ARENA PHARMACEUTICALS INC
Form 10-Q
May 10, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2011

or

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

For the transition period from ______ to ______

Commission File Number: 000-31161

ARENA PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of** **incorporation or organization)**	**23-2908305** **(I.R.S. Employer** **Identification No.)**
6166 Nancy Ridge Drive, San Diego, CA **(Address of principal executive offices)**	**92121** **(Zip Code)**

858.453.7200

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, 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.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	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 x No

The number of shares of common stock outstanding as of the close of business on May 2, 2011:

Class	**Number of Shares Outstanding**
Common Stock, $0.0001 par value	145,894,281

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ARENA PHARMACEUTICALS, INC.

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In this report, Arena Pharmaceuticals, Arena, we, us and our refer to Arena Pharmaceuticals, Inc., and our wholly owned subsidiaries, unless context otherwise provides.

Arena Pharmaceuticals®, Arena® and our corporate logo are registered service marks of Arena. CART and BRL Screening are unregistered service marks of Arena. Any other brand names or trademarks appearing in this Quarterly Report on Form 10-Q are the property of their respective holders.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

Arena Pharmaceuticals, Inc.

Condensed Consolidated Balance Sheets

(In thousands)

	March 31, 2011 (Unaudited)	December 31, 2010 [1]
Assets		
Current assets:		
Cash and cash equivalents	$ 119,862	$ 150,669
Accounts receivable	2,959	3,499
Prepaid expenses and other current assets	2,629	2,638
Total current assets	125,450	156,806
Land, property and equipment, net	89,619	91,533
Acquired technology and other intangibles, net	11,852	12,031
Other non-current assets	5,810	5,992
Total assets	$ 232,731	$ 266,362
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable and other accrued liabilities	$ 4,683	$ 5,017
Accrued compensation	3,246	4,427
Accrued clinical and preclinical study fees	525	1,236
Accrued restructuring	1,782	0
Current portion of deferred revenues	3,880	3,846
Current portion of derivative liabilities	0	607
Current portion of note payable to Siegfried	7,079	3,560
Current portion of note payable to Deerfield[2]	0	17,175
Current portion of lease financing obligations	1,073	998
Total current liabilities	22,268	36,866
Deferred rent	370	412
Deferred revenues, less current portion	43,269	44,231
Derivative liabilities, less current portion	1,225	1,664
Note payable to Siegfried, less current portion	0	6,801
Note payable to Deerfield, less current portion[2]	12,151	20,602
Lease financing obligations, less current portion	75,483	75,771
Other accrued liabilities, less current portion	116	0
Commitments and contingencies and subsequent events		
Stockholders equity:		
Common stock	14	12

Series C convertible preferred stock	0	0
Additional paid-in capital	1,105,981	1,068,634
Treasury stock, at cost	(23,070)	(23,070)
Accumulated other comprehensive income	5,349	4,966
Accumulated deficit	(1,010,425)	(970,527)
Total stockholders equity	77,849	80,015
Total liabilities and stockholders equity	$ 232,731	$ 266,362

1 The balance sheet data at December 31, 2010 has been derived from audited financial statements at that date. It does not include, however, all of the information and notes required by US generally accepted accounting principles for complete financial statements.

2 The outstanding principal balance of the note payable to Deerfield was $22.3 million and $60.0 million at March 31, 2011 and December 31, 2010, respectively. See Note 5.

See accompanying notes to unaudited condensed consolidated financial statements.

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Arena Pharmaceuticals, Inc.

Condensed Consolidated Statements of Operations

(In thousands, except per share data)

(Unaudited)

	Three months ended March 31, 2011	Three months ended March 31, 2010
Revenues:		
Manufacturing services	$ 1,408	$ 1,975
Collaborative agreements	2,517	538
Total revenues	3,925	2,513
Operating Expenses:		
Cost of manufacturing services	2,381	1,865
Research and development	15,935	18,314
General and administrative	6,890	7,014
Restructuring charges	3,467	0
Amortization of acquired technology and other intangibles	436	537
Total operating expenses	29,109	27,730
Loss from operations	(25,184)	(25,217)
Interest and Other Income (Expense):		
Interest income	49	139
Interest expense	(4,694)	(7,650)
Gain from valuation of derivative liabilities	439	1,419
Loss on extinguishment of debt	(10,514)	0
Other	6	39
Total interest and other expense, net	(14,714)	(6,053)
Net loss	(39,898)	(31,270)
Deemed dividend related to beneficial conversion feature of convertible preferred stock	(2,260)	0
Net loss allocable to common stockholders	$ (42,158)	$ (31,270)
Net loss per share allocable to common stockholders, basic	$ (0.35)	$ (0.33)
Net loss per share allocable to common stockholders, diluted	$ (0.35)	$ (0.33)
Shares used in calculating net loss per share allocable to common stockholders, basic	121,654	94,955
Shares used in calculating net loss per share allocable to common stockholders, diluted	121,654	94,955

See accompanying notes to unaudited condensed consolidated financial statements.

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Arena Pharmaceuticals, Inc.

Condensed Consolidated Cash Flow Statements

(In thousands)

(Unaudited)

	Three months ended March 31, 2011	2010
Operating Activities		
Net loss	$ (39,898)	$ (31,270)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,560	2,645
Amortization of acquired technology and other intangibles	436	537
Share-based compensation	1,330	1,811
Gain from valuation of derivative liabilities	(439)	(1,419)
Amortization of prepaid financing costs	283	115
Accretion of note payable to Deerfield	1,599	3,922
Loss on extinguishment of debt	10,514	0
Accretion of note payable to Siegfried	126	66
Gain on disposal of equipment	0	(1)
Changes in assets and liabilities:		
Accounts receivable	524	(557)
Prepaid expenses and other assets	(85)	(135)
Accounts payable and accrued liabilities	(384)	(5,640)
Deferred revenues	(928)	(37)
Deferred rent	(42)	(34)
Net cash used in operating activities	(24,404)	(29,997)
Investing Activities		
Purchases of short-term investments, available-for-sale	0	(145)
Purchases of land, property and equipment	(90)	(1,855)
Proceeds from sale of equipment	0	2
Other non-current assets	3	(152)
Net cash used in investing activities	(87)	(2,150)
Financing Activities		
Principal payments on lease financing obligations	(213)	(147)
Principal payments on note payable to Deerfield	(37,739)	0
Repayment on note payable to Siegfried	(3,430)	0
Proceeds from issuance of common stock	17,662	24,469
Proceeds from issuance of preferred stock	17,750	0
Net cash provided by (used in) financing activities	(5,970)	24,322
Effect of exchange rate changes on cash	(346)	(162)
Net decrease in cash and cash equivalents	(30,807)	(7,987)
Cash and cash equivalents at beginning of period	150,669	94,733
Cash and cash equivalents at end of period	$ 119,862	$ 86,746

See accompanying notes to unaudited condensed consolidated financial statements.

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Notes to Unaudited Condensed Consolidated Financial Statements

1. Basis of Presentation and Recent Events

The accompanying unaudited condensed consolidated financial statements of Arena Pharmaceuticals, Inc., which include our wholly owned subsidiaries, should be read in conjunction with the audited consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2010, as filed with the Securities and Exchange Commission, or SEC, from which we derived our balance sheet as of December 31, 2010. The accompanying financial statements have been prepared in accordance with US generally accepted accounting principles, or GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, since they are interim statements, the accompanying financial statements do not include all of the information and notes required by GAAP for complete financial statements. The accompanying financial statements reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of our management, necessary to a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year.

During the first quarter of 2011, we identified an error in our consolidated financial statements for the years ended December 31, 2003 through December 31, 2008 related to the dividends and accretion of discount on our Series B Convertible Preferred Stock, which is no longer outstanding. The error relates to dividends that were recorded to our accumulated deficit rather than to additional paid-in capital. To correct the error, we recorded a non-cash cumulative adjustment as of December 31, 2008 to reduce both our accumulated deficit and additional paid-in capital by $18.6 million. This adjustment is reflected on the accompanying condensed consolidated balance sheets as of December 31, 2010. We determined that this adjustment was not material to our financial position for any previously reported period, and it had no impact on our results of operations and cash flows.

The preparation of financial statements in accordance with GAAP requires our management to make estimates and assumptions that affect amounts reported in the financial statements and notes thereto. The amounts reported could differ under different estimates and assumptions.

2. Fair Value Disclosures

We measure our financial assets and liabilities at fair value, which is defined as the exit price, or the amount that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

We use the following three-level valuation hierarchy that maximizes the use of observable inputs and minimizes the use of unobservable inputs to value our financial assets and liabilities:

- Level 1 - Observable inputs such as unadjusted quoted prices in active markets for identical instruments.
- Level 2 - Quoted prices for similar instruments in active markets or inputs that are observable for the asset or liability, either directly or indirectly.
- Level 3 - Unobservable inputs based on our assumptions.

The following table presents our valuation hierarchy for our financial assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2011, in thousands:

		Fair Value Measurements at March 31, 2011		
	Balance at March 31, 2011	**Quoted Prices in Active Markets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets:				
Money market funds and cash equivalents[1]	$ 78,241	$ 78,241	$ 0	$ 0
Liabilities:				
Warrants and other derivative instruments	$ 1,225	$ 0	$ 0	$ 1,225

[1] Included in cash and cash equivalents on our condensed consolidated balance sheet.

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The following table presents our valuation hierarchy for our financial assets and liabilities that are measured at fair value on a recurring basis as of December 31, 2010, in thousands:

		Fair Value Measurements at December 31, 2010		
	Balance at December 31, 2010	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market funds and cash equivalents[1]	$ 138,195	$ 138,195	$ 0	$ 0
Liabilities:				
Warrants and other derivative instruments	$ 2,271	$ 0	$ 0	$ 2,271

1 Included in cash and cash equivalents on our consolidated balance sheet.

The following table presents the activity for our derivative liabilities during the three months ended March 31, 2011, in thousands:

	Significant Unobservable Inputs (Level 3)
Balance at December 31, 2010	$ 2,271
Termination of Deerfield Additional Loan Election (see Note 5)	(607)
Gain from valuation of derivative liabilities	(439)
Balance at March 31, 2011	$ 1,225

3. Acquired Technology and Other Intangibles

In February 2001, we acquired Bunsen Rush Laboratories, Inc. for $15.0 million in cash and assumed $0.4 million in liabilities. We allocated $15.4 million to the patented Melanophore screening technology acquired in such transaction. We amortized this technology over its estimated useful life of 10 years, which we determined based on an analysis as of the acquisition date.

In January 2008, we acquired from Siegfried Ltd, or Siegfried, certain drug product facility assets, including manufacturing facility production licenses originally valued at $12.1 million. We are amortizing the manufacturing facility production licenses, which are necessary for us to produce and package tablets and other dosage forms in such facility, over their estimated useful life of 20 years as of the acquisition date.

Acquired technology and other intangibles, net, consisted of the following at March 31, 2011, in thousands:

	Gross Carrying Amount	Accumulated Amortization	Net
Acquired Melanophore screening technology	$ 15,378	$ (15,378)	$ 0
Acquired manufacturing facility production licenses	14,152	(2,300)	11,852
Total acquired technology and other intangibles, net	$ 29,530	$ (17,678)	$ 11,852

4. Note Payable to Siegfried Ltd and Related Agreements

In January 2008, we acquired from Siegfried certain drug product facility assets, including manufacturing facility production licenses, fixtures, equipment, other personal property and real estate assets in Zofingen, Switzerland, under an Asset Purchase Agreement between Siegfried and Arena Pharmaceuticals GmbH, or Arena GmbH, our wholly owned subsidiary. These assets are being used to manufacture lorcaserin and certain drug products for Siegfried. In connection with this transaction, we and Siegfried also entered into a long-term supply agreement for the active pharmaceutical ingredient of lorcaserin, a manufacturing services agreement and a technical services agreement.

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The purchase price under the Asset Purchase Agreement, in Swiss francs, was CHF 31.8 million in cash and 1,488,482 shares of our common stock valued at $8.0 million, which we issued to Siegfried in January 2008. We paid CHF 21.8 million, or $19.6 million, of the cash purchase price in January 2008 and CHF 3.3 million, or $3.4 million, in January 2011. We were required to pay the remaining CHF 6.7 million cash portion of the purchase price in two equal installments, with the first due in January 2012 and the second due in January 2013.

In March 2011, Arena GmbH amended its agreements with Siegfried, effective January 1, 2011, whereby, among other changes, Arena GmbH agreed to accelerate its payments to Siegfried for the remaining CHF 6.7 million of the cash purchase price under the Asset Purchase Agreement to June 2011 and October 2011, respectively. Also under the amended agreements, Siegfried agreed (i) to order from Arena GmbH 400 million units of drug product for manufacture by Arena GmbH in 2011, (ii) to use its reasonable commercial effort to order from Arena GmbH 200 million units of drug product for manufacture by Arena GmbH from January 1, 2012 to June 30, 2012, and (iii) to reduce its fees for providing Arena GmbH with certain technical and business services. The prices under the amended manufacturing services agreement between Arena GmbH and Siegfried are lower than cost and the prices Siegfried paid in 2010.

In accordance with relevant guidance, we recognized a provision for loss related to services to be rendered through June 30, 2012 whereby the costs will exceed the related revenues under the amended manufacturing services agreement. This loss provision, estimated at $0.8 million, was recorded as part of our cost of manufacturing services on our condensed consolidated statements of operations during the three months ended March 31, 2011. Of this amount, $0.7 million is included in the accounts payable and other accrued liabilities line item on our condensed consolidated balance sheet and $0.1 million is reported in the other accrued liabilities line item.

5. Note Payable to Deerfield

In July 2009, pursuant to a Facility Agreement we entered into in June 2009, or the Facility Agreement, with Deerfield Private Design Fund, L.P., Deerfield Private Design International, L.P., Deerfield Partners, L.P., Deerfield International Limited, Deerfield Special Situations Fund, L.P., and Deerfield Special Situations Fund International Limited, or collectively Deerfield, Deerfield provided us with a $100.0 million secured loan. We received net proceeds of $95.6 million from this loan. In connection with the loan, we issued Deerfield warrants to purchase an aggregate of 28,000,000 shares of our common stock, exercisable until June 17, 2013, at an exercise price of $5.42 per share. We refer to these warrants as the 2009 Warrants. Deerfield has the right to require us to accelerate principal payments under the loan under certain circumstances, and at any time we may prepay any or all of the outstanding principal at par.

Deerfield previously had the right to make a one-time election, which we refer to as the Deerfield Additional Loan Election, to loan us up to an additional $20.0 million under the Facility Agreement, with the additional loan maturing on the same date as the original loan, June 17, 2013. For each additional $1.0 million that Deerfield loaned us under the Facility Agreement, we would have been required to issue Deerfield warrants for 280,000 shares of our common stock at an exercise price of $5.42 per share. In addition, Deerfield previously had the right to require us to accelerate payments under the loan in connection with certain equity issuances. Each of these rights was terminated in March 2011 as described below.

In accordance with relevant guidance, we separately valued four components under the Facility Agreement as of the date of the initial loan. Since that date, as discussed below in this note, we have amended the terms of the Facility Agreement, repaid certain of the debt, and exchanged certain of the warrants, which affects how we value and account for the Facility Agreement. The four components under the Facility Agreement were previously valued as of July 6, 2009 as follows:

(1) The $100.0 million loan was valued at $47.9 million on a relative fair value basis, and was recorded as a long-term liability on our condensed consolidated balance sheet.

(2) The 2009 Warrants to purchase an aggregate of 28,000,000 shares of our common stock, net of issuance costs, were valued at $39.1 million on a relative fair value basis. The relative fair value of the warrants was recorded as additional paid-in capital on our condensed consolidated balance sheet, and the resulting debt discount is being accreted to interest expense over the term of the loan or until paid using the effective interest rate method. These warrants were valued at their date of issuance using an option pricing model and the following assumptions: expected life of 3.95 years, risk-free interest rate of 2.0%, expected volatility of 66% and no dividend yield. Because these warrants are eligible for equity classification, no adjustments to the recorded value will be made on an ongoing basis.

(3) The Deerfield Additional Loan Election was valued at $9.5 million. The Deerfield Additional Loan Election was classified as a liability on our condensed consolidated balance sheet and, accordingly, was revalued on each subsequent balance sheet date until it was terminated, with any changes in the fair value between reporting periods recorded in the interest and other income (expense) section of our condensed consolidated statements of operations (see Note 6). Until the Deerfield Additional Loan Election was terminated, we accreted the additional debt discount that resulted from the allocation of proceeds under the Facility Agreement to interest expense using the effective interest rate method.

(4) Deerfield s ability to accelerate principal payments under the loan under certain circumstances, including upon certain changes of control, was valued at $0.5 million. The acceleration right was classified as a liability on our condensed consolidated balance sheet and, accordingly, will be revalued on each subsequent balance sheet date until it is exercised or expires, with any changes in the fair value between reporting periods recorded in the interest and other income (expense) section of our condensed consolidated statements of operations (see Note 6). This allocation of proceeds under the Facility Agreement resulted in additional debt discount that we will accrete to interest expense over the term of the loan or until paid using the effective interest rate method.

As a result of the closing of our public offering of common stock in July 2009, which occurred after we entered into the Facility Agreement, we were required to repay Deerfield $10.0 million that was originally scheduled to be repaid in July 2010. In connection with this $10.0 million repayment, we retired a proportional share of the debt discount and issuance costs directly related to the repaid debt and recognized a non-cash loss on extinguishment of debt of $2.5 million in 2009.

In June 2010, we entered into a Purchase and Exchange Agreement, or the 2010 Purchase Agreement, with Deerfield, pursuant to which we sold Deerfield 11,000,000 shares of our common stock at a price of $3.23 per share, resulting in net proceeds to us of $35.5 million. Also pursuant to the 2010 Purchase Agreement, we exchanged a portion of the 2009 Warrants to purchase an aggregate of 16,200,000 shares of our common stock at an exercise price of $5.42 per share for new warrants, which we refer to as the 2010 Warrants, to purchase a like number of shares of our common stock at an exercise price of $3.45 per share. The outstanding 2010 Warrants are exercisable until June 17, 2013. Other than the exercise price and certain provisions related to cashless exercise and early termination of the warrants, the 2010 Warrants contain substantially the same terms as the 2009 Warrants.

We valued the 2010 Warrants at their June 2010 issuance date using an option pricing model and the following assumptions: expected life of 3.03 years, risk-free interest rate of 1.2%, expected volatility of 72% and no dividend yield. We determined that the incremental value of the 2010 Warrants was $5.5 million, which was recorded as a component of the stock issuance and warrant exchange under the 2010 Purchase Agreement in the stockholders equity section of our condensed consolidated balance sheet. Because the 2010 Warrants are eligible for equity classification, no adjustments to the recorded value will be made on an ongoing basis.

In August 2010, we sold 8,955,224 shares of our common stock at a price of $6.70 per share in a registered direct public offering to Deerfield. As part of this transaction, we entered into the first of two amendments to the Facility Agreement, pursuant to which $30.0 million of the proceeds from this transaction was used to prepay the portion of the principal amount that we otherwise would have been required to repay in July 2012. Net proceeds to us from this transaction, after prepayment of the $30.0 million, were approximately $30.0 million. In connection with this $30.0 million prepayment, we retired a proportional share of the debt discount and issuance costs directly related to the repaid debt and recognized a non-cash loss on extinguishment of debt of $12.4 million in 2010. In accordance with relevant guidance, we also evaluated whether this amendment constituted an extinguishment of debt resulting in extinguishment accounting or modification accounting. Based on our analysis, we determined that this amendment was not a substantial modification and, accordingly, we accounted for this amendment under modification accounting. Had extinguishment accounting been required, we would have recognized a gain or loss based on the difference between the carrying value of our note payable to Deerfield and its fair value.

To reduce our interest payments, in January 2011, we prepaid $20.0 million of the principal amount that was originally scheduled to be repaid to Deerfield in July 2011. In connection with this $20.0 million prepayment, we retired a proportional share of the debt discount and issuance costs directly related to the repaid debt and recognized a non-cash loss on extinguishment of debt of $2.5 million in the three months ended March 31, 2011.

In March 2011, we and Deerfield entered into (i) an Exchange Agreement, (ii) a Securities Purchase Agreement, and (iii) a Second Amendment to the Facility Agreement, or the Second Amendment.

Under the Exchange Agreement, we agreed to exchange 14,368,590 of the 2010 Warrants for new warrants, which we refer to as the 2011 Warrants, to purchase a like number of shares of our common stock at an exercise price of $1.68 per share. The 2011 Warrants will be exercisable beginning on October 1, 2011 and will remain exercisable until June 17, 2015. Other than the exercise period, the exercise price and certain provisions related to cashless exercise and early termination of the warrants, the 2009 Warrants, the 2010 Warrants and the 2011 Warrants each contain substantially the same terms.

Under the Securities Purchase Agreement, Deerfield purchased 12,150,000 shares of our common stock for a purchase price of $1.46 per share and 12,150 shares of our Series C Convertible Preferred Stock, or Series C Preferred, for a purchase price of $1,460.00 per share. Each share of Series C Preferred was convertible into 1,000 shares of our common stock at any time at the option of the holder, subject to certain limitations. See Note 14. The fair value of the common stock into which the Series C Preferred was convertible on the date of issuance exceeded the proceeds, allocated on a relative fair value basis, by $2.3 million, resulting in a beneficial conversion feature that we recognized as a decrease to additional paid-in capital and a deemed dividend to the Series C Preferred stockholders for the three months ended March 31, 2011.

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Under the Second Amendment, we prepaid $17.7 million of the principal amount that we otherwise would have been required to repay to Deerfield in June 2013. Taking into account such prepayment, net proceeds to us under the Securities Purchase Agreement were approximately $17.6 million. In connection with this $17.7 million prepayment, we retired a proportional share of the debt discount and issuance costs directly related to the repaid debt and recognized a non-cash loss on extinguishment of debt of $8.0 million in the three months ended March 31, 2011. In accordance with relevant guidance, we also evaluated whether this amendment constituted an extinguishment of debt resulting in extinguishment accounting or modification accounting. Based on our analysis, we determined that this amendment was not a substantial modification and, accordingly, we accounted for this amendment under modification accounting. Had extinguishment accounting been required, we would have recognized a gain or loss based on the difference between the carrying value of our note payable to Deerfield and its fair value.

The Second Amendment also eliminated the Deerfield Additional Loan Election and our obligation to accelerate payments under the loan in connection with certain equity issuances.

We valued the 2011 Warrants at their March 2011 issuance date using an option pricing model and the following assumptions: expected life of 4.21 years, risk-free interest rate of 1.9%, expected volatility of 82% and no dividend yield. We determined that the incremental value of the 2011 Warrants was $6.0 million, which was recorded as a component of the stock issuance and warrant exchange in the stockholders equity section of our condensed consolidated balance sheet. Because the 2011 Warrants are eligible for equity classification, no adjustments to the recorded value will be made on an ongoing basis.

At March 31, 2011, the outstanding principal balance on the Deerfield loan was $22.3 million, which is due on June 17, 2013. The difference between the $12.2 million recorded value and the $22.3 million outstanding principal balance of the loan as of March 31, 2011 represents the remaining debt discount, which we will accrete over the term of the loan or until paid. The outstanding principal accrues interest at the contractual rate of 7.75% per annum on the stated principal balance, payable quarterly in arrears. Total interest expense of $2.7 million and $5.7 million, including accretion of the debt discount attributable to the warrants and the other derivative financial instruments and amortization of capitalized issuance costs, was recognized in connection with this loan in the three months ended March 31, 2011 and 2010, respectively. The current effective annual interest rate on the loan is 38.4%.

6. Derivative Liabilities

In June 2006 and August 2008, we issued seven-year warrants, which we refer to as the Series B Warrants, to purchase 829,856 and 1,106,344 shares of our common stock, respectively, at an exercise price of $15.49 and $7.71 per share, respectively. The Series B Warrants are related to our Series B Convertible Preferred Stock, which we redeemed in 2008 and is no longer outstanding. The warrants contain an anti-dilution provision and, as a result of subsequent equity issuances at prices below the adjustment price of $6.72 defined in the warrants, as of March 31, 2011, the number of shares issuable upon exercise of the outstanding June 2006 and August 2008 Series B Warrants was increased to 1,227,743 and 1,640,368 respectively, and the exercise price was reduced to $10.47 and $5.20 per share, respectively. The Series B Warrants are classified as a liability on our condensed consolidated balance sheets.

In accordance with relevant guidance, we have revalued these warrants on each subsequent balance sheet date, and will continue to do so until they are exercised or expire, with any changes in the fair value between reporting periods recorded as other income or expense. The June 2006 and August 2008 Series B Warrants were valued at March 31, 2011 and 2010 using an option pricing model and the following assumptions:

	March 31, 2011		March 31, 2010	
	June 2006 Series B Warrants	August 2008 Series B Warrants	June 2006 Series B Warrants	August 2008 Series B Warrants
Risk-free interest rate	1.0%	2.0%	1.7%	2.7%
Dividend yield	0%	0%	0%	0%
Expected volatility	90%	82%	73%	66%
Expected life (years)	2.25	4.37	3.25	5.38

As of the July 2009 issuance date of the Deerfield loan, we separately valued the Deerfield Additional Loan Election, including the 5,600,000 contingently issuable warrants to purchase up to 5,600,000 shares of our common stock. Because the Deerfield Additional Loan Election was classified as a liability on our condensed consolidated balance sheet until this right was terminated in March 2011 (see Note 5), it was revalued on each subsequent balance sheet date, with any changes in the fair value between reporting periods recorded as other income or expense. Upon its termination in March 2011, the $0.6 million value recorded for the Deerfield Additional Loan Election was recorded as a component of the stock issuance and warrant exchange in the stockholders equity section of our condensed consolidated balance sheet.

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We also separately valued Deerfield s right to require us to accelerate payments under the loan under certain circumstances, including upon certain changes of control, at $0.5 million as of the July 2009 issuance date of the Deerfield loan (see Note 5). The value of this acceleration right is classified as a liability on our condensed consolidated balance sheet and, accordingly, will be revalued on each subsequent balance sheet date until it is exercised or expires, with any changes in the fair value between reporting periods recorded as other income or expense. At each reporting date, this acceleration right was valued using a discounted cash flow model.

Our derivative liabilities consisted of the following at March 31, 2011 and December 31, 2010, in thousands:

	March 31, 2011	December 31, 2010
Deerfield Additional Loan Election	$ 0	$ 607
Total current derivative liabilities	0	607
Series B Warrants	975	1,234
Deerfield acceleration right	250	430
Total long-term derivative liabilities	1,225	1,664
Total derivative liabilities	$ 1,225	$ 2,271

The change in the fair value of our derivative liabilities is recorded in the interest and other income (expense) section of our condensed consolidated statements of operations. The following table presents the gain we recognized in the three months ended March 31, 2011 and 2010, in thousands:

	Three months ended March 31, 2011	2010
Series B Warrants	$ 259	$ 212
Deerfield Additional Loan Election	0	1,169
Deerfield acceleration right	180	38
Total gain due to revaluation of derivative liabilities	$ 439	$ 1,419

7. Warrants

As part of our June 2010 sale of common stock to Deerfield (see Note 5), we exchanged 16,200,000 of the 2009 Warrants to purchase shares of our common stock at an exercise price of $5.42 per share for 2010 Warrants to purchase a like number of shares of our common stock at an exercise price of $3.45 per share. We valued the incremental value of the 2010 Warrants at $5.5 million as of their issuance date. As part of our March 2011 sale of common and preferred stock to Deerfield (see Note 5), we exchanged 14,368,590 of the 2010 Warrants to purchase shares of our common stock at an exercise price of $3.45 per share for 2011 Warrants to purchase a like number of shares of our common stock at an exercise price of $1.68 per share, and extended the expiration date of these warrants to June 17, 2015. We valued the incremental value of the 2011 Warrants at $6.0 million as of their issuance date.

The following table summarizes our outstanding warrants as of March 31, 2011:

	Balance Sheet Classification	Number of Warrants	Exercise Price	Expiration Date
Deerfield 2011 Warrants	Equity	14,368,590	$ 1.68	June 17, 2015

Deerfield 2010 Warrants	Equity	1,831,410	$ 3.45	June 17, 2013
Deerfield 2009 Warrants	Equity	11,800,000	$ 5.42	June 17, 2013
August 2008 Series B Warrants	Liability	1,640,368	$ 5.20	August 14, 2015
June 2006 Series B Warrants	Liability	1,227,743	$ 10.47	June 30, 2013
Total number of warrants outstanding		30,868,111		

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8. Share-based Activity

Share-based Compensation

We recognized share-based compensation expense as follows, in thousands, except per share data:

	Three months ended March 31, 2011	Three months ended March 31, 2010
Research and development	$ 525	$ 861
General and administrative	711	950
Restructuring charges	94	0
Total share-based compensation expense and impact on net loss allocable to common stockholders	$ 1,330	$ 1,811
Impact on net loss per share allocable to common stockholders, basic and diluted	$ 0.01	$ 0.02

Share-based Award Activity

The following table summarizes our stock option activity during the three months ended March 31, 2011:

	Options	Weighted-Average Exercise Price
Outstanding at January 1, 2011	8,358,594	$ 7.63
Granted	2,792,382	1.49
Exercised	0	0
Forfeited/cancelled/expired	(547,097)	7.77
Outstanding at March 31, 2011	10,603,879	$ 6.01

The following table summarizes activity with respect to our performance-based restricted stock unit awards during the three months ended March 31, 2011:

	Performance Units	Weighted-Average Grant-Date Fair Value
Outstanding at January 1, 2011	1,666,650	$ 12.50
Granted		
Vested		
Forfeited/cancelled	(333,950)	11.98
Outstanding at March 31, 2011	1,332,700	$ 12.63

9. Concentration of Credit Risk and Major Customers

Financial instruments, which potentially subject us to concentrations of credit risk, consist primarily of cash, cash equivalents and short-term investments. We limit our exposure to credit loss by placing our cash and investments in US government, agency and government-sponsored enterprise obligations and in corporate debt instruments that are rated investment grade, in accordance with our board-approved investment policy.

We manufacture drug products for Siegfried under a manufacturing services agreement, and all of our manufacturing services revenues are attributable to Siegfried.

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Percentages of our total revenues derived from our manufacturing services agreement and from our most significant collaborators for the periods presented are as follows:

	Three months ended March 31,	
Source of Revenue	**2011**	**2010**
Manufacturing services agreement with Siegfried	35.9%	78.6%
Collaboration with Eisai Inc.	50.9%	0
Former collaboration with Ortho-McNeil-Janssen Pharmaceuticals, Inc.	12.9%	21.2%

10. Restructuring Charges

Around the end of March 2011, we completed a reduction of our US workforce of approximately 25%, or a total of 65 employees, that was announced in January 2011 and is part of our revised corporate strategy and reduction in expenditures. We accounted for our restructuring activities in accordance with relevant guidance that requires that a liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. As a result of this restructuring, we recorded a charge of $3.5 million for the three months ended March 31, 2011, including non-cash, share-based compensation charges of $0.1 million, which is reflected as a separate line item in the accompanying condensed consolidated statements of operations. As of March 31, 2011, $1.6 million of this charge has been paid, resulting in a remaining accrual of $1.8 million, the majority of which will be paid in the second and third quarters of 2011.

11. Net Loss Per Share

We compute basic and diluted net loss per share allocable to common stockholders using the weighted-average number of shares of common stock outstanding during the period, less any shares subject to repurchase or forfeiture. There were no shares of our common stock subject to repurchase or forfeiture for the three months ended March 31, 2011 or 2010.

Because we are in a net loss position, we have excluded outstanding unvested performance-based restricted stock unit awards, which are subject to forfeiture, warrants, stock options and convertible preferred stock, as well as unvested restricted stock in our deferred compensation plan, from our calculation of diluted net loss per share because including these securities in the calculation would be antidilutive for the periods presented. The table below presents our securities that would otherwise be included in our diluted net loss per share allocable to common stockholders at March 31, 2011 and 2010.

	Three months ended March 31,	
	2011	**2010**
Warrants	30,868,111	30,241,491
Stock options	10,603,879	8,632,260
Performance-based restricted stock unit awards	1,332,700	1,703,250
Unvested restricted stock	79,169	96,669
Series C Preferred	12,1	