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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

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**Form 10-Q**

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

For the quarterly period ended June 30, 2009

Commission file number: 1-33818

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**ENTEROMEDICS INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction  
of incorporation)

**48-1293684**  
(IRS Employer  
Identification No.)

**2800 Patton Road, St. Paul, Minnesota 55113**  
(Address of principal executive offices, including zip code)

**(651) 634-3003**  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting entity) Smaller Reporting Company

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

As of July 31, 2009, 30,045,406 shares of the registrant's Common Stock were outstanding.

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**Registered Trademarks and Trademark Applications:** In the United States we have registered trademarks for VBLOC, ENTEROMEDICS and MAESTRO each registered with the United States Patent and Trademark Office, and have received a Notice of Allowance and a third extension of time to file a Statement of Use on our application to register the mark EMPOWER. In addition, the marks VBLOC, MAESTRO and ENTEROMEDICS are the subject of either a trademark registration or application for registration in Australia, Brazil, China, Mexico, the European Community, Saudi Arabia, the United Arab Emirates and Switzerland. This Form 10-Q contains other trade names and trademarks and service marks of EnteroMedics and of other companies.

## PART I – FINANCIAL INFORMATION

## ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ENTEROMEDICS INC.  
(A development stage company)

## Condensed Consolidated Balance Sheets

(Unaudited)

	June 30, 2009	December 31, 2008
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 34,567,113	\$ 21,055,108
Short-term investments available for sale	282,259	5,239,892
Interest receivable	3,743	57,965
Other receivables	—	19,308
Prepaid expenses and other current assets	482,076	421,817
Total current assets	35,335,191	26,794,090
Property and equipment, net	1,100,112	1,263,903
Other assets	183,571	220,907
Total assets	<u>\$ 36,618,874</u>	<u>\$ 28,278,900</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Current portion of notes payable	\$ 7,341,138	\$ 2,674,597
Accounts payable	138,020	163,377
Accrued expenses	2,663,777	2,862,102
Accrued interest payable	343,892	177,869
Total current liabilities	10,486,827	5,877,945
Notes payable, less current portion (net discounts of \$1,490,230 and \$1,329,592 at June 30, 2009 and December 31, 2008, respectively)	11,168,632	10,995,811
Common stock warrant liability	5,669,469	—
Total liabilities	<u>27,324,928</u>	<u>16,873,756</u>
Stockholders' equity:		
Common stock, \$0.01 par value 50,000,000 shares authorized; 30,045,406 and 16,899,935 shares issued and outstanding at June 30, 2009 and December 31, 2008, respectively	300,454	168,999
Additional paid-in capital	127,473,135	112,552,256
Deferred compensation	(11,667)	(21,667)
Accumulated other comprehensive income	1,579	12,988
Deficit accumulated during development stage	(118,469,555)	(101,307,432)
Total stockholders' equity	9,293,946	11,405,144
Total liabilities and stockholders' equity	<u>\$ 36,618,874</u>	<u>\$ 28,278,900</u>

See accompanying notes to condensed consolidated financial statements.

**ENTEROMEDICS INC.**  
(A development stage company)

Condensed Consolidated Statements of Operations

(Unaudited)

	<u>Three months ended June 30,</u>		<u>Six months ended June 30,</u>		<u>Period from</u>
	<u>2009</u>	<u>2008</u>	<u>2009</u>	<u>2008</u>	<u>December 19,</u>
					<u>2002</u>
					<u>(inception) to</u>
					<u>June 30,</u>
					<u>2009</u>
Operating expenses:					
Research and development	\$ 4,065,297	\$ 8,911,201	\$ 7,856,347	\$ 15,094,166	\$ 83,885,080
Selling, general and administrative	2,168,959	2,314,485	4,074,914	4,646,994	27,350,681
Total operating expenses	<u>6,234,256</u>	<u>11,225,686</u>	<u>11,931,261</u>	<u>19,741,160</u>	<u>111,235,761</u>
Other income (expense):					
Interest income	23,986	285,824	72,271	781,730	4,011,341
Interest expense	(874,070)	(389,257)	(1,551,532)	(835,546)	(7,028,737)
Change in value of warrant liability	(3,255,602)	—	(3,597,655)	—	(3,952,562)
Other, net	(21,760)	(25,374)	(22,978)	(57,618)	(132,868)
Net loss	<u>\$(10,361,702)</u>	<u>\$(11,354,493)</u>	<u>\$(17,031,155)</u>	<u>\$(19,852,594)</u>	<u>\$(118,338,587)</u>
Net loss per share—basic and diluted	<u>\$ (0.34)</u>	<u>\$ (0.68)</u>	<u>\$ (0.65)</u>	<u>\$ (1.18)</u>	
Shares used to compute basic and diluted net loss per share	<u>30,034,165</u>	<u>16,809,989</u>	<u>26,114,146</u>	<u>16,804,475</u>	

See accompanying notes to condensed consolidated financial statements.

**ENTEROMEDICS INC.**  
(A development stage company)  
Condensed Consolidated Statements of Cash Flows  
(Unaudited)

	Six months ended June 30,		Period from December 19, 2002 (inception) to June 30, 2009
	2009	2008	2009
<b>Cash flows from operating activities:</b>			
Net loss	\$(17,031,155)	\$(19,852,594)	\$(118,338,587)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation	208,408	264,600	1,364,364
Loss on sale of equipment	885	1,046	16,470
Employee stock-based compensation	1,274,533	1,418,372	4,853,732
Nonemployee stock-based compensation	80,514	(78,140)	3,068,268
Amortization of commitment fees, debt issuance costs and original issue discount	418,842	189,842	2,191,924
Amortization of short-term investment premium or discount	224	(20,452)	(308,731)
Change in value of warrant liability	3,597,655	—	3,952,562
Change in operating assets and liabilities:			
Interest receivable	54,222	32,179	(3,743)
Other receivables	19,308	29,643	—
Prepaid expenses and other current assets	(60,259)	2,606	(482,076)
Accounts payable	18,388	203,605	135,696
Accrued expenses	(198,325)	2,071,500	2,663,777
Accrued interest payable	166,023	—	509,714
Net cash used in operating activities	<u>(11,450,737)</u>	<u>(15,737,793)</u>	<u>(100,376,630)</u>
<b>Cash flows from investing activities:</b>			
Purchases of short-term investments available for sale	—	(3,500,234)	(14,882,233)
Maturities of short-term investments available for sale	4,946,000	5,065,000	14,574,414
Purchases of short-term investments held-to-maturity	—	(1,185,837)	(22,414,130)
Maturities of short-term investments held-to-maturity	—	4,450,000	22,750,000
Purchases of property and equipment	(89,247)	(103,528)	(2,478,622)
Net cash provided by (used in) investing activities	<u>4,856,753</u>	<u>4,725,401</u>	<u>(2,450,571)</u>
<b>Cash flows from financing activities:</b>			
Proceeds from stock options exercised	16,136	23,183	155,776
Proceeds from warrants issued	819,400	—	835,057
Proceeds from warrants exercised	—	—	187,652
Proceeds from sale of common stock, net of underwriting fees of \$3,074,315	—	—	40,874,977
Proceeds from sale of common stock in private placement financing	15,076,952	—	15,076,952
Common stock financing costs	(806,499)	—	(2,559,162)
Payment to shareholders for fractional shares upon reverse stock split	—	—	(355)
Proceeds from sale of Series A convertible preferred stock	—	—	1,803,348
Proceeds from sale of Series B convertible preferred stock	—	—	15,300,002
Series B convertible preferred stock financing costs	—	—	(111,079)
Proceeds from sale of Series C convertible preferred stock	—	—	40,825,003
Series C convertible preferred stock financing costs	—	—	(1,486,904)
Proceeds from convertible notes payable	—	—	6,814,846
Proceeds from notes payable	5,000,000	—	35,831,121
Repayments on notes payable	—	(2,683,671)	(15,831,121)
Debt issuance costs	—	—	(321,799)
Net cash provided by (used in) financing activities	<u>20,105,989</u>	<u>(2,660,488)</u>	<u>137,394,314</u>
Net increase (decrease) in cash and cash equivalents	13,512,005	(13,672,880)	34,567,113
<b>Cash and cash equivalents:</b>			
Beginning of period	21,055,108	48,732,309	—
End of period	<u>\$ 34,567,113</u>	<u>\$ 35,059,429</u>	<u>\$ 34,567,113</u>
<b>Supplemental disclosure:</b>			
Interest paid	\$ 966,667	\$ 624,341	\$ 4,327,098
<b>Noncash investing and financing activities:</b>			
Cancellation of Alpha Medical, Inc. Series A convertible preferred stock and common stock	\$ —	\$ —	\$ (661,674)
Issuance of Beta Medical, Inc. Series A convertible preferred stock in exchange for Alpha Medical, Inc. Series A convertible preferred stock and common stock	—	—	661,674
Value of warrants issued with debt	542,144	—	2,907,676
Value of warrants issued for debt commitment	—	—	636,250
Value of warrants issued with Series C financing	—	—	735,438
Value of warrants issued with private placement financing	154,525	—	154,525
Conversion of notes payable to Series B convertible preferred shares	—	—	1,564,843
Conversion of interest payable to Series B convertible preferred shares	—	—	34,809
Conversion of notes payable to Series C convertible preferred shares	—	—	5,250,003
Conversion of interest payable to Series C convertible preferred shares	—	—	131,013
Options issued for deferred compensation	—	—	10,898

Common stock issued to Mayo Foundation and for deferred compensation	—	—	1,770,904
Reclassifications of stock warrant liability	1,529,670	—	2,620,015
Conversion of convertible preferred stock to common stock	—	—	103,138

See accompanying notes to condensed consolidated financial statements.

**EnteroMedics Inc.**  
**(A development stage company)**  
**Notes to Condensed Consolidated Financial Statements**  
**(Unaudited)**

**(1) Summary of Significant Accounting Policies**

***Description of Business***

EnteroMedics Inc. (formerly Beta Medical, Inc.) (the Company) is developing implantable systems to treat obesity and other gastrointestinal disorders. The Company was incorporated in the state of Minnesota on December 19, 2002 and was reincorporated in Delaware on July 22, 2004. The Company is in the development stage and since inception has devoted substantially all of its resources to recruiting personnel, developing its product technology, obtaining patents to protect its intellectual property and raising capital, and has not derived revenues from its primary business activity. The Company is headquartered in St. Paul, Minnesota. In January 2006, the Company established EnteroMedics Europe Sàrl, a wholly-owned subsidiary located in Switzerland.

Since inception, the Company has incurred losses through June 30, 2009 totaling approximately \$118.3 million and has not generated positive cash flows from operations. The Company expects such losses to continue into the foreseeable future as it continues to develop and commercialize its technologies. The Company may need to obtain additional financing and there can be no assurance that the Company will be successful in obtaining additional financing on favorable terms, or at all. If adequate funds are not available, the Company may have to delay development or commercialization of products or license to third parties the rights to commercialize products or technologies that the Company would otherwise seek to commercialize.

***Basis of Presentation***

The Company has prepared the accompanying condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. The Company's fiscal year ends on December 31.

The accompanying condensed consolidated financial statements and notes thereto are unaudited. In the opinion of the Company's management, these statements include all adjustments, which are of a normal recurring nature, necessary to present a fair presentation. Interim results are not necessarily indicative of results for a full year. The condensed consolidated balance sheet as of December 31, 2008 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The information included in this Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

***Principles of Consolidation***

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

***Comprehensive Loss***

Comprehensive loss is defined as the change in equity of a company during a period from transactions and other events and circumstances excluding transactions resulting from investment owners and distributions to owners. The difference from reported net loss for the three and six months ended June 30, 2009 related entirely to net unrealized gains on short-term investments.

***Fair Value of Financial Instruments***

Carrying amounts of certain of the Company's financial instruments, including cash and cash equivalents, prepaid expenses and other current assets, accounts payable and accrued liabilities approximate fair value due to their short maturities. The fair values of investments in debt and equity securities are disclosed in Note 2. The fair value of the Company's long-term debt is approximately \$19,780,000 as of June 30, 2009 based on the present value of estimated future cash flows using a discount rate commensurate with borrowing rates available to the Company.

***Net Loss Per Share***

Basic net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding during the period. Diluted net loss per share is based on the weighted-average common shares outstanding during the period plus dilutive potential common shares calculated using the treasury stock method. Such potentially dilutive shares are excluded when the effect

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would be to reduce a net loss per share. The Company's potential dilutive shares, which include outstanding common stock options, unvested common shares subject to repurchase, convertible preferred stock and warrants, have not been included in the computation of diluted net loss per share for all periods as the result would be anti-dilutive.

The following table sets forth the computation of basic and diluted net loss per share for the three and six months ended June 30, 2009 and 2008:

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
<b>Numerator:</b>				
Net loss	<u>\$(10,361,702)</u>	<u>\$(11,354,493)</u>	<u>\$(17,031,155)</u>	<u>\$(19,852,594)</u>
<b>Denominator for historical basic and diluted net loss per share:</b>				
Weighted-average common shares outstanding	30,034,165	16,809,989	26,114,146	16,804,475
Weighted-average unvested common shares subject to repurchase	—	—	—	—
Denominator for net loss per common share—basic and diluted	<u>30,034,165</u>	<u>16,809,989</u>	<u>26,114,146</u>	<u>16,804,475</u>
Net loss per share—basic and diluted	<u>\$ (0.34)</u>	<u>\$ (0.68)</u>	<u>\$ (0.65)</u>	<u>\$ (1.18)</u>

The following table sets forth the potential shares of common stock that are not included in the calculation of diluted net loss per share because to do so would be anti-dilutive as of the end of each period presented:

	June 30,	
	2009	2008
Stock options outstanding	5,137,288	3,193,706
Warrants to purchase common stock	9,236,046	683,235

### Recently Issued Accounting Standards

In June 2008, the Financial Accounting Standards Board (FASB) issued Emerging Issues Task Force No. 07-5 (EITF 07-5), *Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity's Own Stock*. EITF 07-5 requires entities to evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock by assessing the instrument's contingent exercise provisions and settlement provisions. Instruments not indexed to their own stock fail to meet the scope exception of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, paragraph 11(a), and should be classified as a liability and marked-to-market. The statement is effective for fiscal years beginning after December 15, 2008 and is to be applied to outstanding instruments upon adoption with the cumulative effect of the change in accounting principle recognized as an adjustment to the opening balance of retained earnings. The Company adopted EITF 07-5 on January 1, 2009 and assessed any outstanding equity-linked financial instruments. The Company concluded that effective January 1, 2009 warrants issued November 2008 with a recorded value of \$1.4 million on December 31, 2008 were to be reclassified from equity to a liability. The cumulative effect of the change in accounting principle on January 1, 2009 was a \$130,968 increase to the deficit accumulated during development stage.

In September 2006, FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 was effective for the Company starting in fiscal 2008 with respect to financial assets and liabilities. In February 2008, the FASB released FASB Staff Position FAS 157-2—*Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. The adoption of SFAS 157 on January 1, 2008 did not have a material impact on the Company's consolidated financial statements (see Note 2).

In October 2008, FASB issued FASB Staff Position FAS 157-3 (FSP 157-3), *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*, which amended SFAS 157 to illustrate key considerations in determining the fair value of a financial asset in an inactive market. FSP 157-3 was effective upon issuance. Its additional guidance was incorporated into the measurements of fair value of applicable financial assets disclosed in Note 2, and did not have a material impact on the preparation of the consolidated financial statements.

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In April 2009, FASB issued FASB Staff Position FAS 157-4 (FSP 157-4), *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, which amended SFAS 157 to define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date. FSP 157-4 is effective for the Company during the quarter ended June 30, 2009. The adoption of FSP 157-4 did not have a material impact on the consolidated financial statements.

In May 2008, FASB issued Statement of Financial Accounting Standards No. 162 (SFAS 162), *The Hierarchy of Generally Accepted Accounting Principles*. This standard is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with generally accepted accounting principles in the United States for non-governmental entities. In June 2009, FASB approved the FASB Accounting Standards Codification (the Codification) as the single source of authoritative, nongovernmental accounting principles generally accepted in the United States of America (GAAP), excluding the guidance issued by the Securities and Exchange Commission (SEC). FASB approved an Exposure Draft that replaced SFAS 162 and modified GAAP by establishing only two levels of GAAP, authoritative and nonauthoritative. This was accomplished by authorizing the Codification to become the single source of authoritative U.S. accounting and reporting standards, except for rules and interpretive releases of the SEC, which are sources of authoritative GAAP for SEC registrants. All other nongrandfathered, non-SEC accounting literature not included in the Codification has become nonauthoritative. The Codification is effective for financial statements for interim or annual reporting periods ending after September 15, 2009. The Company does not expect the Codification to have a material impact on the consolidated financial statements.

In April 2009, FASB issued FASB Staff Position FAS 107-1 (FSP 107-1) and Accounting Principles Board Opinion No. 28-1 (APB 28-1), *Interim Disclosures about Fair Value of Financial Instruments*, which expands the fair value disclosures required for all financial instruments within the scope of Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, to interim periods for publicly traded entities. FSP 107-1 also requires entities to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments in financial statements on an interim basis and to highlight any changes of the methods and significant assumptions from prior periods. FSP 107-1 is effective for the Company during the quarter ended June 30, 2009. The adoption of FSP 107-1 did not have a material impact on the consolidated financial statements.

In May 2009, FASB issued Statement of Financial Accounting Standards No. 165 (SFAS 165), *Subsequent Events*. This standard is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, this standard sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. SFAS 165 is effective for the Company during the quarter ended June 30, 2009. The adoption of SFAS 165 did not have a material impact on the consolidated financial statements (see Note 7).

There have been no other significant changes in recent accounting pronouncements during the six months ended June 30, 2009 as compared to the recent accounting pronouncements described in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

## **(2) Fair Value Measurement**

Effective January 1, 2008, the Company adopted the fair value measurement and disclosure provisions of SFAS 157 for its financial assets as described below.

SFAS 157 defines fair value as the price that would be received to sell an asset or transfer a liability in an orderly transaction between market participants at the measurement date, and establishes a framework for measuring fair value. It also establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under SFAS 157 are described below:

- Level 1 – Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
- Level 2 – Quoted prices for similar assets and liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active or model-derived valuations for which all significant inputs are observable, either directly or indirectly.
- Level 3 – Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

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The Company's assets that are measured at fair value on a recurring basis are classified within Level 1 or Level 2 of the fair value hierarchy. The Company does not hold any assets that are measured at fair value using Level 3 inputs. The types of instruments the Company invests in that are valued based on quoted market prices in active markets include U.S. treasury securities. Such instruments are classified by the Company within Level 1 of the fair value hierarchy. U.S. treasuries are valued using unadjusted quoted prices for identical assets in active markets that the Company can access.

The types of instruments the Company invests in that are valued based on quoted prices in less active markets, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency include the Company's U.S. agency securities, commercial paper, U.S. corporate bonds and municipal obligations. Such instruments are classified by the Company within Level 2 of the fair value hierarchy. The Company values these types of assets using consensus pricing or a weighted average price, which is based on multiple pricing sources received from a variety of industry standard data providers (e.g. Bloomberg), security master files from large financial institutions, and other third-party sources. The multiple prices obtained are then used as inputs into a distribution-curve-based algorithm to determine the daily market price.

The following table sets forth by level, within the fair value hierarchy, the Company's financial assets accounted for at fair value under SFAS 157 as of June 30, 2009. As required by SFAS 157, assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

All short-term investments at June 30, 2009 are classified as Level 2 in connection with our adoption of SFAS 157 and are as follows:

	<b>Significant Other Observable Inputs Level 2</b>
U.S. agency securities	\$ 282,259
Total	<u>\$ 282,259</u>

The short-term investments available for sale at June 30, 2009 had contractual maturities of less than one year. The amortized cost and fair value of short-term investments available for sale, and the related gross unrealized gains and losses, were as follows at June 30, 2009:

	<b>Cost</b>	<b>Gross Unrealized</b>		<b>Fair value</b>
		<b>Gains</b>	<b>Losses</b>	
U.S. agency securities	\$280,681	\$ 1,578	\$ —	\$282,259
Total	<u>\$280,681</u>	<u>\$ 1,578</u>	<u>\$ —</u>	<u>\$282,259</u>

### **(3) Commitments**

#### ***Operating Lease***

The Company rents its office, warehouse and laboratory facilities under an operating lease, which expires on September 30, 2015. At June 30, 2009, future minimum payments under the lease are as follows:

<b><u>Years ending December 31:</u></b>	
Remaining six months in 2009	\$ 118,594
2010	247,951
2011	274,564
2012	280,055
2013	285,656
2014	291,369
2015	221,788
	<u>\$1,719,977</u>

### **(4) Notes Payable**

On November 18, 2008 the Company entered into a Loan and Security Agreement (the Loan Agreement) with Silicon Valley Bank (SVB), Western Technology Investment (WTI) and Horizon Technology Management LLC (Horizon and, collectively with SVB and WTI, the Lenders), in an aggregate principal amount of up to \$20.0 million. On November 21, 2008, SVB and WTI each funded a Term Loan in the aggregate principal amount of \$10.0 million and \$5.0 million, respectively. The additional \$5.0 million Term Loan was automatically funded by Horizon on April 28, 2009 when the trading price of the Company's common stock on the NASDAQ Global Market exceeded a target amount specified in the Loan Agreement. The \$5.0 million loan requires monthly interest-only

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payments through June 30, 2009 at an annual percentage rate of 12.0% followed by 30 equal principal and interest installments beginning July 1, 2009 at an annual percentage rate of 11.0%. A final payment fee of \$250,000 is due December 1, 2011, the maturity date. In conjunction with the funding, the Company issued 296,763 common stock warrants with an exercise price of \$1.668 per share and a ten year life to Horizon. The warrants give Horizon the option to purchase either (i) shares of our common stock with a per share exercise price equal to \$1.668, or (ii) shares of our stock (including common stock) issued in an equity financing that occurs after the warrant issue date and on or before May 18, 2010 at the per share price of the stock sold in the financing.

Scheduled debt principal payments are as follows as of June 30, 2009:

<u>Years Ending December 31:</u>	
Remaining six months in 2009	\$ 3,566,130
2010	7,761,313
2011	8,672,557
	<u>20,000,000</u>
Less: Original issue discount	(1,490,230)
Notes payable, net	<u>\$18,509,770</u>

### (5) Stock-based Compensation

As of June 30, 2009, the Company has adopted the EnteroMedics Inc. 2003 Stock Incentive Plan (the Plan) that includes both incentive stock options and nonqualified stock options to be granted to employees, officers, consultants, independent contractors, directors and affiliates of the Company. Prior to January 1, 2006, the Company accounted for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*, and related interpretations, and followed the minimum value disclosure provisions of Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation*. Under APB 25, compensation expense is based on the difference, if any, on the date of the grant, between the fair value of the Company's stock and the exercise price. Employee stock-based compensation determined under APB 25 is recognized over the option vesting period. Accordingly, for those grants made through December 31, 2005, the Company recognized compensation expense pursuant to APB 25 for stock options granted to employees with an exercise price below the estimated fair value of our common stock on the date of grant. For disclosure purposes pursuant to SFAS 123, the Company estimated the date of grant fair value using the minimum value option-pricing model.

Effective January 1, 2006, the Company adopted the fair value provisions of Statement of Financial Accounting Standards No. 123R (SFAS 123R), *Share-Based Payment*, which supersedes its previous accounting under APB 25. SFAS 123R requires the recognition of compensation expense, using a fair-value-based method, for costs related to all share-based payments including stock options. SFAS 123R requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The Company adopted SFAS 123R using the prospective transition method, which requires that for nonpublic entities that used the minimum value method for either pro forma or financial statement recognition purposes, SFAS 123R shall be applied to option grants or modifications to existing options after the required effective date. For options granted prior to the new SFAS 123R effective date and for which the requisite service period has not been performed as of January 1, 2006, the Company continues to apply the intrinsic value provisions of APB 25 on the remaining unvested awards. All option grants valued after January 1, 2006 are expensed on a straight-line basis over the vesting period.

The provisions of SFAS 123R are applied to all share-based payment awards issued to employees and where appropriate, nonemployees, unless another source of literature applies. When determining the measurement date of a nonemployee's share-based payment award, the Company follows Emerging Issues Task Force Abstract No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services*, which requires measuring the stock options at fair value and remeasuring such stock options to the current fair value until the performance date has been reached.

Based on the application of these standards, stock-based compensation expense for stock-based awards under the Company's 2003 Stock Incentive Plan for the three and six months ended June 30, 2009 and 2008 was allocated to operating expenses as follows:

	<u>Three months ended</u>		<u>Six months ended</u>	
	<u>June 30,</u>		<u>June 30,</u>	
	<u>2009</u>	<u>2008</u>	<u>2009</u>	<u>2008</u>
Research and development	\$ 218,120	\$ 264,941	\$ 373,450	\$ 510,329
Selling, general and administrative	576,010	464,450	981,597	829,903
Total	<u>\$ 794,130</u>	<u>\$ 729,391</u>	<u>\$ 1,355,047</u>	<u>\$ 1,340,232</u>

As of June 30, 2009 there was \$8,519,994 of total unrecognized compensation costs, net of estimated forfeitures, related to employee unvested stock option awards granted after January 1, 2006, which are expected to be recognized over a weighted-average period of 2.89 years.

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The estimated grant-date fair values of the stock options were calculated using the Black-Scholes valuation model, based on the following assumptions for the three and six months ended June 30, 2009 and 2008:

	Employees		Employees	
	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Risk-free interest rates	2.28%-2.99%	3.89%	1.90%-2.99%	3.49%-3.89%
Expected life	6-6.25 years	6-6.25 years	6-6.25 years	5-6.25 years
Expected dividends	0%	0%	0%	0%
Expected volatility	96.90%-99.00%	68.38%-68.50%	88.10%-99.00%	67.63%-69.38%
	Nonemployees		Nonemployees	
	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Risk-free interest rates	3.51%-3.53%	3.98%	2.68%-3.53%	3.43%-3.98%
Expected life	6.45-9.98 years	10 years	6.45-9.98 years	10 years
Expected dividends	0%	0%	0%	0%
Expected volatility	100.50%	74.00%	99.70%-100.50%	74.00%-75.25%

Option activity under the Plan for the six months ended June 30, 2009 was as follows:

	Shares Available For Grant	Outstanding Options	
		Number of Shares	Weighted-Average Exercise Price
<b>Balance, December 31, 2008</b>	851,236	2,797,178	\$ 4.80
Shares reserved	3,000,000	—	—
Options granted	(2,440,300)	2,440,300	2.92
Options exercised	—	(35,078)	.46
Options cancelled	65,112	(65,112)	5.78
<b>Balance, June 30, 2009</b>	<u>1,476,048</u>	<u>5,137,288</u>	\$ 3.92

### (6) Stock Purchase

On February 19, 2009, the Company entered into several securities purchase agreements for the sale of 13,110,393 shares of its common stock, together with warrants to purchase an aggregate of 6,555,197 shares of its common stock, in a private placement transaction with several accredited investors (the Private Placement). The purchase price per share was \$1.15, which equaled the consolidated closing bid price of the Company's common stock as reported by the NASDAQ Stock Market on February 19, 2009. The warrants will be exercisable at any time and from time to time beginning on the date that is six months and one day after the closing of the Private Placement and ending four years after the closing of the Private Placement. The warrants have an exercise price of \$1.38 per share, which equals 120% of the consolidated closing bid price of the Company's common stock as reported by the NASDAQ Stock Market on February 19, 2009. On February 24, 2009, the Company completed the final closing of the Private Placement receiving gross proceeds of \$15.9 million, less a placement agent fee of \$617,443 and certain other expenses. In addition, the placement agent received a warrant to purchase 218,242 shares of common stock in the same form as that issued to participants in the Private Placement.

### (7) Subsequent Events

On July 2, 2009, the Company's stockholders approved the filing of an amendment to Article IV, Section 1 of the Company's Fifth Amended and Restated Certificate of Incorporation increasing the number of shares of common stock authorized for issuance by 35,000,000 shares from 50,000,000 to 85,000,000. The total number of shares of preferred stock and common stock authorized for issuance under the Fifth Amended and Restated Certificate of Incorporation is 5,000,000 and 85,000,000, respectively.

The Company has evaluated subsequent events occurring through August 7, 2009, the date on which this Quarterly Report on Form 10-Q was issued.

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

*The following discussion should be read in conjunction with the condensed consolidated financial statements and notes thereto appearing elsewhere in this Quarterly Report on Form 10-Q.*

*Except for the historical information contained herein, the matters discussed in this "Management's Discussion and Analysis of Financial Condition and Results of Operations," are forward-looking statements that involve risks and uncertainties. In some cases, these statements may be identified by terminology such as "may," "will," "should," "expects," "could," "intends," "might," "plans," "anticipates," "believes," "estimates," "predicts," "potential," or "continue," or the negative of such terms and other comparable terminology. These statements involve known and unknown risks and uncertainties that may cause our results, level of activity, performance or achievements to be materially different from those expressed or implied by the forward-looking statements. Factors that may cause or contribute to such differences include, among others, those discussed in Part I, Item 1A "Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2008. Except as may be required by law, we undertake no obligation to update any forward-looking statement to reflect events after the date of this report.*

**Overview**

We are a development stage medical device company focused on the design and development of devices that use neuroblocking technology to treat obesity and other gastrointestinal disorders. Our proprietary neuroblocking technology, which we refer to as VBLOC therapy, is designed to intermittently block the vagus nerve using high frequency, low energy, electrical impulses. We currently have no products approved for sale. Our initial product under development is the Maestro System, which uses VBLOC therapy to limit the expansion of the stomach, reduce the frequency and intensity of stomach contractions and produce a feeling of early and prolonged fullness. We were formerly known as Beta Medical, Inc. and were incorporated in Minnesota on December 19, 2002. We were reincorporated in Delaware on July 22, 2004. Since inception, we have devoted substantially all of our resources to the development and commercialization of our Maestro System.

Based on our understanding of vagal nerve function and nerve blocking from our preclinical studies and the results of our initial clinical trials, we believe the Maestro System may offer obese patients a minimally invasive treatment alternative that has the potential to result in significant and sustained weight loss. We believe that our Maestro System will allow bariatric surgeons to help obese patients who are concerned about the risks and complications associated with gastric banding and gastric bypass surgery. We are continuing to evaluate the Maestro System in human clinical trials conducted internationally and to date the Maestro System has demonstrated a favorable safety profile. Preliminary results from a feasibility study conducted outside the U.S., indicate that the Maestro System may provide durable and ongoing weight-loss for people with obesity. As of January 12, 2009, the most recent follow-up of nine RF2 patients, among the earliest patients implanted in the VBLOC-RF2 trial, showed an excess weight loss (EWL) of 37.6% at 18 months of VBLOC therapy. At that time, the most recent results for the prior follow-up periods demonstrated an EWL of 28.1% in 17 RF2 patients at 12 months and an EWL of 17.9% in 35 RF2 patients at six months of VBLOC therapy. We have completed enrollment and implantation of subjects in our first U.S. pivotal trial, the EMPOWER trial. We plan to review the data from our EMPOWER trial to support our premarket approval (PMA) application in late 2009 and submit the application for the Maestro System shortly thereafter. We anticipate commercialization in the United States beginning in early 2011 if and when the FDA grants us approval. In addition, data from sub-group analyses demonstrate that VBLOC therapy may hold promise in improving the co-morbidities of diabetes and hypertension, independent of, and prior to, substantial weight loss. We are conducting, or plan to conduct, feasibility studies in each of these co-morbidities to assess VBLOC therapy's potential in addressing multiple indications.

We obtained CE marking approval for sale of the Maestro System in the European Union on March 4, 2009. The method of assessing conformity with applicable regulatory requirements varies depending on the class of the device, but for our Maestro System (which falls into Class III), the method involved a combination of self-assessment by the manufacturer of the safety and performance of the device, and a third-party assessment by a Notified Body, usually of the design of the device and of the manufacturer's quality system. We used KEMA in the Netherlands as the Notified Body for our CE marking approval process.

If and when we obtain FDA approval of our Maestro System we intend to market our products in the United States through a direct sales force supported by field technical and marketing managers who provide training, technical and other support services to our customers. Outside the United States we intend to use direct, dealer or distributor sales models as the targeted geography best dictates. To date, we have relied on third-party manufacturers and suppliers for the production of our Maestro System. We currently anticipate that we will continue to rely on third-party manufacturers and suppliers for the production of the Maestro System following commercialization.

To date, we have generated no revenue from the sale of products, and we have incurred net losses in each year since our inception. As of June 30, 2009, we had a deficit accumulated during the development stage of \$118.3 million. We expect our losses to continue and to increase as we continue our development activities and expand our commercialization activities. We have financed our operations primarily through public and private placement of our equity securities and issuance of debt.

## Financial Overview

### Revenue

To date, we have not commercialized any products and we have not generated any revenue. We do not expect to generate revenue until 2011 and then, only if we receive FDA approval of our Maestro System. Any revenue from initial sales of a new product is difficult to predict and in any event will only modestly reduce our continued and increasing losses resulting from our research and development and other activities.

### Research and Development Expenses

Our research and development expenses primarily consist of engineering, product development and clinical and regulatory expenses, incurred in the development of our Maestro System. Research and development expenses also include employee compensation, including stock-based compensation, consulting services, outside services, materials, supplies, depreciation and travel. We expense research and development costs as they are incurred. From inception through June 30, 2009, we have incurred a total of \$83.9 million in research and development expenses.

### Selling, General and Administrative Expenses

Our selling, general and administrative expenses consist primarily of compensation for executive, finance, market development and administrative personnel, including stock-based compensation. Other significant expenses include costs associated with attending medical conferences, professional fees for legal services, including legal services associated with our efforts to obtain and maintain broad protection for the intellectual property related to our products, and accounting services, cash management fees, consulting fees and travel expenses. From inception through June 30, 2009, we have incurred \$27.4 million in selling, general and administrative expenses.

## Results of Operations

### Comparison of the Three Months Ended June 30, 2009 and 2008

*Research and Development Expenses.* Research and development expenses were \$4.1 million for the three months ended June 30, 2009, compared to \$8.9 million for the three months ended June 30, 2008. The decrease of \$4.8 million, or 54.4%, is primarily due to decreases of \$3.3 million, \$989,000, and \$391,000 in professional services, device costs, and compensation expense, respectively. Professional services and device cost decreases are driven by the completion of enrollment and implants in our EMPOWER clinical study during 2008. We are currently incurring costs related to follow-up visits, which are less expensive than the cost of the implantation procedure, and do not require us to incur new device costs. The reduction in compensation expense is the result of a reduction-in-force completed December 1, 2008.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses were \$2.2 million for the three months ended June 30, 2009, compared to \$2.3 million for the three months ended June 30, 2008. The decrease of \$146,000, or 6.3%, is primarily due to a decrease in professional services, including decreases of \$70,000 in legal fees and \$60,000 in general consulting services including the conversion of consultants to employees.

*Interest Income.* Interest income was \$24,000 for the three months ended June 30, 2009, compared to \$286,000 for the three months ended June 30, 2008. The decrease of \$262,000, or 91.6%, is primarily due to a decrease in the short-term interest rate environment and a decrease in the average cash, cash equivalents and short-term investment balance from \$43.2 million during the second quarter of 2008 to \$36.3 million during the second quarter of 2009. The decreased average cash, cash equivalents and short-term investments balance is the result of \$37.4 million in net cash used in operating and investing activities from January 1, 2008 through June 30, 2009, offset by \$15.0 million of debt funding received in November 2008, of which we received net proceeds of \$7.1 million after transaction expenses, facility charges and existing debt pay off, \$15.1 million of net private placement proceeds received February 24, 2009, and \$5.0 million of additional debt funding received in April 2009.

*Interest Expense.* Interest expense was \$874,000 for the three months ended June 30, 2009, compared to \$389,000 for the three months ended June 30, 2008. The increase of \$485,000, or 124.5%, was primarily the result of entering into a \$20.0 million debt facility, of which \$15.0 million was funded in November 2008 that resulted in net proceeds of \$7.1 million after transaction expenses, facility charges and existing debt pay off and the funding of the remaining \$5.0 million in April 2009. The effective rates on the \$15.0 million and \$5.0 million debt fundings are approximately 19% and 22%, respectively, compared to the old debt facility containing several outstanding loans with effective interest rates primarily ranging from approximately 15% to 17%.

*Change in Value of Warrant Liability.* The change in value of warrant liability was \$3.3 million for the three months ended June 30, 2009, compared to zero for the three months ended June 30, 2008. This is the result of adopting EITF 07-5 on January 1, 2009, which resulted in warrants issued November 2008 with a recorded value of \$1.4 million on December 31, 2008 being reclassified from equity to a liability. The fair market value of the 1,779,372 warrants, with a weighted-average exercise price of \$1.24, was \$5.7 million as of June 30, 2009. The fair market value was calculated using the Black-Scholes valuation model, which resulted in a \$3.3 million increase for the three months ended June 30, 2009. The increase was primarily the result of our stock price increasing from a closing price of \$1.36 on March 31, 2009 to \$3.33 on June 30, 2009.

### **Comparison of the Six Months Ended June 30, 2009 and 2008**

**Research and Development Expenses.** Research and development expenses were \$7.9 million for the six months ended June 30, 2009, compared to \$15.1 million for the six months ended June 30, 2008. The decrease of \$7.2 million, or 48.0%, is primarily due to decreases of \$4.6 million, \$1.7 million and \$548,000 in professional services, device costs and compensation expense, respectively. Professional services and device cost decreases are driven by the completion of enrollment and implants in our EMPOWER clinical study during 2008. We are currently incurring costs related to follow-up visits, which are less expensive than the cost of the implantation procedure, and do not require us to incur new device costs. The reduction in compensation expense is the result of a reduction-in-force completed December 1, 2008. The reduction-in-force also resulted in a decrease of \$177,000 in employee stock-based compensation expense compared to the six months ended June 30, 2008.

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses were \$4.1 million for the six months ended June 30, 2009, compared to \$4.6 million for the six months ended June 30, 2008. The decrease of \$572,000, or 12.3%, is primarily due to a decrease of \$534,000 in professional services. The decrease in professional services is made up of decreases of \$186,000 in legal fees, \$134,000 in reduced marketing and public relations activity and \$203,000 in other general consulting services, including the conversion of consultants to employees.

**Interest Income.** Interest income was \$72,000 for the six months ended June 30, 2009, compared to \$782,000 for the six months ended June 30, 2008. The decrease of \$709,000, or 90.8%, is primarily due to a decrease in short-term interest rates and a reduction in total cash available to invest. The average cash, cash equivalents and short-term investment balance was \$33.3 million and \$47.8 million for the six months ended June 30, 2009 and 2008, respectively. The decreased average cash, cash equivalents and short-term investments balance is the result of \$37.4 million in net cash used in operating and investing activities from January 1, 2008 through June 30, 2009, offset by \$15.0 million of debt funding received in November 2008, of which we received net proceeds of \$7.1 million after transaction expenses, facility charges and existing debt pay off, \$15.1 million of net private placement proceeds received February 24, 2009, and \$5.0 million of additional debt funding received in April 2009.

**Interest Expense.** Interest expense was \$1.6 million for the six months ended June 30, 2009, compared to \$836,000 for the six months ended June 30, 2008. The increase of \$716,000, or 85.7%, was primarily the result of entering into a \$20.0 million debt facility, of which \$15.0 million was funded in November 2008 that resulted in net proceeds of \$7.1 million after transaction expenses, facility charges and existing debt pay off and the funding of the remaining \$5.0 million in April 2009. The effective rates on the \$15.0 million and \$5.0 million debt fundings are approximately 19% and 22%, respectively, compared to the old debt facility containing several outstanding loans with effective interest rates primarily ranging from approximately 15% to 17%.

**Change in Value of Warrant Liability.** The change in value of warrant liability was \$3.6 million for the six months ended June 30, 2009, compared to zero for the six months ended June 30, 2008. This is the result of adopting EITF 07-5 on January 1, 2009, which resulted in warrants issued November 2008 with a recorded value of \$1.4 million on December 31, 2008 being reclassified from equity to a liability. The fair market value of the 1,779,372 warrants, with a weighted-average exercise price of \$1.24, was \$5.7 million as of June 30, 2009. The fair market value was calculated using the Black-Scholes valuation model, which resulted in a \$3.6 million increase for the six months ended June 30, 2009. The increase was primarily the result of our stock price increasing from a closing price of \$1.46 on January 1, 2009 to \$3.33 on June 30, 2009.

### **Liquidity and Capital Resources**

We have incurred losses since our inception in December 2002 and, as of June 30, 2009 we had a deficit accumulated during the development stage of \$118.3 million. We have financed our operations to date principally through the sale of capital stock, debt financing and interest earned on investments. Prior to our initial public offering (IPO) in November 2007, we had received net proceeds of \$63.2 million from the sale of common stock and preferred stock and \$30.8 million in debt financing, \$746,000 to finance equipment purchases and \$30.0 million to finance working capital. Through our IPO we received net proceeds of \$39.1 million after expenses and underwriters' discounts and commissions and including the partial exercise of the underwriters' over-allotment option. In November 2008, we entered into a \$20.0 million working capital debt facility, replacing the existing debt financing. We received net proceeds of \$7.1 million from the first draw of \$15.0 million after transaction expenses, facility charges and existing debt pay off. The debt facility provided that the additional \$5.0 million draw was to be available and automatically fund under the terms of the loan agreement if and when the trading price of our common stock on the NASDAQ Global Market met or exceeded a target amount on or before June 30, 2009. The Company's trading price achieved this target and therefore, on April 28, 2009, the automatic funding of the additional \$5.0 million was made to the Company under the debt facility. The \$5.0 million loan requires monthly interest-only payments through June 30, 2009 at an annual percentage rate of 12.0% followed by 30 equal principal and interest installments beginning July 1, 2009 at an annual percentage rate of 11.0%. A final payment fee of \$250,000 is due December 1, 2011, the maturity date. In conjunction with the funding, the Company issued 296,763 common stock warrants with an exercise price of \$1.668 per share and a ten year life. The warrants give the Lender the option to purchase either (i) shares of the Company's common stock with a per share exercise price equal to \$1.668, or (ii) shares of the Company's stock (including common stock) issued in an equity financing that

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occurs after the warrant issue date and on or before May 18, 2010 at the per share price of the stock sold in the financing. On February 24, 2009, we completed the sale of 13,110,393 shares of our common stock, together with warrants to purchase an aggregate of 6,555,197 shares of our common stock, in a private placement transaction with several accredited investors. We received gross proceeds of \$15.9 million less a placement agent fee of \$617,000 and certain other expenses.

As of June 30, 2009, we had \$34.8 million in cash, cash equivalents and short-term investments. Of this amount \$29.3 million was invested in short-term money market funds that are not considered to be bank deposits and are not insured or guaranteed by the federal deposit insurance company or other government agency. These money market funds seek to preserve the value of the investment at \$1.00 per share; however, it is possible to lose money investing in these funds. Our cash and investment balances are held in a variety of interest bearing instruments, including obligations of U.S. government agencies and money market funds. Cash in excess of immediate requirements is invested in accordance with our investment policy, primarily with a view to liquidity and capital preservation. At times, such deposits may be in excess of insured limits. We have not experienced any losses on our deposits of cash and cash equivalents.

The fair value of our short-term investment holdings are based on security prices from one or multiple industry established pricing sources. Examples of these pricing sources are Bloomberg, Interactive Data Corporation, Reuters, JJ Kenny, and Merrill Lynch. Each pricing source uses a different confidential method for pricing securities using various inputs, such as interest rates, known historical trades, yield curve information, benchmark data, prepayment speeds, credit quality, or broker/dealer quotes. Management regularly reviews the pricing methodology used by our third party asset managers to ensure consistency of the fair-value determination with Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*, and proper classification of the underlying assets and liabilities within that standard's fair-value hierarchy. We also review each of our short-term investment positions and assess whether there is any other-than temporary impairment as well as the reasonableness of the fair market values being reported. Based on our review of short-term investments held at June 30, 2009, there were no indicators of other-than temporary impairment present.

The remaining unpaid balance of the \$20.0 million in debt financing as of June 30, 2009 is collateralized by a first security priority lien on all of our assets, excluding intellectual property. We have entered into account control agreements in order to perfect the lender's first security interest in our cash and investment accounts. In the event we have less than five remaining months of liquidity, we are required to grant a temporary lien on our intellectual property. The number of remaining months of liquidity is calculated by dividing cash and cash equivalents as of the end of any particular month by the sum of our total operating expenses for each of the immediately preceding five months. The debt financing agreement also requires us to (1) maintain a cash and cash equivalents balance that exceeds our aggregate operating expenses for the most recent five calendar month period ending prior to the determination date and (2) secure aggregate net proceeds of at least \$20.0 million by January 9, 2010 from new capital transactions, of which \$10.0 million is required by June 30, 2009. On February 24, 2009, we completed a private placement transaction with several accredited investors, receiving gross proceeds of \$15.9 million less a placement agent fee of \$617,000 and certain other expenses. The date by which we are required to secure the remaining aggregate net proceeds under the capital covenant may be extended upon the achievement of certain milestones defined in the debt financing agreement. There are no additional liquidity covenants that we are required to maintain under the terms of our debt financing agreements.

### ***Net Cash Used in Operating Activities***

Net cash used in operating activities was \$11.5 million and \$15.7 million for the six months ended June 30, 2009 and 2008, respectively. Net cash used in operating activities primarily reflects the net loss for those periods, which was partially offset by depreciation and amortization, change in value of warrant liability, stock-based compensation and changes in operating assets and liabilities.

### ***Net Cash Provided by Investing Activities***

Net cash provided by investing activities was \$4.9 million and \$4.7 million for the six months ended June 30, 2009 and 2008, respectively. Net cash provided by investing activities is primarily related to the proceeds from the maturity of short-term investments partially offset by the purchase of short-term investments and, to a lesser extent, the purchase of property and equipment.

### ***Net Cash Provided by (Used in) Financing Activities***

Net cash provided by financing activities was \$20.1 million for the six months ended June 30, 2009 compared to net cash used in financing activities of \$2.7 million for the six months ended June 30, 2008. Net cash provided by financing activities for the six months ended June 30, 2009 is primarily attributable to the completion of a private placement transaction that resulted in gross proceeds of \$15.9 million for the issuance of common stock and common stock warrants, offset by \$806,000 in financing costs incurred through June 30, 2009 and debt funding proceeds of \$5.0 million automatically funded on April 28, 2009 per the terms of the \$20.0 million debt facility we entered into on November 18, 2008. Net cash used in financing activities for the six months ended June 30, 2008 is primarily attributable to the repayments of long-term debt.

### ***Operating Capital and Capital Expenditure Requirements***

To date, we have not commercialized any products and we have not earned any operating revenues. We anticipate that we will continue to incur substantial net losses for the next several years as we develop our products, prepare for the potential commercial launch of our Maestro System, develop the corporate infrastructure required to sell our products, operate as a publicly-traded company and pursue additional applications for our technology platform.

We do not expect to generate any product revenue from sales in the United States until early 2011. We do not anticipate generating any product revenue in the United States unless and until we successfully obtain FDA approval for our Maestro System. We believe the net proceeds from our IPO in November 2007, the credit facility entered into November 2008 and the private placement closed February 24, 2009, together with our pre-existing cash, cash equivalents and short-term investment balances and interest income we earn on these balances will be sufficient to meet our anticipated cash requirements into 2010. If our available cash, cash equivalents and investment balances are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or debt securities or enter into an additional credit facility. The sale of additional equity and debt securities may result in dilution to our stockholders. If we raise additional funds through the issuance of debt securities, these securities could have rights senior to those of our common stock and could contain covenants that would restrict our operations. We may require additional capital beyond our currently forecasted amounts. Any such required additional capital may not be available on reasonable terms, if at all. If we are unable to obtain additional financing, we may be required to reduce the scope of, delay, or eliminate some or all of, our planned research, development and commercialization activities, which could materially harm our business.

Our forecast of the period of time through which our financial resources will be adequate to support our operations, the costs to complete development of products and the cost to commercialize our products are forward-looking statements and involve risks and uncertainties, and actual results could vary materially and negatively as a result of a number of factors, including the factors discussed in Part I, Item 1A, *Risk Factors*, of our Annual Report on Form 10-K for the year ended December 31, 2008. We have based these estimates on assumptions that may prove to be wrong, and we could utilize our available capital resources sooner than we currently expect.

Because of the numerous risks and uncertainties associated with the development of medical devices, such as our Maestro System, we are unable to estimate the exact amounts of capital outlays and operating expenditures necessary to complete the development of the products and successfully deliver a commercial product to the market. Our future capital requirements will depend on many factors, including but not limited to the following:

- the scope, rate of progress, results and cost of our clinical trials and other research and development activities;
- the cost and timing of regulatory approvals;
- the cost and timing of establishing sales, marketing and distribution capabilities;
- the cost of establishing clinical and commercial supplies of our Maestro System and any products that we may develop;
- the rate of market acceptance of our Maestro System and VBLOC therapy and any other product candidates;
- the cost of filing and prosecuting patent applications and defending and enforcing our patent and other intellectual property rights;
- the cost of defending, in litigation or otherwise, any claims that we infringe third-party patent or other intellectual property rights;
- the effect of competing products and market developments;
- the cost of explanting clinical devices;
- the terms and timing of any collaborative, licensing or other arrangements that we may establish;
- any revenue generated by sales of our future products; and
- the extent to which we acquire or invest in businesses, products and technologies, although we currently have no commitments or agreements relating to any of these types of transactions.

### **Critical Accounting Policies and Estimates**

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States. In doing so, we have to make estimates and assumptions that affect our reported amounts of assets, liabilities and expenses, as well as related disclosure of contingent assets and liabilities. In many cases, we could reasonably have used different accounting policies and estimates. In some cases, changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ materially from our estimates. To the extent that there are material differences between these estimates and actual results, our financial condition or results of operations will be affected. We base our estimates on past experiences and other assumptions that we believe are reasonable under the circumstances, and we evaluate these estimates on an ongoing basis.

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Our significant accounting policies are fully described in Note 2 to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2008 filed with the U.S. Securities and Exchange Commission (SEC).

### Contractual Obligations

During the six months ended June 30, 2009, there were no material changes to our contractual obligation disclosures as set forth under the caption, "Contractual Obligations" in Part II, Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, of our Annual Report on Form 10-K for the year ended December 31, 2008, other than the funding of a \$5.0 million term loan on April 28, 2009 as discussed in Note 4 to our condensed consolidated financial statements included in this Quarterly Report on Form 10-Q.

The following table summarizes our contractual obligations as of June 30, 2009 and the effect those obligations are expected to have on our financial condition and liquidity position in future periods:

Contractual Obligations	Payments Due By Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Operating lease	\$ 1,719,977	\$ 238,362	\$ 542,078	\$ 571,340	\$ 368,197
Long-term debt, including interest	24,011,937	9,204,775	14,807,162	—	—
Other long-term liabilities	50,000	50,000	—	—	—
Total contractual cash obligations	<u>\$ 25,781,914</u>	<u>\$ 9,493,137</u>	<u>\$ 15,349,240</u>	<u>\$ 571,340</u>	<u>\$ 368,197</u>

The table above reflects only payment obligations that are fixed and determinable. Our operating lease commitments relate to our corporate headquarters in St. Paul, Minnesota. Other long-term liabilities consist of obligations required under the terms of our license agreements with the Mayo Foundation for Medical Education and Research (Mayo Foundation).

### Off-Balance Sheet Arrangements

As of June 30, 2009, we did not have any off-balance sheet arrangements.

### Recent Accounting Pronouncements

In June 2008, the Financial Accounting Standards Board (FASB) issued Emerging Issues Task Force No. 07-5 (EITF 07-5), *Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity's Own Stock*. EITF 07-5 requires entities to evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock by assessing the instrument's contingent exercise provisions and settlement provisions. Instruments not indexed to their own stock fail to meet the scope exception of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, paragraph 11(a), and should be classified as a liability and marked-to-market. The statement is effective for fiscal years beginning after December 15, 2008 and is to be applied to outstanding instruments upon adoption with the cumulative effect of the change in accounting principle recognized as an adjustment to the opening balance of retained earnings. We adopted EITF 07-5 on January 1, 2009 and assessed any outstanding equity-linked financial instruments. We concluded that effective January 1, 2009 warrants issued November 2008 with a recorded value of \$1.4 million on December 31, 2008 were to be reclassified from equity to a liability. The cumulative effect of the change in accounting principle on January 1, 2009 was a \$130,968 increase to the deficit accumulated during development stage.

In September 2006, FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 was effective for us starting in fiscal 2008 with respect to financial assets and liabilities. In February 2008, the FASB released FASB Staff Position FAS 157-2—*Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. The adoption of SFAS 157 on January 1, 2008 did not have a material impact on our consolidated financial statements (see Note 2 to our condensed consolidated financial statements).

In October 2008, FASB issued FASB Staff Position FAS 157-3 (FSP 157-3), *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*, which amended SFAS 157 to illustrate key considerations in determining the fair value of a financial asset in an inactive market. FSP 157-3 was effective upon issuance. Its additional guidance was incorporated into the measurements of fair value of applicable financial assets disclosed in Note 2 to our condensed consolidated financial statements, and did not have a material impact on the preparation of our consolidated financial statements.

In April 2009, FASB issued FASB Staff Position FAS 157-4 (FSP 157-4), *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, which amended SFAS 157 to define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date. FSP 157-4 is effective for us during the quarter ended June 30, 2009. The adoption of FSP 157-4 did not have a material impact on the consolidated financial statements.

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In May 2008, FASB issued Statement of Financial Accounting Standards No. 162 (SFAS 162), *The Hierarchy of Generally Accepted Accounting Principles*. This standard is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with generally accepted accounting principles in the United States for non-governmental entities. In June 2009, FASB approved the FASB Accounting Standards Codification (the Codification) as the single source of authoritative, nongovernmental accounting principles generally accepted in the United States of America (GAAP), excluding the guidance issued by the Securities and Exchange Commission (SEC). FASB approved an Exposure Draft that replaced SFAS 162 and modified GAAP by establishing only two levels of GAAP, authoritative and nonauthoritative. This was accomplished by authorizing the Codification to become the single source of authoritative U.S. accounting and reporting standards, except for rules and interpretive releases of the SEC, which are sources of authoritative GAAP for SEC registrants. All other nongrandfathered, non-SEC accounting literature not included in the Codification has become nonauthoritative. The Codification is effective for financial statements for interim or annual reporting periods ending after September 15, 2009. We do not expect the Codification to have a material impact on our consolidated financial statements.

In April 2009, FASB issued FASB Staff Position FAS 107-1 (FSP 107-1) and Accounting Principles Board Opinion No. 28-1 (APB 28-1), *Interim Disclosures about Fair Value of Financial Instruments*, which expands the fair value disclosures required for all financial instruments within the scope of Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, to interim periods for publicly traded entities. FSP 107-1 also requires entities to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments in financial statements on an interim basis and to highlight any changes of the methods and significant assumptions from prior periods. FSP 107-1 is effective for us during the quarter ended June 30, 2009. The adoption of FSP 107-1 did not have a material impact on the consolidated financial statements.

In May 2009, FASB issued Statement of Financial Accounting Standards No. 165 (SFAS 165), *Subsequent Events*. This standard is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, this standard sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. SFAS 165 is effective for us during the quarter ended June 30, 2009. The adoption of SFAS 165 did not have a material impact on the consolidated financial statements.

There have been no other significant changes in recent accounting pronouncements during the six months ended June 30, 2009 as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our exposure to market risk is confined to our cash, cash equivalents and short-term investments. As of June 30, 2009, we had \$34.8 million in cash, cash equivalents and short-term investments. The goals of our investment policy are preservation of capital, fulfillment of liquidity needs and fiduciary control of cash and investments. We also seek to maximize income from our investments without assuming significant risk. To achieve our goals, we maintain a portfolio of cash equivalents and investments in a variety of securities of high credit quality. The securities in our investment portfolio are not leveraged, are classified as either available for sale or held-to-maturity and are, due to their very short-term nature, subject to minimal interest rate risk. We currently do not hedge interest rate exposure. Because of the short-term maturities of our investments, we do not believe that an increase in market rates would have any material negative impact on the value of our investment portfolio. We have no investments denominated in foreign currencies and therefore our investments are not subject to foreign currency exchange risk.

### **ITEM 4T. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), defines the term “disclosure controls and procedures” as those controls and procedures designed to ensure that information required to be disclosed by a 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 SEC’s rules and forms and that such information is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based on their evaluation as of June 30, 2009 our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms.

## Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended June 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

We are not currently a party to any litigation and we are not aware of any pending or threatened litigation against us that could have a material adverse effect on our business, operating results or financial condition. The medical device industry in which we operate is characterized by frequent claims and litigation, including claims regarding patent and other intellectual property rights as well as improper hiring practices. As a result, we may be involved in various legal proceedings from time to time.

### ITEM 1A. RISK FACTORS

There have been no material changes during the six months ended June 30, 2009 to the risk factors set forth in Part I, Item 1A, *Risk Factors*, of our Annual Report on Form 10-K for the year ended December 31, 2008.

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

#### Unregistered Sales of Equity Securities

As previously described in our Current Report on Form 8-K filed April 29, 2009, on April 28, 2009, we received an additional \$5.0 million in debt funding from Horizon Technology Management LLC (Horizon) under the terms of the loan agreement entered into November 18, 2008. As part of the term loan draw, on April 28, 2009 the Company issued a warrant (the Warrant) to Horizon to purchase an aggregate number of shares equal to \$495,000 divided by the exercise price of the Warrant. The Warrant gives Horizon the option to purchase either (i) shares of our common stock with a per share exercise price equal to \$1.668, or (ii) shares of our stock (including common stock) issued in an equity financing that occurs after the Warrant issue date and on or before May 18, 2010 at the per share price of the stock sold in the financing. A total of 296,763 common stock warrants with an exercise price of \$1.668 per share and a ten year life were issued to Horizon on April 28, 2009.

The sales and issuances of securities described in the paragraphs above were deemed to be exempt from registration under the Securities Act by virtue of Section 4(2) of the Securities Act, as transactions by an issuer not involving any public offering.

#### Uses of Proceeds from Sale of Registered Securities

Our initial public offering of common stock was effected through a Registration Statement on Form S-1 (File No. 333-143265), that was declared effective by the SEC on November 14, 2007. We registered 5,750,000 shares of our common stock with a proposed maximum aggregate offering price of \$46.0 million, of which we sold 5,489,849 shares with gross proceeds to the Company of approximately \$43.9 million. The offering was completed after the sale of the 5,489,849 shares. J.P. Morgan Securities Inc. and Morgan Stanley & Co. Incorporated acted as joint book-running managers of the offering and, together with Cowen and Company, LLC and Leerink Swann LLC, who acted as the managing underwriters of the offering. Of this amount, \$3.1 million was paid in underwriting discounts and commissions, and an additional \$1.7 million of expenses were incurred, all of which was incurred during the fiscal year ended December 31, 2007. None of the expenses were paid, directly or indirectly, to directors, officers or persons owning 10% or more of our common stock, or to our affiliates.

We currently intend to use the aggregate net proceeds of \$39.1 million from our initial public offering as follows:

- approximately \$20.0 million for achieving regulatory approval of our product;
- approximately \$10.0 million for research and product development activities;
- approximately \$5.0 million for initiating sales and marketing efforts; and
- the remainder for working capital and other general corporate purposes.

Management has broad discretion over the uses of the proceeds of the initial public offering. As of June 30, 2009, approximately \$8.0 million of the aggregate net proceeds from our initial public offering remained invested in a variety of interest bearing instruments, including obligations of U.S. government agencies and money market funds or in operating cash accounts.

#### Purchases of Equity Securities

None.

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**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Our 2009 Annual Meeting of Stockholders (Annual Meeting) was held on May 6, 2009 in Minneapolis, Minnesota. At the Annual Meeting, our stockholders voted on the following matters set forth in our Proxy Statement, which was filed with the SEC pursuant to Regulation 14A of the Exchange Act and mailed to stockholders on April 6, 2009:

Proposal 1 – Election of three Class II directors to hold office until the 2012 Annual Meeting and until the director’s successor is elected and has qualified, or, if sooner, until the director’s death, resignation or removal.

Based on the following results of voting, each of the Class II directors was re-elected:

<u>NOMINEE</u>	<u>FOR</u>	<u>WITHHELD</u>
Luke Evin, Ph.D.	17,958,825	1,094,053
Bobby I. Griffin.	19,015,537	37,341
Paul H. Klingenstein	19,015,542	37,336

Election of one Class II director to hold office until the 2011 Annual Meeting and until the director’s successor is elected and has qualified, or, if sooner, until the director’s death, resignation or removal.

Based on the following results of voting, the Class II director was re-elected and will become a Class I director, filling the vacancy resulting from the resignation of Ellen Koskinas:

<u>NOMINEE</u>	<u>FOR</u>	<u>WITHHELD</u>
Jon T. Tremmel	19,015,537	37,341

Proposal 2 – Amendment to the EnteroMedics Inc. 2003 Stock Incentive Plan (the Plan), to increase the number of shares authorized for issuance under the Plan by 3,000,000 shares, from 3,901,103 shares to 6,901,103 shares.

Based on the following results of voting, an increase to the number of shares authorized for issuance under the Plan was approved:

<u>FOR</u>	<u>AGAINST</u>
16,842,550	292,859

At a Special Meeting of Stockholders held on July 2, 2009 in St. Paul, Minnesota our stockholders voted on the following matter set forth in our Proxy Statement, which was filed with the SEC pursuant to Regulation 14A of the Exchange Act and mailed to stockholders on June 1, 2009:

Amend Article IV, Section 1 of the Company’s Fifth Amended and Restated Certificate of Incorporation to increase the number of shares of common stock authorized for issuance by 35 million shares from 50 million to 85 million.

Based on the following results of voting, an increase to the number of shares of common stock authorized for issuance was approved:

<u>FOR</u>	<u>AGAINST</u>
23,272,029	119,533

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

The list of exhibits on the accompanying Exhibit Index are filed or incorporated by reference (as stated therein) as part of this Quarterly Report on Form 10-Q.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**ENTEROMEDICS INC.**

By: /s/ Mark B. Knudson, Ph.D.

Mark B. Knudson, Ph.D.  
*President and Chief Executive Officer*  
*(Principal Executive Officer)*

By: /s/ Greg S. Lea

Greg S. Lea  
*Senior Vice President and Chief Financial Officer*  
*(Principal Financial and Accounting Officer)*

Dated: August 7, 2009

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Description of Document</b>
3.1	Amended and Restated Certificate of Incorporation of the Company, as currently in effect. (Incorporated herein by reference to Exhibit 3.2 to Amendment No. 6 to the Company's Registration Statement on Form S-1 filed on November 9, 2007 (File No. 333-143265)).
3.2*	Certificate of Amendment to the Fifth Amended and Restated Certificate of Incorporation of the Company, dated as of July 2, 2009.
3.3	Amended and Restated Bylaws of the Company, as currently in effect. (Incorporated herein by reference to Exhibit 3.4 to Amendment No. 1 to the Company's Registration Statement on Form S-1 filed on July 6, 2007 (File No. 333-143265)).
4.1	Specimen certificate for shares of common stock (Incorporated herein by reference to Exhibit 4.1 to Amendment No. 2 to the Company's Registration Statement on Form S-1 filed on August 14, 2007 (File No. 333-143265)).
4.2	Amended and Restated Investors' Rights Agreement, dated as of July 6, 2006, by and between the Company and the parties named therein. (Incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-1 filed on May 25, 2007 (File No. 333-143265)).
10.1*	Consulting agreement, dated June 1, 2009, by and between the Company and Nicholas L. Teti, Jr.
31.1*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Filed herewith

**CERTIFICATE OF AMENDMENT**  
**TO THE**  
**FIFTH AMENDED AND RESTATED**  
**CERTIFICATE OF INCORPORATION**  
**OF**  
**ENTEROMEDICS INC.**

I, Greg S. Lea, certify that:

1. The following resolution was duly adopted and approved by the board of directors of EnteroMedics Inc. (the "Corporation") at a meeting of the board of directors held on May 5, 2009, in accordance with the applicable provisions of Section 242 of the General Corporation Law of the State of Delaware:

RESOLVED, that Article IV, Section 1 of the Fifth Amended and Restated Certificate of Incorporation of EnteroMedics Inc. is hereby amended and restated to read in full as follows:

"1. Authorized Stock. The Corporation is authorized to issue two classes of shares to be designated respectively Preferred Stock, par value \$0.01 per share, and Common Stock, par value \$0.01 per share. The total number of shares of Preferred Stock authorized is 5,000,000. The total number of shares of Common Stock authorized is 85,000,000."

2. The foregoing amendment was duly adopted by the stockholders of the Corporation in accordance with Section 242 of the General Corporation Law of the State of Delaware on July 2, 2009 at a Special Meeting of the Stockholders of the Corporation, and such resolution has not been subsequently modified or rescinded.

Dated: July 2, 2009

/s/ Greg S. Lea

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Greg S. Lea, Senior Vice President, Chief Financial  
Officer and Secretary

**CONSULTING AGREEMENT**

This Consulting Agreement (this "Agreement") is entered into as of June 1, 2009 (the "Effective Date"), by and between EnteroMedics Inc. (the "Company"), a Delaware corporation, whose principal place of business is 2800 Patton Road, St. Paul, MN 55113, and Nicholas L. Teti, Jr. (the "Consultant"), whose address is .

WHEREAS, the Consultant currently serves as a member of the Company's Board of Directors;

WHEREAS, the Company desires that the Consultant provide additional services to the Company as an independent contractor and the Consultant desires to provide such additional services as an independent contractor.

NOW, THEREFORE, in consideration of the mutual representations, promises and agreements contained herein, the adequacy and sufficiency of which are hereby acknowledged, the Company and the Consultant hereby agree as follows:

1. **Term of Agreement.** The Company hereby engages the Consultant as a consultant, subject to the terms and conditions hereof, for the period commencing as of the Effective Date and ending on June 1, 2010 (the "Term"), except as the Term may be extended by mutual written agreement of the parties hereto or earlier terminated as hereafter provided. The period during which the Consultant is performing services under this Agreement shall be referred to herein as the "Consulting Period."

2. **Consulting Services.** During the Consulting Period, the Consultant shall perform consulting services for the Company. Such consulting services are anticipated to include, but not limited to, working with Company management at a strategic level with respect to the Company's commercialization planning, business and corporate development activities and investor relations. During the Term, the Consultant will devote 160 hours per month to accomplishing his duties and responsibilities under this Agreement. Consultant shall make himself available in person for meetings and consultation with Company employees at the Company's headquarters in St. Paul, Minnesota upon reasonable request. Consultant's principal contact at EnteroMedics shall be Mark B. Knudson, Ph.D., and Consultant shall accept instructions/directions from and report to this contact person or any other designee specified by Dr. Knudson.

3. **Independent Contractor.**

(a) The Consultant shall perform the consulting services described in Section 2 as an independent contractor without the power to bind or represent the Company for any purpose whatsoever. Nothing herein contained shall be construed to constitute the parties hereto as partners or as joint venturers, or either as agent of the other, or as employer and employee. The Consultant shall not present himself as an employee of the Company or any of its affiliates.

(b) The Consultant shall not be entitled to participate in any employee benefit plans maintained by on behalf of the Company or any of its affiliates during the Consulting Period. The Consultant hereby acknowledges his separate responsibility for all federal and state withholding taxes, Federal Insurance Contribution Act taxes, workers' compensation and unemployment compensation taxes and business license fees, if applicable.

#### 4. Compensation.

(a) Consulting Fee. In remuneration for the consulting services to be performed under this Agreement by the Consultant during the Consulting Period, the Consultant shall receive an annual consulting fee equal to two hundred seventy-five thousand dollars (\$275,000) (the "Consulting Fee"), payable no less frequently than monthly in arrears. The Consulting Fee shall be in addition to, and not in lieu of, those fees or other remuneration to which the Consultant may be entitled pursuant to Company policies in his position as member of the Board of Directors.

(b) Equity Award. As additional compensation for the consulting services to be performed by the Consultant under this Agreement, the Company shall grant the Consultant a non-qualified option to purchase one hundred fifty thousand (150,000) shares of the Company's common stock at the closing market price of the Company's common stock on the date such award is approved by the Company's Board of Directors. This option shall have a 10-year term and shall vest one-thirtieth per month for three years and shall be vested in full on the third anniversary of the grant date.

5. Expenses. The Company will reimburse Consultant for actual incidental expenses (with no increase for handling or other mark-up) incurred in performing this Agreement, but such expenses shall not exceed one hundred dollars (\$100) per month without the Company's prior written consent. Travel expenses must be approved in advance by the Company. Consultant shall provide the Company with appropriate documentation for tax purposes for all expenses paid by the Company. Consultant shall submit monthly invoices for time and expenses.

6. Termination. During the Term, this Agreement and the Consulting Period may be terminated at any time by the Company or the Consultant, with or without cause, upon thirty (30) days' prior written notice to the other party. The Agreement may be terminated by the Company immediately for any willful breach by Consultant of this Agreement or any willful misconduct or malfeasance by Consultant that may be detrimental or harmful to the Company. In the event of the termination of this Agreement pursuant to this Section 6, the Company's obligations under Section 4(a) shall cease on the effective date of such termination. In the event of the Consultant's death or permanent disability, the Agreement and Consulting Period shall terminate. The provisions of this Section 6, as well as Sections 7, 8, 9 and 15 shall survive the expiration or termination of this Agreement and shall remain in full force and effect in accordance with the terms thereof.

7. Exclusivity. Due to the confidential nature of the information which will be disclosed to Consultant in connection with his performance of the consulting services under this Agreement, Consultant shall not do any other consulting work for any other third party in the area of the Company's products, services or Technology or for any competitor or potential competitor of the Company during the Term and for a period of six months thereafter without prior approval by the Company. The Company's "Technology" shall include the Company's proprietary VBLOC™, vagal blocking therapy, and Maestro™ System or any similar device or

related processes, products or services related to obesity management or treatment of gastrointestinal disorders, including, without limitation, the use of neuroblocking or neurostimulation to treat obesity, its associated co-morbidities, metabolic syndrome and gastrointestinal disorders.

8. Confidential Information; Non-Solicitation. The parties hereto recognize that a major need of the Company is to preserve its specialized knowledge, trade secrets, and confidential information. The strength and good will of the Company is derived from the specialized knowledge, trade secrets, and confidential information generated from experience with the activities undertaken by the Company. The disclosure of this information and knowledge to competitors would be beneficial to them and detrimental to the Company. The Consultant acknowledges that the proprietary information, observations and data obtained by him during the Consulting Period concerning the business or affairs of the Company are the property of the Company. By reason of being a member of the Company's Board of Directors and through the services provided under this Agreement, the Consultant has or will have access to, and has obtained or will obtain, specialized knowledge, trade secrets and confidential information about the Company's operations. Therefore, the Consultant hereby agrees as follows, recognizing that the Company is relying on these agreements in entering into this Agreement:

(a) The Consultant will not use, disclose to others, or publish or otherwise make available to any other party any inventions or any Confidential Information about the affairs of the Company, including but not limited to confidential information concerning the results of the Company's clinical trials and financial condition. "Confidential Information" shall include any information considered by the Company to be confidential and/or proprietary that is disclosed by the Company to Consultant, all confidential information of third parties that is to be held as confidential by the Company, commercial or trade secrets about Company's proprietary Technology, products, devices and methods, as well as information about the Company's engineering designs, plans and standards, commercial plans, sales and marketing plans, techniques and reports, analytical techniques, technical information, employee information, or financial and business records, any of which contains proprietary information created or acquired by the Company and which information is held in confidence by Company. Confidential Information does not include information which: (i) becomes generally available to the public, unless said Confidential Information was disclosed in violation of a confidentiality agreement; or (ii) becomes available to the Consultant on a non-confidential basis from a source other than the Company or its agents, provided that such source is not bound by a confidentiality agreement with the Company or has not breached a duty of confidentiality to the Company in disclosing such information.

(b) During the Term and for twelve (12) months thereafter, the Consultant will not directly or indirectly through another entity (i) induce any employee of the Company to leave the Company's employ (unless the Board of Directors shall have authorized such employment and the Company shall have consented thereto in writing) or in any way interfere with the relationship between the Company and any employee thereof or (ii) tortuously interfere with the Company's business relationship with any supplier, customer, vendor, clinical trial sponsor or other business relation of the Company.

9. Intellectual Property; Works of Authorship.

(a) Consultant agrees to disclose promptly to the Company all inventions, improvements, know-how, formulas, trade secrets, secret processes, technical information, or any other intellectual property (other than works of authorship) made or conceived, either alone or jointly with others, during the term of this Agreement and for six (6) months thereafter as a result of the services provided pursuant to this Agreement or of the Confidential Information obtained by Consultant during the term of this Agreement or any extension thereof. Consultant agrees that the Company shall be the exclusive owner of the entire right, title, and interest in and to any and all such intellectual property, including any patent applications and any patents that may issue therefrom anywhere in the world. Consultant agrees to assign all right, title, and interest in and to such intellectual property to the Company without further payment from the Company. Consultant also agrees that, upon the Company's request and at the Company's expense, Consultant will provide reasonable assistance to the Company in prosecuting, maintaining, and protecting patents covering any such intellectual property.

(b) Any original work of authorship including any written, pictorial, graphic or audiovisual work, sound recording, courseware design or architecture in any form including, but not limited to, computer generated files and code, created by the Consultant in the course of providing services to the Company under this Agreement shall be deemed as "works made for hire" and be the sole property of the Company and the Company shall own all the rights including the rights to copyright in the work. To the extent that any of the foregoing does not qualify as a "work made for hire," Consultant hereby irrevocably transfers, assigns and conveys the exclusive copyright ownership thereof to the Company, free and clear of any liens, claims or other encumbrances, to the fullest extent permitted by law. Consultant agrees to execute all documents and perform all acts that the Company may reasonably request in order to assist the Company in perfecting its rights in and to the works developed under this Agreement anywhere in the world. The Company will reimburse Consultant for any expenses reasonably incurred by Consultant in so doing.

(c) The obligations to assign inventions and copyrights to the Company shall not apply to any invention or copyrights for which no equipment, supplies, facility or trade secret information of the Company was used and which was developed entirely on the Consultant's own time, and (1) which does not relate (a) directly to the business of the Company or (b) to the Company's actual or demonstrably anticipated research or development, or (2) which does not result from any work performed by the Consultant for the Company.

10. Entire Agreement. This Agreement sets forth the entire agreement and understanding of the parties hereto with respect to the matters covered hereby and supersedes any prior agreement or understanding whether oral or written between the parties with respect to the matters covered hereby. Nothing in this Agreement shall be construed to grant Consultant any right of service on the Company's Board of Directors or committee thereof.

11. Notices. All notices required or permitted by this Agreement shall be in writing and may be delivered in person, sent by certified or registered mail, return receipt required, postage paid to the addresses stated above or to such other address as either party may designate or by facsimile to such facsimile number as either party may designate. All mailing notices shall be deemed effective upon depositing in the mail.

12. Waiver. The waiver of either party of a breach of any provision of this Agreement shall not operate as or be construed as a continuing waiver or as a consent to or waiver of such subsequent breach.

13. Modification. This Agreement may only be modified in writing signed by both parties.

14. Nonassignable. Since the consulting services to be provided under this Agreement are personal, all duties to be performed by Consultant may not be assigned to any other individual or third party without the written consent of the Company.

15. Governing Law. This Agreement shall be governed by and construed in accordance with the internal laws of the State of Minnesota, without regard to its principles of conflicts of laws. ANY RIGHT TO TRIAL BY JURY WITH RESPECT TO ANY CLAIM, ACTION, SUIT OR PROCEEDING ARISING OUT OF THIS AGREEMENT OR ANY OF THE MATTERS CONTEMPLATED HEREBY IS WAIVED BY THE COMPANY AND CONSULTANT. THE COMPANY AND CONSULTANT HEREBY SUBMIT TO THE EXCLUSIVE JURISDICTION OF THE FEDERAL AND STATE COURTS LOCATED IN HENNEPIN COUNTY, MINNESOTA, IN CONNECTION WITH ANY DISPUTE RELATED TO THIS AGREEMENT OR ANY OF THE MATTERS CONTEMPLATED HEREBY.

16. Severability. If one or more provisions of this Agreement are held to be unenforceable under applicable law, such provision shall be excluded from this Agreement and the balance of the Agreement shall be interpreted as if such provision were so excluded and shall be enforceable in accordance with its terms.

17. Counterparts. This Agreement may be executed in one or more counterparts, each of which shall be deemed to be an original and all of which together shall constitute one and the same instrument.

*(remainder of page intentionally left blank)*

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the day and year first above written.

ENTEROMEDICS INC.

By: /s/ Mark B. Knudson, Ph.D.

Name: Mark B. Knudson, Ph.D.

Title: President and Chief Executive Officer

CONSULTANT

/s/ Nicholas L. Teti, Jr.

Nicholas L. Teti, Jr.

## CERTIFICATION

I, Mark B. Knudson, Ph.D., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of EnteroMedics Inc.;

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

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

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

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

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

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

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

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

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

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

/s/ MARK B. KNUDSON, PH.D.

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**Mark B. Knudson, Ph.D.**  
**President and Chief Executive Officer**

Date: August 7, 2009

## CERTIFICATION

I, Greg S. Lea, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of EnteroMedics Inc.;

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

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

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

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

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

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

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

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

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

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

/s/ GREG S. LEA

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**Greg S. Lea**  
**Senior Vice President and Chief Financial Officer**

Date: August 7, 2009

**CERTIFICATION**

Pursuant to the requirement set forth in Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350), Mark B. Knudson, Ph.D., in his capacity as Chief Executive Officer of EnteroMedics Inc., hereby certifies that, to the best of his knowledge:

1. The Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2009 to which this Certification is attached as Exhibit 32.1 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act, and
2. That the information contained in the Report fairly presents, in all material respects, the financial condition and the results of operations of EnteroMedics Inc. as of, and for, the periods covered by the Report.

By: \_\_\_\_\_ /s/ Mark B. Knudson, Ph.D.

**Mark B. Knudson, Ph.D.**  
**President and Chief Executive Officer**

Date: August 7, 2009

**CERTIFICATION**

Pursuant to the requirement set forth in Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350), Greg S. Lea, in his capacity as Chief Financial Officer of EnteroMedics Inc., hereby certifies that, to the best of his knowledge:

1. The Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2009 to which this Certification is attached as Exhibit 32.2 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act, and
2. That the information contained in the Report fairly presents, in all material respects, the financial condition and the results of operations of EnteroMedics Inc. as of, and for, the periods covered by the Report.

By: \_\_\_\_\_ /s/ Greg S. Lea  
**Greg S. Lea**  
**Senior Vice President and Chief Financial Officer**

Date: August 7, 2009