The agreement provides for, among other things: (i) an annual base salary of $300,000, and (ii) an aggregate of 5,500,000 options to purchase the Company's stock at an exercise price of $0.34 per common share that vest 1,000,000 option shares on March 31, 2004 and the balance thereafter at a rate of 500,000 per calendar quarter, beginning June 30, 2004 which an exercise term expiring in ten years. The stock option is subject to the shareholders approval to modify the Company's 1998 Stock Option Plan to (i) increase the number of shares reserved for issuance and (ii) authorize issuance of stock options having an exercise price less than fair market value of the common stock of the Company on the date of issuance. The employment agreement term is for a two year period which automatically renews for successive one-year periods unless either the Company or the employee provides 90 days' notice of non-renewal. The Company is in the process of finalizing an amendment to the employment agreement, among other things, to adjust the Company's commitment to issue stock options from 5,500,000 shares to 8,750,000 shares and to provide for an exercise price of $0.13 per share. Upon grant, the option will have a ten-year term and will provide for vesting in the amount of 2,750,000 shares on June 30, 2004 and the balance thereafter at a rate of 250,000 shares per calendar month, beginning July 31, 2004.

During April 2004, the Company committed to issue to current employees stock options that upon grant, will be exercisable for an aggregate of 1,425,000 shares of the Company's common stock at an exercise price of $0.13 per common share and will vest 25% annually over four years and provide for immediate vesting upon change of control. The grant of these stock options is subject to the shareholders approval to modify the Company's 1998 Stock Option Plan to (i) increase the number of shares reserved for issuance and (ii) authorize issuance of stock options having an exercise price less than fair market value of the common stock of the Company on the date of issuance.

Other Legal Proceedings

Beginning in 1992, actions were commenced against the Company and numerous other pharmaceutical manufacturers, in connection with the alleged exposure to diethylstilbestrol ("DES"). The defense of all of such matters was assumed by the Company's insurance carrier, and a substantial number have been settled by the carrier. Currently, several actions remain pending with the Company as a defendant in the Pennsylvania Court of Common Pleas, Philadelphia Division, and the insurance carrier is defending each action. The Company and its legal counsel do not believe any of such actions will have a material impact on the Company's financial condition. The ultimate outcome of these lawsuits cannot be determined at this time, and accordingly, no adjustment has been made to the consolidated financial statements.

The Company is named as a defendant in an action entitled Alfred Kohn v. Halsey Drug Co. in the Supreme Court of New York, Bronx County. The plaintiff seeks damages of $1 million for breach of an alleged oral contract to pay a finder's fee for a business transaction involving the Company. Discovery in this action has been completed. The Company's motion for summary judgment was due to be heard by the Court on August 8, 2003. Plaintiff Kohn deceased shortly prior to such hearing date, and the motion for summary judgment and any trial of this matter have been stayed pending the substitution of Mr. Kohn's estate as the plaintiff. The Company does not believe this action will have a material impact on the Company's financial condition. The ultimate outcome of this lawsuit cannot be determined at this time, and accordingly, no adjustment has been made to the consolidated financial statements.

On June 13, 2002, the Company was named an additional defendant in an Amended Complaint filed in the matter entitled Vintage Pharmaceuticals, Inc., v. Watson Pharmaceuticals, Inc., and Halsey Drug Company, Inc., pending in the United States District Court for the Northern District of Alabama, Civil Action No. CV 01-B-1847-NE. Vintage seeks unspecified damages from the Company for allegedly interfering with Vintage's contract to produce Monodox(R), the brand name of doxycycline monohydrate, for Watson. During the first quarter 2004, Watson's motion for summary judgment was approved by the Court and the case was dismissed against Watson. In May 2004, the Company filed for and received an order dismissing this case with prejudice.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCE CONDITION AND RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2004 VS. THREE MONTHS ENDED MARCH 31, 2003

NET PRODUCT REVENUES

The Company's net product revenues for the three months ended March 31, 2004 of $628,000 represents a decrease of $898,000 (59%) as compared to net revenues for the three months ended March 31, 2003 of $1,526,000. The decrease in net product revenues was primarily a result of the Company's decision in the fourth quarter of 2003 to restructure operations and cease the manufacture of finished dosage products. The net product revenues in the first quarter of 2004 reflect the sale of substantially all remaining inventories of saleable finished dosage products by the Company.

COST OF MANUFACTURING

For the three months ended March 31, 2004, cost of manufacturing decreased $1,620,000 as compared to the three months ended March 31, 2003. As a percentage of sales, cost of manufacturing was 200% and 188% for March 31, 2004 and 2003, respectively. The percentage increase reflects the remaining fixed costs of manufacturing during the shutdown of operations at the Company's generic finished dosage manufacturing operations in the first quarter of 2004. The shutdown of generic finished dosage manufacturing operations was completed in March, 2004.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses as a percentage of sales for the three months ended March 31, 2004 and 2003 were 194% and 112%, respectively. Overall these expenses in the first three months of 2004 decreased $490,000 or 29% for the same period in 2003. The decrease is due primarily to a reduction in sales and marketing expenses of $84,000 reduced payroll expenses of $80,000 resulting from the Company's decision in the fourth quarter of 2003 to eliminate the sale of generic finished dosage products and reduce administrative staff, and a $183,000 benefit for settlement of trade payables at a discount.

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses were $238,000 and $329,000 for the three months ended March 31, 2004 and 2003, respectively. The Company has restructured its operations and expects to devote substantially all of its resources in 2004 to research and development activities relating to its ADF Technologies and Opioid Synthesis Technologies.

NET INCOME (LOSS)

For the three months ended March 31, 2004, the Company had net income of $680,000 as compared to a net loss of $10,575,000 for the three months ended March 31, 2003. Included in net income are gains on debt restructuring of $12,401,000 and asset sales of $1,754,000 and other income of $403,000 relating to settlement of a liability at discount. Also included was interest expense of $958,000 and amortization of deferred debt discount and private offering costs of $10,843,000 as compared to interest expense of $1,433,000 and amortization of deferred debt discount and private offering costs of $5,767,000 for the same period in 2003.

LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2004 the Company had cash and cash equivalents of $7,282,000 as compared to $942,000 at December 31, 2003. The Company had working capital deficit of $2,013,000 at March 31, 2004 and a working capital deficit of $3,770,000 at December 31, 2003. The Company had an accumulated deficit of $208,865,000 and

$209,545,000 as March 31, 2004 and December 31, 2003, respectively. The Company had an operating loss of $2,084,000 during the three months ended March 31, 2004.

On February 6, 2004, the Company consummated a private offering of securities for an aggregate purchase price of approximately $12.3 million (the "2004 Debenture Offering"). The securities issued in the 2004 Debenture Offering consisted of convertible senior secured debentures (the "2004 Debentures"). The 2004 Debentures were issued by the Company pursuant to a certain Debenture and Share Purchase Agreement dated as of February 6, 2004 (the "2004 Purchase Agreement") by and among the Company, Care Capital Investments II, LP ("Care Capital"), Essex Woodlands Health Ventures V, L.P. ("Essex"), Galen Partners III, L.P. and each of the Purchasers listed on the signature page thereto (collectively, the "2004 Debenture Investor Group"). As the conversion price of such debentures was less than the fair market value of the Company's common stock on the date of issue, beneficial conversion features were determined to exist. The Company recorded approximately $12.3 million of debt discount limited to the face amount of the new debt, which is being amortized over the life of the debt, which matures July 31, 2004, subject to extension to October 31, 2004. During the three months ended March 31, 2004, the Company recognized approximately $3.8 million of amortization expense from this transaction.

On April 14, 2004 the Company completed an additional closing under the 2004 Purchase Agreement and issued additional 2004 Debentures in the aggregate principal amount of approximately $579,000, bringing the principal amount of the 2004 Debentures issued by the Company under the 2004 Purchase Agreement to an aggregate amount of approximately $12.879 million. As the conversion price of such debentures was less than the fair market value of the Company's common stock on the date of issue, beneficial conversion features were determined to exist. The Company recorded approximately $.6 million of debt discount limited to the face amount of the new debt, which will be amortized over the life of the debt, which matures July 31, 2004, subject to extension to October 31, 2004.

Of the approximate $12.879 million in 2004 Debentures issued in the 2004 Debenture Offering, approximately $2.0 million of 2004 Debentures were issued in exchange for the surrender of like amount of principal plus accrued interest outstanding under Company's 5% convertible senior secured debentures issued pursuant to working capital bridge loan transactions with Care Capital, Essex Woodlands and Galen Partners III, L.P., Galen International III, L.P., and Galen Employee Fund III, L.P. (collectively, "Galen") during November and December, 2003. The 2004 Purchase Agreement further provides that the Company may issue additional 2004 Debentures in the principal amount of up to approximately $1.121 million on or prior to June 5, 2004, provided that the aggregate principal amount of 2004 Debentures issued pursuant to the 2004 Purchase Agreement shall not exceed $14.0 million without the consent of the holders of 60% of the principal amount of the 2004 Debentures then held by Care Capital, Essex and Galen.

The 2004 Debentures, issued at par, bear interest at the rate of 1.62% per annum, the short-term Applicable Federal Rate on the date of issuance. The 2004 Debentures are secured by a lien on all assets of the Company. In addition, each of Houba, Inc. and Axiom Pharmaceutical Corporation, each a wholly-owned subsidiary of the Company, has executed in favor of the 2004 Debenture holders, an unconditional agreement of guaranty of the Company's obligations under the 2004 Purchase Agreement. Each guaranty is secured by all assets of such subsidiary. In addition, the Company has pledged the stock of each such subsidiary to the holders of the 2004 Debentures to further secure its obligations under the 2004 Purchase Agreement.

In accordance with the terms of an Amended and Restated Subordination Agreement dated as of February 6, 2004 between the Company, the holders of the 2004 Debentures and the holders of the Company's other outstanding debentures, the liens on the Company's and its subsidiary's assets as well as the payment priority of the 2004 Debentures are (i) subordinate to the Company's lien and payment obligations in favor of Watson Pharmaceuticals under the Watson Term Loan Agreement, and (ii) senior to the Company's lien and payment obligations in favor of the holders of the Company's other outstanding debentures in the aggregate principal amount of approximately $87.7 million.

The 2004 Debentures (including the principal amount plus interest accrued at the date of conversion) will

convert automatically into the Company's Series A convertible preferred stock (the "Series A Preferred") immediately following the Company's receipt of shareholder approval at its next shareholders' meeting to restate the Company's Certificate of Incorporation (the "Charter Amendment") to authorize the Series A Preferred and the Junior Preferred Shares (as described below) and the filing of the Charter Amendment with the Office of the New York Department of State (the date of such filing, the "Charter Amendment Filing Date"), as provided in the 2004 Purchase Agreement. The 2004 Debentures will convert into Series A Preferred at a price per share (the "Series A Conversion Price") of $0.6425, representing the average of the closing bid and asked prices of the Company's Common Stock for the twenty (20) trading days ending February 4, 2004, as reported by the Over-the-Counter ("OTC") Bulletin Board. The Series A Conversion Price is subject to adjustment, from time to time, to equal the consideration per share received by the Company for its Common Stock, or the conversion/exercise price per share of the Company's Common Stock issuable under rights or options for the purchase of, or stock or other securities convertible into, Common Stock ("Convertible Securities"), if lower than the then applicable Series A Conversion Price.

Based on the $0.6425 Series A Conversion Price of the Series A Shares and estimating the interest accrual under the 2004 Debentures prior to the Charter Amendment Filing Date, the 2004 Debentures with an aggregate principal amount of $14.0 million would be convertible into an aggregate of approximately 21.8 million Series A Preferred shares.

In general, the Series A Preferred shares have a liquidation preference equal to five (5) times the initial $0.6425 Series A Conversion Price (the "Series A Liquidation Preference"). In addition, the Series A Preferred shares are convertible into the Company's Common Stock, with each Series A Preferred share convertible into the number of shares of Common Stock obtained by dividing (i) the Series A Liquidation Preference, by (ii) the $0.6425 Series A Conversion Price, as such conversion price may be adjusted, from time to time, pursuant to the dilution protections of such shares. Without limiting the Series A Liquidation Preference, the holders of Series A Preferred shares also have the right to participate with the holders of the Company's Common Stock upon the occurrence of a liquidation event, including the Company's merger, sale of all or substantially all of its assets or a change of control transaction, on an as-converted basis (but for these purposes only, assuming the Series A Preferred shares to be convertible into only thirty percent (30%) of the shares of Common Stock into which they are otherwise then convertible). The holders of Series A Preferred shares also have the right to vote as part of a single class with all holders of the Company's voting securities on all matters to be voted on by such security holders. Each holder of Series A Preferred shares will have such number of votes as shall equal the number of votes he would have had if such holder converted all Series A Preferred shares held by such holder into shares of Common Stock immediately prior to the record date relating to such vote.

The 2004 Purchase Agreement provides that each of Care Capital, Essex and Galen (collectively, the "Lead 2004 Investors") has the right to designate for nomination one member of the Company's Board of Directors, and that the Lead Investors collectively may designate one additional member of the Board (collectively, the Designees"). The Purchase Agreement further provides that the Designees, if so requested by such Designee in his sole discretion, shall be appointed to the Company's Executive Committee, Compensation Committee and any other Committee of the Board of Directors. The Designees of Care Capital, Essex and Galen are Messrs. Karabelas, Thangaraj and Wesson, respectively, each of whom are current Board members. Effective as of the closing of the 2004 Purchase Agreement, the Lead 2004 Investors may collectively nominate one additional Designee to the Board. The Company has agreed to nominate and appoint to the Board of Directors, subject to shareholder approval, one designee of each of Care Capital, Essex and Galen, and one collective designee of the Lead 2004 Investors, for so long as each holds a minimum of 50% of the Series A Preferred shares initially issued to such party (or at least 50% of the shares of Common Stock issuable upon conversion of the Series A Preferred shares).

As of February 6, 2004, the date of the initial closing of the 2004 Purchase Agreement, the Company had issued and outstanding and aggregate of approximately $87.7 million in principal amount of 5% convertible senior

secured debentures maturing March 31, 2006 issued pursuant to three separate Debenture Purchase Agreements dated March 10, 1998, as amended (the "1998 Debentures"), May 26, 1999, as amended (the "1999 Debentures") and December 20, 2002 (the "2002 Debentures"), respectively. The 1998 Debentures, 1999 Debentures and 2002 Debentures are referred to collectively as the "1998-2002 Debentures". After giving effect to the Company's issuance of additional 5% convertible senior secured debentures in satisfaction of interest payments on the 1998-2002 Debentures, as of February 10, 2004, the 1998-2002 Debentures were convertible into an aggregate of approximately 190.4 million shares of the Company's Common Stock.

Simultaneous with the execution of the 2004 Purchase Agreement, and as a condition to the initial closing of the 2004 Purchase Agreement, the Company, the 2004 Debenture Investor Group and each of the holders of the 1998-2002 Debentures executed a certain Debenture Conversion Agreement, dated as of February 6, 2004 (the "Conversion Agreement"). In accordance with the terms of the Conversion Agreement, each holder of the 2004 Debentures agreed to convert the 2004 Debentures held by such holder into the Company's Series A Preferred shares and each holder of 1998-2002 Debentures agreed to convert the 1998-2002 Debentures held by such holder into the Company's Series B convertible preferred stock (the "Series B Preferred") and/or Series C-1, C-2 and/or C-3 convertible preferred stock (collectively, the "Series C Preferred"). The Series C Shares together with the Series B Shares are herein referred to as, the "Junior Preferred Shares", and the Junior Preferred Shares together with the Series A Preferred, are collectively referred to as the "Preferred Stock". The Conversion Agreement provides, among other things, for the automatic conversion of the 2004 Debentures and the 1998-2002 Debentures (collectively, the "Outstanding Debentures") into the appropriate class of Preferred Stock immediately following the Company's receipt of shareholder approval to the Charter Amendment authorizing the creation of the Preferred Stock and the filing of the Charter Amendment with the Office of the New York Department of State.

Under the Conversion Agreement, the holders of approximately $6.7 million in principal amount of 2002 Debentures issued during 2003 will convert such 2002 Debentures (plus accrued and unpaid interest) into Series B Preferred Shares. Of the remaining approximate $81 million in principal amount of the 1998-2002 Debentures, approximately $31.6 million is comprised of 1998 Debentures, approximately $21.8 million is comprised of 1999 Debentures and approximately $27.6 million is comprised of 2002 Debentures. The 1998 Debentures will be converted into Series C-1 Preferred shares. The 1999 Debentures will be converted into Series C-2 Preferred shares. The remaining balance of the 2002 Debentures shall be converted into Series C-3 Preferred shares.

The number of Junior Preferred Shares to be received by each holder of 1998-2002 Debentures is based on the respective prices at which the 1998-2002 Debentures were convertible into Common Stock. The 2002 Debentures issued in 2003 have a conversion price of $0.3420 per share. The 1998 Debentures, 1999 Debentures and the remaining balance of the 2002 Debentures have conversion prices of $0.5776, $0.5993 and $0.3481 per share, respectively. Based on the respective conversion prices of the 1998-2002 Debentures, and estimating the interest accrual on the 1998-2002 Debentures prior to the Charter Amendment Filing Date, the 1998-2002 Debentures are convertible into an aggregate of approximately 20.0 million Series B Preferred shares, 56.5 million Series C-1 Preferred shares, 37.5 million Series C-2 Preferred shares and 80.9 million Series C-3 Preferred shares.

In general, the Junior Preferred Shares have a liquidation preference equal to one (1) time the principal amount plus accrued and unpaid interest of the 1998-2002 Debentures converted into Junior Preferred Shares The liquidation preference of the Series B Preferred has priority over, and will be satisfied prior to, the liquidation preference of the Series C Preferred. The liquidation preference for each class of the Junior Preferred Shares is equal to the conversion prices of such shares. The Junior Preferred Shares are convertible into the Company's Common Stock, with each Junior Preferred Share convertible into one share of Common Stock. The holders of the Junior Preferred Shares have the right to vote as part of the single class with all holders of the Company's Common Stock and the holders of the Series A Preferred on all matters to be voted on by such stockholders, with each holder of Junior Preferred Shares having such number of votes as shall equal the number of votes he would have had if such holder had converted all Junior Preferred Shares held by such holder into Common Stock immediately prior to the record date relating to such vote.

The Company was a party to a certain loan agreement with Watson Pharmaceuticals ("Watson") pursuant to which Watson made term loans to the Company (the "Watson Term Loan Agreement") in the aggregate principal amount of $21.4 million as evidenced by two promissory notes (the "Watson Notes"). It was a condition to the completion of the 2004 Debenture Offering that simultaneous with the closing of the 2004 Purchase Agreement, the Company shall have paid Watson the sum of approximately $4.3 million (which amount was funded from the proceeds of the 2004 Debenture Offering) and conveyed to Watson certain Company assets in consideration for Watson's forgiveness of approximately $16.4 million of indebtedness under the Watson Notes. As part of such transaction, the Watson Notes were amended to extend the maturity date of such notes from March 31, 2006 to June 30, 2007, to provide for satisfaction of future interest payments under the Watson Notes in the form of the Company's Common Stock, to reduce the principal amount of the Watson Notes from $21.4 million to $5.0 million, and to provide for the forbearance from the exercise of rights and remedies upon the occurrence of certain events of default under the Watson Notes (the Watson Notes as so amended, the "Amended and Restated Watson Note"). Simultaneous with the issuance of the Amended and Restated Watson Note, each of the Lead 2004 Investors and the other investors in the 2004 Debentures as of February 10, 2004 (collectively, the "Watson Note Purchasers") purchased the Amended and Restated Note from Watson in consideration for a payment to Watson of $1.0 million.

In addition to Watson's forgiveness of approximately $16.4 million under the Watson Notes, as additional consideration for the Company's payment to Watson of approximately $4.3 million and the Company's conveyance of certain Company assets, all supply agreements between the Company and Watson were terminated and Watson waived the dilution protections contained in the Common Stock purchase warrant dated December 20, 2002 exercisable for approximately 10.7 million shares of the Company's Common Stock previously issued by the Company to Watson, to the extent such dilution protections were triggered by the transactions provided in the 2004 Debenture Offering.

The Amended and Restated Watson Note in the principal amount of $5.0 million as purchased by the Watson Note Purchasers is secured by a first lien on all of the Company's and its subsidiaries' assets, senior to the lien securing the Outstanding Debentures and all other Company indebtedness, carries a floating rate of interest equal to the prime rate plus 4.5% and matures on June 30, 2007.

As of April 14, 2004, after giving effect to the payment to Watson of approximately $4.3 million to restructure the Watson Term Loan and the payment of legal and other professional fees relating to the 2004 Debenture Offering, the Company realized net proceeds from the 2004 Debenture Offering of approximately $ 5.8 million (the "2004 Debenture Offering Proceeds").

In February, 2004, the Company sold certain non-revenue generating ANDAs. In addition, on March 19, 2004, the Company and its wholly-owned subsidiary, Axiom Pharmaceutical Corporation, entered into an Asset Purchase Agreement with IVAX Pharmaceuticals New York LLC ("IVAX"). Pursuant to the Purchase Agreement, the Company and Axiom agreed to sell to IVAX substantially all of the Company's assets used in the operation of the Company's former generic manufacturing and packaging operations located in Congers, New York. Shareholder approval is necessary to complete this transaction and will be sought of the Company's next annual meeting of shareholders. The cash proceeds received from this Purchase Agreement have been recorded as deferred asset proceeds on the Company's balance sheet until shareholder approval is received. After giving effect to the payment of legal and other professional fees relating to these assets divestment transactions, the Company estimates that it will realize aggregate net proceeds from such transactions of approximately $4.3 million. (the "Asset Divestment Proceeds").

The development, scale- up and commercialization of APIs incorporating the Company's Opioid Synthesis Technologies and ADF Technology are subject to various factors, many of which are outside the Company's control. To date, a portion of such technologies have been tested in laboratory settings, and none have been tested in clinical

settings. All such technologies will need to be successfully scaled up to be commercially viable, of which no assurance can be given. The Company is unable to provide any assurances that the patent application associated with the ADF Technology will issue, or if such patent issues that the claims granted will be sufficiently broad to provide economic value. Additionally, the Company must satisfy, and continue to maintain compliance with the DEA's and FDA's requirements for the maintenance of its controlled substances research and manufacturing registrations. The process of seeking a DEA registration to import NRMs and the continuing development of the Company's Opioid Synthesis Technologies and ADF Technology are intended to continue through 2004. The Company is unable to provide any assurance that the ADF Technology or the Opioid Synthesis Technologies will be commercially viable. In addition, no assurance can be given that the Company will succeed in obtaining the DEA registration to import NRMs. The Company is committing substantially all of its resources and available capital to the development of the ADF Technology and the Opioid Synthesis Technologies. The failure of the Company to successfully develop the ADF Technology will have a material adverse effect on the Company's operations and financial condition.

The Company estimates that to scale up its hydrocodone bitartrate process #1, Opioid Synthesis Technology to desirable commercial scale at its Culver Facility, additional funding of approximately $7.0 million will be required for facility improvements, the purchase, installation and validation of new API manufacturing equipment, environmental waste management compliance, the preparation of the drug master files for the API to be produced at the facility, and related direct labor expense (collectively, the "API Scale Up Expenses"). The Company is a party to a certain Hydrocodone Option Agreement dated February 6, 2004 with Watson Pharmaceuticals ("Watson") pursuant to which the Company has granted Watson a six (6) month exclusive option to enter into a supply agreement with the Company for supply of hydrocodone bitartrate API (the "Hydrocodone API"). If such option is exercised by Watson, at Watson's sole discretion, of which there can be no assurance, Watson will fund 50% of the API Scale Up Expenses, up to a maximum of $3.5 million and the Company has agreed to use commercially reasonable efforts to obtain financing dedicated to fund its portion of the API Scale Up Expenses. In the event the Company is unable to secure financing dedicated to fund its portion of the API Scale Up Expenses, the Hydrocodone Option provides that the parties will discuss alternatives relating to the scale up of the its Opioid Synthesis Technology for Hydrocodone API.

There can be no assurance that Watson will exercise the Hydrocodone Option or, even if exercised, that the Company will succeed in obtaining financing dedicated to fund its portion of the API Scale Up Expenses. As described in this Report, no portion of the 2004 Debenture Offering Proceeds or the Asset Divestment Proceeds is budgeted for the API Scale Up Expenses. Until such time, if any, as the Company secures third-party financing dedicated to the API Scale Up Expenses, the Company will be unable to complete the commercial scale up of its Opioid Synthesis Technologies.

Except for the professional fees related to prosecution of the Import Registration, the 2004 Debenture Offering Proceeds and the Asset Divestment Proceeds will be dedicated to the development of the Company's ADF Technology, the Opioid Synthesis Technologies and for administrative and related operating expenses.

Subsequent to the completion of the restructuring of its operations, the Company is no longer engaged in the manufacture and sale of finished dosage generic pharmaceutical products. As a result, the Company has no ability presently to generate revenue from generic product sales. Accordingly, the Company must rely on its current cash reserves to fund the development of its ADF Technology, the Opioid Synthesis Technologies and related ongoing operating expenses. The Company's future sources of revenue, if any, will be derived from the sale of API manufactured using its Opioid Synthesis Technologies, contract signing fees, milestone payments and royalties and/or profit sharing payments from licensees for the Company's ADF Technology or Opioid Synthesis Technologies. The Company estimates that its current cash reserves will be sufficient to fund the development of the ADF Technology, the Opioid Synthesis Technologies and related operating expenses through January 2005. To fund operations through December, 2005, the Company estimates that it must raise additional financing, or enter into alliances or collaboration agreements with third parties providing for net proceeds to the Company of at least $5 million. No assurance can be given that the Company will be successful in obtaining any such financing or in

securing collaborative agreements with third parties on acceptable terms, if at all, or if secured, that such financing or collaborative agreements will provide for payments to the Company sufficient to continue to fund operations. In the absence of such financing or third-party collaborative agreements, the Company will be required to scale back or terminate operations and/or seek protection under applicable bankruptcy laws.

Even assuming the Company is successful in securing additional sources of financing to fund the continued development of the ADF Technology or the Opioid Synthesis Technologies, or otherwise enters into alliances or collaborative agreements relating to such technologies, there can be no assurance that the Company's development efforts will result in commercial scale technologies, or that if such technologies are capable of being scaled up, that they will result in commercially viable products. The Company is also unable to provide any assurance that it will succeed in its application to the DEA for a registration to import NRMs. The Company's failure to successfully develop the ADF Technology in a timely manner will have a material adverse impact on its financial condition and results of operations.

CRITICAL ACCOUNTING POLICIES

Financial Reporting Release No. 60, which was released by the Securities and Exchange Commission ("SEC") in December 2001, requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements. Note A of the Notes to Consolidated Financial Statements, as contained in the Company's Annual Report on Form 10-K, includes a summary of the Company's significant accounting policies and methods used in the preparation of the financial statements. In preparing these financial statements, the Company has made its best estimates and judgments of certain amounts included in the financial statements, giving due consideration to materiality. The application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. The Company does not believe there is a great likelihood that materially different amounts would be reported under different conditions or using different assumptions. The Company's critical accounting policies are as follows:

Revenue Recognition

The Company recognizes revenue at the time a product is shipped to customers. The Company established sales provisions for estimated chargebacks, discounts, rebates, returns, pricing adjustments and other sales allowances concurrently with the recognition of revenue. The sales provisions are established based upon consideration of a variety of factors, including but not limited to, actual return and historical experience by product type, the number and timing of competitive products approved for sale, the expected market for the product, estimated customer inventory levels by product, price declines and current and projected economic conditions and levels of competition. Actual product return, chargebacks and other sales allowances incurred are, however, dependent upon future events. Management continually monitors the factors that influence sales allowance estimates and make adjustments to these provisions when allowances may differ from established allowances.

Allowance For Doubtful Accounts

Estimates are used in determining the allowance for doubtful accounts based on the Company's historical collections experience, current trends, credit policy and a percentage of its accounts receivable by aging category. In determining these percentages, the Company looks at historical write-offs of its receivables. The Company also looks at the credit quality of its customer base as well as changes in its credit policies. The Company continuously monitors collections and payments from its customers. While credit losses have historically been within expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past.

Inventories

The Company's inventories are stated at the lower of cost or market, with cost determined on the first-in, first-out basis. In evaluating whether inventory is stated at the lower of cost or market, management considers such factors as the amount of inventory on hand, remaining shelf life and current and expected market conditions, including levels of competition. As appropriate, the Company records provisions to reduce inventories to their net realizable value.

Income Taxes

Deferred income taxes are recognized for temporary differences between financial statement and income tax bases of assets and liabilities and loss carry-forwards for which income tax benefits are expected to be realized in future years. A valuation allowance is established, when necessary, to reduce deferred tax assets to the amount expected to be realized. In estimating future tax consequences, the Company generally considers all expected future events other than an enactment of changes in the tax laws or rates. The Company has recorded a full valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. While the Company has considered future taxable income in assessing the need for the valuation allowance, in the event the Company were to determine that it would be able to realize its deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made.

Stock Compensation

The Company accounts for stock-based employee compensation arrangements in accordance with provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25") and complies with the disclosure provision of SFAS No. 148, "Accounting for Stock-based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123" ("SFAS No. 148"). If the Company were to include the cost of stock-based employee compensation in the financial statements, the Company's operating results would decline based on the fair value of the stock-based employee compensation.

Deferred Debt Discount

Deferred debt discount results from the issuance of stock warrants and beneficial conversion features in connection with the issuance of subordinated debt and other notes payable. The amount of the discount is recorded as a reduction of the related obligation and is amortized over the remaining life of the related obligations. Management determines the amount of the discount, based, in part, by the relative fair values ascribed to the warrants determined by an independent valuation or through the use of the Black-Scholes valuation model. Inherent in the Black-Scholes valuation model are assumptions made by management regarding the estimated life of the warrant, the estimated volatility of the Company's common stock and the expected dividend yield.

ITEM 4. CONTROLS AND PROCEDURES

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14 as of the end of the period covered by this Report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic Securities and Exchange Commission filings. No significant changes were made in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

Disclosure controls and procedures are those controls and other procedures that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

PART II

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

During the quarter ended March 31, 2004, the Company issued Convertible Subordinated Debentures in the aggregate principal amount of approximately $12,313,000 (the "Convertible Debentures"). Approximately $2,049,000 of the Convertible Debentures were issued in exchange for principal and accrued interest on the Company's outstanding 5% bridge loans notes issued in November and December, 2003 and in satisfaction of accrued interest on certain of the Company's 5.0% Convertible Subordinated Debentures issued in 1998 and 1999.

Each of the holders of the Convertible Debentures are accredited investors as defined in Rule 501(a) of Regulation D promulgated under the Securities Act of 1933, as amended (the "Act"). The Convertible Debentures were issued without registration under the Act in reliance upon Section 4(2) of the Act and Regulation D promulgated thereunder.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) The exhibits required to be filed as part of this Report on form 10-Q are listed in the attached Exhibit Index.

(b) Reports on Form 8-K.

The Company filed a Current Report on Form 8-K dated February 10, 2004 relating to the Company's private offering of $12.3 million of Convertible Senior Secured Debentures.

The Company filed a Current Report on Form 8-K dated March 25, 2004 relating to the sale of the Company's Congers, New York assets.

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.

Date: May 14, 2004 HALSEY DRUG CO., INC.

By: /s/ Andrew D. Reddick

Andrew D. Reddick
President & Chief Executive Officer

By: /s/ Peter A. Clemens

Peter A. Clemens
Senior Vice President & Chief Financial Officer

EXHIBIT INDEX

Exhibit	Document
31.1	Certification of Periodic Report by Chief Executive Officer pursuant to Rule 13a-14 and 15d-14 of the Securities Exchange Act of 1934
31.2	Certification of Periodic Report by Chief Financial Officer pursuant to Rule 13a-14 and 15d-14 of the Securities Exchange Act of 1934
32.1	Certification of Periodic Report by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Periodic Report by Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

EXHIBIT 31.1

CERTIFICATION OF PERIODIC REPORT PURSUANT TO RULES 13a-14 AND 15d-14
OF THE SECURITIES EXCHANGE ACT OF 1934

I, Andrew D. Reddick, the Chief Executive Officer of Halsey Drug Co., Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Halsey Drug Co., Inc.;

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

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

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

   b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2004

/s/ Andrew D. Reddick

Andrew D. Reddick
Chief Executive Officer

EXHIBIT 31.2

CERTIFICATION OF PERIODIC REPORT PURSUANT TO RULES 13a-14 AND 15d-14
OF THE SECURITIES EXCHANGE ACT OF 1934

I, Peter A. Clemens, the Chief Financial Officer of Halsey Drug Co., Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Halsey Drug Co., Inc.;

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

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

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   d) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   e) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   f) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

   b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2004

/s/ Peter A. Clemens

Peter A. Clemens
Chief Financial Officer

EXHIBIT 32.1

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

In connection with the Quarterly Report of Halsey Drug Co., Inc. (the "Company") on Form 10-Q for the period ending March 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Andrew D. Reddick, the Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

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

Dated: May 14, 2004

/s/ Andrew D. Reddick

Andrew D. Reddick
Chief Executive Officer

EXHIBIT 32.2

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

In connection with the Quarterly Report of Halsey Drug Co., Inc. (the "Company") on Form 10-Q for the period ending March 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Peter A. Clemens, the Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

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

Dated: May 14, 2004

/s/ Peter A. Clemens

Peter A. Clemens
Chief Financial Officer