ARENA PHARMACEUTICALS INC
Form 10-Q
August 09, 2010

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 June 30, 2010

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	**23-2908305**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
6166 Nancy Ridge Drive, San Diego, CA	**92121**
(Address of principal executive offices)	**(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 August 5, 2010:

Class	**Number of Shares Outstanding**
Common Stock, $0.0001 par value	112,346,464

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ARENA PHARMACEUTICALS, INC.

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PART I FINANCIAL INFORMATION

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)

	June 30, 2010 (Unaudited)	December 31, 2009 *
Assets		
Current assets:		
Cash and cash equivalents	$ 97,040	$ 94,733
Short-term investments, available-for-sale	21,458	20,716
Accounts receivable	1,900	1,415
Prepaid expenses and other current assets	4,220	4,409
Total current assets	124,618	121,273
Land, property and equipment, net	92,090	95,445
Acquired technology and other intangibles, net	11,505	13,123
Other non-current assets	6,637	6,437
Total assets	$ 234,850	$ 236,278
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable and other accrued liabilities	$ 5,076	$ 9,677
Accrued compensation	3,234	3,928
Accrued clinical and preclinical study fees	3,046	2,279
Deferred revenues	4,070	4,086
Derivative liabilities	2,195	
Current portion of lease financing obligations	853	717
Current portion of note payable to Siegfried	3,079	
Total current liabilities	21,553	20,687
Deferred rent	489	564
Derivative liabilities	2,613	6,642
Note payable to Siegfried, less current portion	5,748	9,143
Note payable to Deerfield**	50,470	47,906
Lease financing obligations, less current portion	76,311	76,769
Commitments		
Stockholders equity:		
Common stock	12	10
Additional paid-in capital	1,024,609	961,269

Treasury stock, at cost	(23,070)	(23,070)
Accumulated other comprehensive income	729	945
Accumulated deficit	(924,614)	(864,587)
Total stockholders equity	77,666	74,567
Total liabilities and stockholders equity	$ 234,850	$ 236,278

* The balance sheet data at December 31, 2009 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.

** The outstanding principal balance of the note payable to Deerfield at June 30, 2010 and December 31, 2009 was $90.0 million. 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 June 30, 2010	Three months ended June 30, 2009	Six months ended June 30, 2010	Six months ended June 30, 2009
Revenues:				
Manufacturing services	$ 1,437	$ 1,508	$ 3,412	$ 2,926
Collaborative agreements	1,022	920	1,560	2,160
Total revenues	2,459	2,428	4,972	5,086
Operating Expenses:				
Cost of manufacturing services	1,630	1,643	3,495	2,997
Research and development	20,502	24,205	38,816	66,825
General and administrative	6,760	5,660	13,774	13,302
Restructuring charges		3,324		3,324
Amortization of acquired technology and other intangibles	531	573	1,068	1,139
Total operating expenses	29,423	35,405	57,153	87,587
Loss from operations	(26,964)	(32,977)	(52,181)	(82,501)
Interest and Other Income (Expense):				
Interest income	92	46	231	216
Interest expense	(2,281)	(1,935)	(9,931)	(3,652)
Gain (Loss) from valuation of derivative liabilities	415	(2,492)	1,834	(2,127)
Other	(19)	(625)	20	(533)
Total interest and other expense, net	(1,793)	(5,006)	(7,846)	(6,096)
Net loss	$ (28,757)	$ (37,983)	$ (60,027)	$ (88,597)
Net loss per share, basic and diluted	$ (0.28)	$ (0.48)	$ (0.60)	$ (1.16)
Shares used in calculating net loss per share, basic and diluted	104,136	79,212	99,571	76,701

See accompanying notes to unaudited condensed consolidated financial statements.

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Arena Pharmaceuticals, Inc.

Condensed Consolidated Cash Flow Statements

(In thousands)

(Unaudited)

	Six months ended June 30, 2010	Six months ended June 30, 2009
Operating Activities		
Net loss	$ (60,027)	$ (88,597)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	5,314	5,583
Amortization of acquired technology and other intangibles	1,068	1,139
Share-based compensation	3,129	3,740
Deferred income tax provision		267
(Gain) Loss from valuation of derivative liabilities	(1,834)	2,127
Amortization of short-term investment premium		66
Amortization of prepaid financing costs	121	64
Accretion of note payable to Deerfield	2,564	
Accretion of note payable to Siegfried	129	120
Loss on disposal of equipment	44	249
Changes in assets and liabilities:		
Accounts receivable	(527)	139
Prepaid expenses and other assets	110	(22)
Accounts payable and accrued liabilities	(4,932)	(22,009)
Deferred revenue	(17)	
Deferred rent	(76)	(61)
Net cash used in operating activities	(54,934)	(97,195)
Investing Activities		
Purchases of short-term investments, available-for-sale	(238)	
Proceeds from sales/maturities of short-term investments, available-for-sale		32,622
Purchases of land, property and equipment	(2,700)	(2,536)
Proceeds from sale of equipment	2	259
Deposits, restricted cash and other non-current assets	(300)	135
Net cash provided by (used in) investing activities	(3,236)	30,480
Financing Activities		
Principal payments on lease financing obligations	(322)	(316)
Proceeds from lease financing		15,000
Proceeds from issuance of common stock	60,213	15,151
Net cash provided by financing activities	59,891	29,835
Effect of exchange rate changes on cash	586	(933)
Net increase (decrease) in cash and cash equivalents	2,307	(37,813)
Cash and cash equivalents at beginning of period	94,733	73,329
Cash and cash equivalents at end of period	$ 97,040	$ 35,516

See accompanying notes to unaudited condensed consolidated financial statements.

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Notes to Unaudited Condensed Consolidated Financial Statements

1. Basis of Presentation

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, 2009, as filed with the Securities and Exchange Commission, or SEC, from which we derived our balance sheet as of December 31, 2009. 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.

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.

During the second quarter of 2010, we identified an error in our consolidated financial statements as of and for the year ended December 31, 2009 and the three months ended March 31, 2010. This error was that we overstated interest expense by $3.0 million and $1.3 million for the year ended December 31, 2009 and the three months ended March 31, 2010, respectively, as a result of incorrectly applying the effective interest method to the accretion component of the debt discount on our note payable to Deerfield. The total interest expense on this note is comprised of such accretion and the 7.75% coupon rate applied to the outstanding and undiscounted principal balance. In accordance with the relevant guidance, management evaluated the materiality of the error from a qualitative and quantitative perspective. Based on such evaluation, we concluded that correcting the cumulative error would be immaterial to the expected full year results for 2010 and correcting the error would not have had a material impact on any individual prior period financial statements or affect the trend of financial results. Accordingly, we recorded a non-cash adjustment during the second quarter of 2010 to reduce both the cumulative interest expense and the note payable to Deerfield by $4.3 million.

2. Short-term Investments, Available-for-Sale

We define short-term investments as income-yielding securities that can be readily converted to cash, and classify such investments as available-for-sale. We carry these securities at fair value, and report unrealized gains and losses as a separate component of accumulated other comprehensive income or loss. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in interest income. Realized gains and losses and declines in securities judged to be other than temporary are included in other income or expense. The cost of securities sold is based on the specific identification method. Interest and dividends on available-for-sale securities are included in interest income.

The following table summarizes the investment categories comprising our available-for-sale securities at June 30, 2010 and December 31, 2009, in thousands:

	Maturity in Years	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
June 30, 2010					
US government and agency obligations	Less than 1	$ 20,671	$ 787	$	$ 21,458
Total available-for-sale securities		$ 20,671	$ 787	$	$ 21,458
December 31, 2009					
US government and agency obligations	Less than 1	$ 20,433	$ 404	$ (121)	$ 20,716
Total available-for-sale securities		$ 20,433	$ 404	$ (121)	$ 20,716

3. 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.

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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 June 30, 2010, in thousands:

		Fair Value Measurements at June 30, 2010		
	Balance at June 30, 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)	$ 54,384	$ 54,384	$	$
US government and agency obligations (2)	21,458	21,458		
Liabilities:				
Warrants and other derivative instruments	$ 4,808	$	$	$ 4,808

(1) Included in cash and cash equivalents on our condensed consolidated balance sheet.
(2) Included in short-term investments, available-for-sale on our condensed consolidated balance sheet.

The following table presents the activity for our derivative liabilities during the six months ended June 30, 2010, in thousands:

	Significant Unobservable Inputs (Level 3)
Balance at December 31, 2009	$ 6,642
Gain from change in valuation of derivative liabilities	(1,834)
Balance at June 30, 2010	$ 4,808

4. 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 technology, our primary screening technology, acquired in such transaction. We are amortizing the Melanophore screening technology over its estimated useful life of 10 years, which was determined based on an analysis, as of the acquisition date, of the conditions in, and the economic outlook for, the pharmaceutical and biotechnology industries and the patent life of the technology.

In January 2008, we acquired from Siegfried Ltd, or Siegfried, certain assets, including manufacturing facility production licenses and an assembled workforce originally valued at $12.1 million and $1.6 million, respectively. 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. We amortized the acquired workforce over its estimated benefit of two years, which was determined based on an analysis as of the acquisition date.

Acquired technology and other intangibles, net, consisted of the following at June 30, 2010, in thousands:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Acquired Melanophore screening technology	$ 15,378	$ (14,345)	$ 1,033
Acquired manufacturing facility production licenses	11,968	(1,496)	10,472
Acquired workforce	1,550	(1,550)	
Total identifiable intangible assets, net	$ 28,896	$ (17,391)	$ 11,505

5. Note Payable to Deerfield

In July 2009, pursuant to a Facility Agreement we entered into in June 2009 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 and we issued Deerfield warrants to purchase an aggregate of 28,000,000 shares of our common stock at an exercise price of $5.42 per share. We refer to these warrants as the 2009 Warrants. We received net proceeds of $95.6 million from this loan.

On or before June 17, 2011, Deerfield may 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 loans us under the Facility Agreement, we will issue Deerfield warrants for 280,000 shares of common stock at an exercise price of $5.42 per share. All of the warrants issued or issuable in connection with the Facility Agreement are exercisable until June 17, 2013.

Under certain circumstances, Deerfield also has the right to require us to accelerate principal payments under the loan. At any time we may prepay any or all of the outstanding principal at par, and we may be required to make the scheduled repayments earlier in connection with certain equity issuances. At June 30, 2010, the outstanding principal balance on the Deerfield loan was $90.0 million.

In accordance with relevant guidance, we separately valued four components under the Facility Agreement at the July 2009 issuance date as follows:

(1) The $100.0 million loan was valued at $47.9 million on a relative fair value basis, and is 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 these warrants is 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 the 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, including the 5,600,000 contingently issuable warrants to purchase up to 5,600,000 shares of our common stock, was valued at $9.5 million. The Deerfield Additional Loan Election 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 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 is being accreted to interest expense over the term of the loan or until paid using the effective interest rate method.

(4) Deerfield s ability to accelerate principal payments under the loan was valued at $0.5 million. The 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 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 is being accreted to interest expense over the term of the loan or until paid using the effective interest rate method.

The difference between the $50.5 million recorded value of the note payable to Deerfield and the $90.0 million outstanding principal balance of the loan as of June 30, 2010 represents the remaining debt discount, which will be accreted to interest expense over the term of the loan or until paid.

The loan matures on June 17, 2013, and the outstanding principal accrues interest at a rate of 7.75% per annum on the stated principal balance, payable quarterly in arrears. Total interest expense of $0.4 million and $6.1 million, including accretion of the debt discount

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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 and six months ended June 30, 2010, respectively. These amounts include the non-cash correction of prior period errors described in Note 1, which resulted in a $4.3 million decrease to interest expense in the three months ended June 30, 2010 and a $3.0 million decrease to interest expense in the six months ended June 30, 2010. At June 30, 2010, we expected interest expense of $15.4 million to be paid in cash over the remaining term of the loan. The effective annual interest rate on the loan is 38.5%.

As a result of the closing of our public offering of common stock in July 2009, 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 recorded a loss on extinguishment of debt of $2.5 million in 2009. The schedule of our remaining required principal repayments is as follows: $20.0 million in July 2011, $30.0 million in July 2012, and $40.0 million at maturity. See Note 11.

In June 2010, we entered into a Purchase and Exchange Agreement, or Purchase Agreement, with Deerfield, pursuant to which Deerfield purchased 11,000,000 shares of our common stock at a purchase price of $3.23 per share, resulting in net proceeds to us of $35.5 million. Also pursuant to the Purchase Agreement, we exchanged 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 New Warrants, to purchase a like number of shares of our common stock at an exercise price of $3.45 per share. The New Warrants are exercisable beginning on December 7, 2010 and will remain exercisable until June 17, 2013, which is the same date the 2009 Warrants expire. Other than the exercise price and certain provisions related to cashless exercise and early termination of the warrants, the New Warrants contain substantially the same terms as the 2009 Warrants.

We valued the New Warrants at their June 7, 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 New Warrants was $5.5 million, which was recorded as a component of the stock issuance and warrant exchange under the Purchase Agreement in the stockholders equity section of our condensed consolidated balance sheet. Because the New Warrants are eligible for equity classification, no adjustments to the recorded value will be made on an ongoing basis.

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 June 30, 2010 the number of shares issuable upon exercise of the outstanding June 2006 and August 2008 Series B Warrants was increased to 1,045,929 and 1,396,058 respectively, and the exercise price was reduced to $12.29 and $6.11 per share, respectively.

In January 2009, we adopted amendments to the authoritative guidance related to contracts in an entity s own equity. These amendments provide a two-step model to be applied in determining whether a financial instrument or an embedded feature in a financial instrument is indexed to an entity s own stock that would qualify such financial instruments or embedded features for a scope exception. This scope exception specifies that a contract that would otherwise meet the definition of a derivative but is both (i) indexed to the entity s own stock and (ii) classified in the stockholders equity section of the balance sheet would not be considered a derivative financial instrument. Our adoption of these amendments resulted in the determination that our Series B Warrants are ineligible for equity classification as a result of provisions in the Series B Warrants that may result in an adjustment to the warrant exercise price. As such, upon adoption of the new amendments, we recorded a $9.7 million adjustment to equity, a $2.1 million liability for the fair value of the Series B Warrants and a $7.6 million adjustment to the opening accumulated deficit balance as a cumulative effect of a change in accounting principle. 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 Series B Warrants were valued at June 30, 2010 using an option pricing model and the following assumptions: expected life of 3.0 years, risk-free interest rate of 1.0%, expected volatility of 72% and no dividend yield. The August 2008 Series B Warrants were valued at June 30, 2010 using an option pricing model and the following assumptions: expected life of 5.12 years, risk-free interest rate of 1.9%, expected volatility of 64% and no dividend yield.

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, as of the July 2009 issuance date of the Deerfield loan (see Note 5). The value of the Deerfield Additional Loan Election 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. In July 2009, the Deerfield Additional Loan Election was valued using an option pricing model and the following assumptions: expected life of 2 to 3 years, risk-free interest rate of 2.0%, expected volatility of 66% and no dividend yield. At June 30, 2010, the Deerfield Additional Loan Election was revalued using an option pricing model and

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the following assumptions: expected life of 2 to 2.5 years, risk-free interest rate of 1.0%, expected volatility of 72% and no dividend yield.

We also separately valued Deerfield s right to require us to accelerate principal payments of the loan under certain circumstances 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 the issuance date and at June 30, 2010, this acceleration right was valued using a discounted cash flow model.

Our derivative liabilities consisted of the following as of June 30, 2010 and December 31, 2009, in thousands:

	June 30, 2010	December 31, 2009
Deerfield Additional Loan Election	$ 2,195	
Total current derivative liabilities	2,195	
Deerfield Additional Loan Election		$ 3,831
Series B Warrants	2,153	2,386
Deerfield acceleration right	460	425
Total long-term derivative liabilities	2,613	6,642
Total derivative liabilities	$ 4,808	$ 6,642

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 (loss) we recorded in the three and six months ended June 30, 2010 and 2009, in thousands:

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Series B Warrants	$ 21	$ (2,492)	$ 233	$ (2,127)
Deerfield Additional Loan Election	467		1,636	
Deerfield acceleration right	(73)		(35)	
Total gain (loss) due to revaluation of derivative liabilities	$ 415	$ (2,492)	$ 1,834	$ (2,127)

7. Share-based Activity

Share-based Compensation

We use the Black-Scholes option pricing model to estimate the grant-date fair value of share-based awards in determining our share-based compensation expense. In June 2009, our stockholders approved our 2009 Long-Term Incentive Plan and, concurrently, our 2006 Long-Term Incentive Plan, as amended, was terminated. The table below sets forth the weighted-average assumptions and estimated fair value of stock options we granted under these plans during the three and six months ended June 30, 2010 and 2009:

Three months ended June 30,	Six months ended June 30,

	2010	2009	2010	2009
Risk-free interest rate	2.1%	1.7%	2.4%	2.0%
Dividend yield	0%	0%	0%	0%
Expected volatility	79%	80%	72%	86%
Expected life (years)	5.76	5.72	5.76	5.72
Weighted-average estimated fair value per share of stock options granted	$ 2.03	$ 1.63	$ 2.06	$ 2.87

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In June 2009, our stockholders also approved our 2009 Employee Stock Purchase Plan and, concurrently, our 2001 Employee Stock Purchase Plan, as amended, was terminated. The table below sets forth the weighted-average assumptions and estimated fair value of the options to purchase stock granted under these plans for multiple offering periods during the three and six months ended June 30, 2010 and 2009:

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Risk-free interest rate	0.1% - 2.8%	0.1% -5.0%	0.1% -2.8%	0.1% -5.1%
Dividend yield	0%	0%	0%	0%
Expected volatility	62% -82%	53% - 82%	62% - 82%	53% -82%
Expected life (years)	0.25 - 2.0	0.25 - 2.0	0.25 -2.0	0.25 -2.0
Weighted-average estimated fair value per share of options granted under our employee stock purchase plans	$ 1.41 - 2.28	$ 1.45 - 4.70	$ 1.41 -2.28	$ 1.45 -4.70

Expected volatility is based on a combination of 75% historical volatility of our common stock and 25% market-based implied volatilities from traded options on our common stock, with historical volatility being more heavily weighted due to the low volume of traded options on our common stock. The expected life of options is determined based on historical experience of similar awards, giving consideration to the contractual terms of the share-based awards, vesting schedules and post-vesting terminations. The risk-free interest rates are based on the US Treasury yield curve, with a remaining term approximately equal to the expected term used in the option pricing model.

Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Based on historical experience, forfeitures of unvested options were estimated to be 7.0% at June 30, 2010 and 8.5% at June 30, 2009. If actual forfeitures vary from estimates, we will recognize the difference in compensation expense in the period the actual forfeitures occur or when stock options vest.

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

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Research and development	$ 924	$ 932	$ 1,785	$ 1,824
General and administrative	394	481	1,344	1,610
Restructuring charges		306		306
Total share-based compensation expense and impact on net loss	$ 1,318	$ 1,719	$ 3,129	$ 3,740
Impact on net loss per share, basic and diluted	$ 0.01	$ 0.02	$ 0.03	$ 0.05

Share-based Award Activity

The following table summarizes our stock option activity during the six months ended June 30, 2010:

	Options	Weighted-Average Exercise Price
Outstanding at January 1, 2010	7,226,824	$ 8.94
Granted	1,605,587	3.23

Exercised	(45,455)	0.82
Forfeited/cancelled/expired	(477,927)	9.46
Outstanding at June 30, 2010	8,309,029	$ 7.85

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The following table summarizes activity with respect to our performance-based restricted stock unit awards during the six months ended June 30, 2010:

	Performance Units	Weighted-Average Grant-Date Fair Value
Outstanding at January 1, 2010	1,714,350	$ 12.44
Granted		
Vested		
Forfeited/cancelled	(13,900)	8.30
Outstanding at June 30, 2010	1,700,450	$ 12.47

8. 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.

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

	Three months ended June 30,		Six months ended June 30,	
Source of revenue	**2010**	**2009**	**2010**	**2009**
Manufacturing services agreement with Siegfried	58.4%	62.1%	68.6%	57.5%
Collaboration with Ortho-McNeil-Janssen Pharmaceuticals, Inc.	25.6%	37.5%	23.4%	42.1%

9. Net Loss Per Share

We compute basic and diluted net loss per share 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 and six months ended June 30, 2010 or 2009.

Because we are in a net loss position, we have excluded the following outstanding unvested performance-based restricted stock unit awards, which are subject to forfeiture, warrants and stock options, as well as unvested restricted stock in our deferred compensation plan, from our calculation of diluted net loss per share for the three and six months ended June 30, 2010 and 2009 because these securities are antidilutive:

	Three and six months ended June 30,	
	2010	**2009**
Warrants	30,441,987	2,030,253
Stock options	8,309,029	7,283,823
Performance-based restricted stock unit awards	1,700,450	1,737,750

Unvested restricted stock	84,169	101,669
Total	40,535,635	11,153,495

Had they been dilutive, these securities would have been included in our computation of diluted net loss per share.

10. Comprehensive Income (Loss)

We report all components of comprehensive income (loss), including foreign currency translation gain and loss and unrealized gains and losses on investment securities, in the financial statements in the period in which they are recognized. Comprehensive income

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(loss) is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. Below is a reconciliation, in thousands, of our net loss to comprehensive loss for all periods presented.

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Net loss	$ (28,757)	$ (37,983)	$ (60,027)	$ (88,597)
Foreign currency translation gain (loss)	131	1,336	(720)	(841)
Unrealized gain (loss) on available-for-sale securities and other investments, net of taxes	495	(12)	504	(29)
Comprehensive loss	$ (28,131)	$ (36,659)	$ (60,243)	$ (89,467)