ORION ENERGY SYSTEMS, INC.
Form 10-Q
February 09, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the Quarterly Period Ended December 31, 2010

OR

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

Commission file number 001-33887

Orion Energy Systems, Inc.

(Exact name of Registrant as specified in its charter)

Wisconsin	**39-1847269**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification number)**
2210 Woodland Drive, Manitowoc, Wisconsin	**54220**
(Address of principal executive offices)	**(Zip code)**

Registrant s telephone number, including area code: (920) 892-9340

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 þ No o

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) during the preceding 12 months (or for shorter period that the registrant was required to submit and post such files). Yes o No o

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 accelerated filer, large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

There were 22,818,902 shares of the Registrant s common stock outstanding on February 7, 2011.

Orion Energy Systems, Inc.
Quarterly Report On Form 10-Q
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PART I FINANCIAL INFORMATION

Item 1: Financial Statements

ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	March 31, 2010	December 31, 2010
Assets		
Cash and cash equivalents	$ 23,364	$ 9,858
Short-term investments	1,000	1,010
Accounts receivable, net of allowances of $382 and $467	14,617	24,326
Inventories, net	25,991	32,230
Deferred tax assets		502
Prepaid expenses and other current assets	2,974	3,140
Total current assets	67,946	71,066
Property and equipment, net	30,500	37,741
Patents and licenses, net	1,590	1,634
Deferred tax assets	2,610	2,662
Other long-term assets	975	2,963
Total assets	$ 103,621	$ 116,066
Liabilities and Shareholders Equity		
Accounts payable	$ 7,761	$ 15,363
Accrued expenses and other	3,844	4,190
Deferred tax liabilities	44	
Current maturities of long-term debt	562	1,261
Total current liabilities	12,211	20,814
Long-term debt, less current maturities	3,156	4,618
Deferred revenue, long-term	186	1,599
Other long-term liabilities	398	399
Total liabilities	15,951	27,430
Commitments and contingencies (See Note F)		
Shareholders equity:		
Preferred stock, $0.01 par value: Shares authorized: 30,000,000 shares at March 31, 2010 and December 31, 2010; no shares issued and outstanding at March 31, 2010 and December 31, 2010		
Common stock, no par value: Shares authorized: 200,000,000 at March 31, 2010 and December 31, 2010; shares issued: 29,911,203 and 30,224,199 at March 31, 2010 and December 31, 2010; shares outstanding: 22,442,380 and 22,792,302 at March 31, 2010 and December 31, 2010		
Additional paid-in capital	122,515	123,965
Shareholder notes receivable		(157)
	(32,011)	(31,767)

Treasury stock: 7,468,823 and 7,431,897 common shares at March 31, 2010 and December 31, 2010		
Accumulated deficit	(2,834)	(3,405)
Total shareholders equity	87,670	88,636
Total liabilities and shareholders equity	$ 103,621	$ 116,066

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

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ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except share and per share amounts)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2009	2010	2009	2010
Product revenue	$ 17,205	$ 27,663	$ 41,645	$ 54,080
Service revenue	2,090	2,008	4,897	3,994
Total revenue	19,295	29,671	46,542	58,074
Cost of product revenue	10,633	18,784	27,727	35,566
Cost of service revenue	1,568	1,674	3,455	3,089
Total cost of revenue	12,201	20,458	31,182	38,655
Gross profit	7,094	9,213	15,360	19,419
Operating expenses:				
General and administrative	3,051	2,709	9,357	8,642
Sales and marketing	3,063	3,235	9,176	10,124
Research and development	404	614	1,315	1,797
Total operating expenses	6,518	6,558	19,848	20,563
Income (loss) from operations	576	2,655	(4,488)	(1,144)
Other income (expense):				
Interest expense	(67)	(99)	(197)	(223)
Dividend and interest income	49	3	248	19
Total other income (expense)	(18)	(96)	51	(204)
Income (loss) before income tax	558	2,559	(4,437)	(1,348)
Income tax expense (benefit)	(249)	1,915	(1,072)	(777)
Net income (loss)	$ 807	$ 644	$ (3,365)	$ (571)
Basic net income (loss) per share	$ 0.04	$ 0.03	$ (0.15)	$ (0.03)
Weighted-average common shares outstanding	21,792,175	22,726,426	21,709,799	22,629,776
Diluted net income (loss) per share	$ 0.04	$ 0.03	$ (0.15)	$ (0.03)
Weighted-average common shares and share equivalents outstanding	22,567,575	23,110,633	21,709,799	22,629,776

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

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ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine Months Ended December 31,	
	2009	**2010**
Operating activities		
Net loss	$ (3,365)	$ (571)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,956	3,145
Stock-based compensation expense	1,064	931
Deferred income tax benefit	(1,234)	(597)
Change in allowance for notes and accounts receivable	384	85
Other	15	25
Changes in operating assets and liabilities:		
Accounts receivable	(1,950)	(9,794)
Inventories	(4,285)	(6,239)
Prepaid expenses and other assets	1,414	(350)
Accounts payable	5,193	7,602
Accrued expenses	633	346
Net cash used in operating activities	(175)	(5,417)
Investing activities		
Purchase of property and equipment	(4,268)	(2,885)
Purchase of property and equipment leased to customers under operating leases	(5,328)	(7,375)
Purchase of short-term investments		(10)
Sale of short-term investments	5,522	
Additions to patents and licenses	(186)	(158)
Proceeds from sales of long-term assets	6	1
Long-term assets		(330)
Net cash used in investing activities	(4,254)	(10,757)
Financing activities		
Payment of long-term debt	(640)	(528)
Proceeds from long-term debt	200	2,689
Proceeds from shareholder notes		1
Repurchase of common stock into treasury	(400)	
Excess tax benefits from stock-based compensation	95	193
Deferred financing costs and offering costs		(61)
Proceeds from issuance of common stock	947	374
Net cash provided by financing activities	202	2,668
Net decrease in cash and cash equivalents	(4,227)	(13,506)
Cash and cash equivalents at beginning of period	36,163	23,364
Cash and cash equivalents at end of period	$ 31,936	$ 9,858

Supplemental cash flow information:				
Cash paid for interest	$	215	$	192
Cash paid for income taxes		30		31
Supplemental disclosure of non-cash investing and financing activities				
Shares issued from treasury for stock note receivable	$		$	158
Shares surrendered into treasury for stock option exercise	$		$	51

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

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ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES
UNAUDITED NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE A DESCRIPTION OF BUSINESS

Organization

The Company includes Orion Energy Systems, Inc., a Wisconsin corporation, and all consolidated subsidiaries. The Company is a developer, manufacturer and seller of lighting and energy management systems and a seller and integrator of renewable energy technologies to commercial and industrial businesses, predominantly in North America.

In August 2009, we created Orion Engineered Systems, a new operating division offering additional alternative renewable energy systems. During the quarter ended December 31, 2010, the new division exceeded the thresholds for segment reporting and, accordingly, the Company has introduced the presentation of operating segments in this quarter. See Note I Segment Reporting of these financial statements for further discussion of our reportable segments.

The corporate offices and manufacturing operations are located in Manitowoc, Wisconsin and an operations facility is located in Plymouth, Wisconsin.

NOTE B SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of consolidation

The condensed consolidated financial statements include the accounts of Orion Energy Systems, Inc. and its wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

Reclassifications

Certain items have been reclassified from the fiscal year 2010 classifications to conform to the fiscal year 2011 presentation. The reclassification had no effect on net cash used in operating activities, total assets, net income (loss) or income (loss) per share.

Basis of presentation

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included. Interim results are not necessarily indicative of results that may be expected for the year ending March 31, 2011 or other interim periods.

The condensed consolidated balance sheet at March 31, 2010 has been derived from the audited consolidated financial statements at that date but does not include all of the information required by GAAP for complete financial statements.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended March 31, 2010 filed with the SEC on June 14, 2010.

Use of estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during that reporting period. Areas that require the use of significant management estimates include revenue recognition, inventory obsolescence, bad debt reserves, accruals for warranty expenses, income taxes and certain equity transactions. Accordingly, actual results could differ from those estimates.

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Cash and cash equivalents

The Company considers all highly liquid, short-term investments with original maturities of three months or less to be cash equivalents.

Short-term investments available for sale

The amortized cost and fair value of marketable securities, with gross unrealized gains and losses, as of March 31, 2010 and December 31, 2010 were as follows (in thousands):

	March 31, 2010					
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short Term Investments
Money market funds	$ 22,297	$	$	$ 22,297	$ 22,297	$
Bank certificates of deposit	1,000			1,000		1,000
Total	$ 23,297	$	$	$ 23,297	$ 22,297	$ 1,000

	December 31, 2010					
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short Term Investments
Money market funds	$ 484	$	$	$ 484	$ 484	$
Bank certificate of deposit	1,010			1,010		1,010
Total	$ 1,494	$	$	$ 1,494	$ 484	$ 1,010

As of March 31, 2010 and December 31, 2010, the Company s financial assets described in the table above were measured at fair value on a recurring basis employing quoted prices in active markets for identical assets (level 1 inputs).

The Company s certificate of deposit is pledged as security for an equipment lease.

Fair value of financial instruments

The carrying amounts of the Company s financial instruments, which include cash and cash equivalents, short-term investments, accounts receivable, and accounts payable and deferred revenue, approximate their respective fair values due to the relatively short-term nature of these instruments. Based upon interest rates currently available to the Company for debt with similar terms, the carrying value of the Company s long-term debt is also approximately equal to its fair value.

Accounts receivable

The majority of the Company s accounts receivable are due from companies in the commercial, industrial and agricultural industries, as well as wholesalers. Credit is extended based on an evaluation of a customer s financial condition. Generally, collateral is not required for end users; however, the payment of certain trade accounts receivable from wholesalers is secured by irrevocable standby letters of credit. Accounts receivable are due within 30-60 days. Accounts receivable are stated at the amount the Company expects to collect from outstanding balances. The Company provides for probable uncollectible amounts through a charge to earnings and a credit to an allowance for doubtful accounts based on its assessment of the current status of individual accounts. Balances that are still outstanding after the Company has used reasonable collection efforts are written off through a charge to the allowance for doubtful accounts and a credit to accounts receivable.

Inventories

Inventories consist of raw materials and components, such as ballasts, metal sheet and coil stock and molded parts; work in process inventories, such as frames and reflectors; and finished goods, including completed fixtures or

systems, wireless energy management systems and accessories, such as lamps, meters and power supplies. All inventories are stated at the lower of cost or market value with cost determined using the first-in, first-out (FIFO) method. The Company reduces the carrying value of its inventories for differences between the cost and estimated net realizable value, taking into consideration usage in the preceding 12 months, expected demand, and other information indicating obsolescence. The Company records as a charge to cost of product revenue the amount required to reduce the carrying value of inventory to net realizable value. As of March 31, 2010 and December 31, 2010, the Company had inventory obsolescence reserves of $756,000 and $798,000, respectively.

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Costs associated with the procurement and warehousing of inventories, such as inbound freight charges and purchasing and receiving costs, are also included in cost of product revenue.
Inventories were comprised of the following (in thousands):

	March 31, 2010	December 31, 2010
Raw materials and components	$ 11,107	$ 14,128
Work in process	669	402
Finished goods	14,215	17,700
	$ 25,991	$ 32,230

Property and Equipment
Property and equipment were comprised of the following (in thousands):

	March 31, 2010	December 31, 2010
Land and land improvements	$ 1,436	$ 1,474
Buildings	14,072	15,749
Furniture, fixtures and office equipment	6,615	8,056
Equipment leased to customers under finance agreements	1,586	8,582
Plant equipment	7,627	7,919
Construction in progress	6,777	6,484
	38,113	48,264
Less: accumulated depreciation and amortization	(7,613)	(10,523)
Net property and equipment	$ 30,500	$ 37,741

The Company capitalized $21,000 and none, respectively, of the interest costs for construction in progress for the nine months ended December 31, 2009 and 2010, respectively. Included in construction in progress are costs related to Company-owned equipment leased to customers under Orion Throughput Agreements, or OTAs, and solar power purchase agreements, or PPAs, of $3.7 million and $4.0 million as of March 31, 2010 and December 31, 2010, respectively.
Patents and Licenses
Patents and licenses are amortized over their estimated useful life, ranging from 7 to 17 years, using the straight line method.
Other Long-Term Assets
Other long-term assets include $27,000 and $68,000 of deferred financing costs as of March 31, 2010 and December 31, 2010, respectively.
Also included in other long-term assets are amounts due from a third party finance company to which the Company has sold, without recourse, the future cash flows from OTAs entered into with customers. Such receivables are recorded at the present value of the future cash flows discounted at 7.5%. As of December 31, 2010, the following amounts were due from the third party finance company in future periods (in thousands):

Fiscal 2013	$ 336
Fiscal 2014	336
Fiscal 2015	403

Total gross long-term receivable		1,075
Less: amount representing interest		(164)
Net long-term receivable	$	911

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Accrued Expenses

Accrued expenses include warranty accruals, accrued wages and benefits, accrued vacation, sales tax payable and other various unpaid expenses. Accrued legal costs were $1.2 million and $1.1 million as of March 31, 2010 and December 31, 2010, respectively.

The Company generally offers a limited warranty of one year on its products in addition to those standard warranties offered by major original equipment component manufacturers. The manufacturers warranties cover lamps and ballasts, which are significant components in the Company s products.

Changes in the Company s warranty accrual were as follows (in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2009	2010	2009	2010
Beginning of period	$ 42	$ 59	$ 55	$ 60
Provision to cost of revenue	40	20	60	95
Charges	(44)	(18)	(77)	(94)
End of period	$ 38	$ 61	$ 38	$ 61

Revenue Recognition

The Company offers a financing program, called an OTA, for a customer s lease of the Company s energy management systems. The OTA is structured as an operating lease and upon successful installation of the system and customer acknowledgement that the system is operating as specified, product revenue is recognized on a monthly basis over the life of the OTA contract, typically a 12-month renewable agreement with a maximum term of between two and five years.

The Company offers a separate financing program, called a PPA, for the Company s renewable energy product offerings. A PPA is a supply side agreement for the generation of electricity and subsequent sale to the end user. Upon the customer s acknowledgement that the system is operating as specified, product revenue is recognized on a monthly basis over the life of the PPA contract, typically in excess of 10 years.

Other than for OTA and PPA sales, revenue is recognized when the following four criteria are met:

persuasive evidence of an arrangement exists;

delivery has occurred and title has passed to the customer;

the sales price is fixed and determinable and no further obligation exists; and

collectability is reasonably assured

These four criteria are met for the Company s product-only revenue upon delivery of the product and title passing to the customer. At that time, the Company provides for estimated costs that may be incurred for product warranties and sales returns. Revenues are presented net of sales tax and other sales related taxes.

As discussed in Recent Accounting Pronouncements , the Company elected to adopt the revised guidance of ASC 605-25 related to multiple-element arrangements during the quarter ended December 31, 2010. This guidance was retrospectively applied to the beginning of the Company s fiscal year.

For sales contracts consisting of multiple elements of revenue, such as a combination of product sales and services, the Company determines revenue by allocating the total contract revenue to each element based on their relative selling prices. In such circumstances, the Company uses a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (1) vendor-specific objective evidence (VSOE) of fair value, if available, (2) third-party evidence (TPE) of selling price if VSOE is not available, and (3) best estimate of the selling price if neither VSOE nor TPE is available (a description as to how the Company determined VSOE, TPE and estimated selling price is provided below).

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To determine the selling price in multiple-element arrangements, the Company established VSOE of selling price for its HIF lighting and energy management system products using the price charged for a deliverable when sold separately. In addition, the Company determines the selling price for its installation and recycling services through establishing TPE by obtaining independent quotes from installation contractors and evaluating similar services in standalone arrangements with similarly situated customers. Service revenue is recognized when services are complete and customer acceptance has been received. Recycling services provided in connection with installation entail the disposal of the customer s legacy lighting fixtures. The Company s service revenues other than for installation and recycling that are completed prior to delivery of the product are included in product revenue using management s best estimate of selling price, as VSOE or TPE evidence does not exist. These services include comprehensive site assessment, site field verification, utility incentive and government subsidy management, engineering design, and project management. For these services, management s best estimate of selling price is determined by considering several external and internal factors including, but not limited to, pricing practices, margin objectives, competition, geographies in which the Company offers its products and services and internal costs. The determination of estimated selling price is made through consultation with and approval by management, taking into account all of the preceding factors.

To determine the selling price for solar renewable product and services sold through the Company s Engineered Systems group, the Company uses management s best estimate of selling price giving consideration to external and internal factors including, but not limited to, pricing practices, margin objectives, competition, scope and size of individual projects, geographies in which the Company offers its products and services and internal costs. The Company has completed a limited number of renewable project sales and accordingly, does not have sufficient VSOE or TPE evidence.

The nature of the Company s multiple element arrangements are similar to a construction project with materials being delivered and contracting and project management activities occurring according to an installation schedule. The significant deliverables include the shipment of products and related transfer of title and the installation. The Company s manufactured technologies are typically delivered within two weeks of receipt of a customer s purchase order. The timing of delivery on renewable projects through the Company s Engineered Systems division is dependent upon a contractual schedule agreed upon with the customer and executed in advance of the project start date. Installation for lighting and energy management projects is typically completed within four to six weeks, but can be longer dependent upon the size of the project, the complexity of the interior facility layout and the availability of the customer s schedule to complete the project. Installation for renewable projects completed through the Company s Engineered Systems division can often take three to six months to complete and can be longer dependent upon weather issues during installation.

Costs of products delivered, and services performed, that are subject to additional performance obligations or customer acceptance are deferred and recorded in prepaid expenses and other current assets on the Condensed Consolidated Balance Sheet. These deferred costs are expensed at the time the related revenue is recognized. Deferred costs amounted to $415,000 and $436,000 as of March 31, 2010 and December 31, 2010, respectively.

Deferred revenue relates to advance customer billings, energy efficiency rebates received related to OTAs, investment tax grants received related to PPAs and a separate obligation to provide maintenance on OTAs and is classified as a liability on the Condensed Consolidated Balance Sheet. The fair value of the maintenance is readily determinable based upon pricing from third-party vendors. Deferred revenue related to maintenance services is recognized when the services are delivered, which occurs in excess of a year after the original OTA is executed.

Deferred revenue was comprised of the following (in thousands):

	March 31, 2010	December 31, 2010
Deferred revenue current liability	$ 338	$ 518
Deferred revenue long term liability	186	1,599
Total deferred revenue	$ 524	$ 2,117

Income Taxes

The Company recognizes deferred tax assets and liabilities for the future tax consequences of temporary differences between financial reporting and income tax basis of assets and liabilities, measured using the enacted tax rates and laws expected to be in effect when the temporary differences reverse. Deferred income taxes also arise from the future tax benefits of operating loss and tax credit carryforwards. A valuation allowance is established when management determines that it is more likely than not that all or a portion of a deferred tax asset will not be realized.

ASC 740, *Income Taxes*, also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination. The Company has classified the amounts recorded for uncertain tax benefits in the balance sheet as other liabilities (non-current) to the extent that payment is not anticipated within one year. The Company recognizes penalties and interest related to uncertain tax liabilities in income tax expense. Accrued penalties and interest were immaterial as of the date of adoption and are included in the unrecognized tax benefits.

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Deferred tax benefits have not been recognized for income tax effects resulting from the exercise of non-qualified stock options. These benefits will be recognized in the period in which the benefits are realized as a reduction in taxes payable and an increase in additional paid-in capital. For the nine months ended December 31, 2009 and 2010, realized tax benefits from the exercise of stock options were $0.1 million and $0.2 million, respectively.

Stock Option Plans

The fair value of each option grant for the three and nine months ended December 31, 2009 and 2010 was determined using the assumptions in the following table:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2009	**2010**	**2009**	**2010**
Weighted average expected term	5.9 years	6.0 years	6.4 years	5.6 years
Risk-free interest rate	2.33%	1.47%	2.56%	2.06%
Expected volatility	60%	74.8%	60%	60% 74.8%
Expected forfeiture rate	3%	10%	3%	10%
Expected dividend yield	0%	0%	0%	0%

Net Income (Loss) per Common Share

Net income (loss) per share of common stock was as follows for the three and nine months ended December 31, 2009 and 2010:

	Three months Ended December 31,		Nine months Ended December 31,	
	2009	**2010**	**2009**	**2010**
Numerator:				
Net income (loss)(in thousands)	$ 807	$ 644	$ (3,365)	$ (571)
Denominator:				
Weighted-average common shares outstanding	21,792,175	22,726,426	21,709,799	22,629,776
Weighted-average effect of assumed conversion of stock options and warrants	775,400	384,207	—	—
Weighted-average common shares and common share equivalents outstanding	22,567,575	23,110,633	21,709,799	22,629,776
Net income (loss) per common share:				
Basic	$ 0.04	$ 0.03	$ (0.15)	$ (0.03)
Diluted	$ 0.04	$ 0.03	$ (0.15)	$ (0.03)

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per common share is computed by dividing the net income (loss) by the weighted-average number of diluted common shares outstanding during the period. Diluted shares outstanding are calculated by adding to the weighted average shares any outstanding stock options and warrants based upon the treasury stock method. Diluted net loss per share is the same as basic net loss per share for periods with a net loss because the effects of potentially dilutive securities are anti-dilutive.

The Company had the following anti-dilutive securities outstanding which were excluded from the calculation of diluted net loss per share for the nine months ended:

	December 31,	**December 31,**

	2009	2010
Warrants	357,144	45,040
Stock Options	3,564,200	3,651,648
	3,921,344	3,696,688

Concentration of Credit Risk and Other Risks and Uncertainties

The Company s cash is deposited with three financial institutions. At times, deposits in these institutions exceed the amount of insurance provided on such deposits. The Company has not experienced any losses in such accounts and believes that it is not exposed to any significant risk on these balances.

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The Company currently depends on one supplier for a number of components necessary for its products, including ballasts and lamps. If the supply of these components were to be disrupted or terminated, or if this supplier were unable to supply the quantities of components required, the Company may have short-term difficulty in locating alternative suppliers at required volumes. Purchases from this supplier accounted for 47% and 17% of total cost of revenue for the three months ended December 31, 2009 and 2010, respectively, and 28% of total cost of revenue for both the nine months ended December 31, 2009 and 2010, respectively.

For the three and nine months ended December 31, 2009, no customers accounted for more than 10% of revenue. For the three and nine months ended December 31, 2010, one customer accounted for 20% and 10% of revenue, respectively.

As of March 31, 2010, no customer accounted for more than 10% of the accounts receivable balance. As of December 31, 2010, one customer accounted for more than 10% of the accounts receivable balance.

Recent Accounting Pronouncements

In July 2010, the FASB issued Accounting Standards Update 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* (ASU 2010-20). ASU 2010-20 requires further disaggregated disclosures that improve financial statement users understanding of (1) the nature of an entity s credit risk associated with its financing receivables and (2) the entity s assessment of that risk in estimating its allowance for credit losses as well as changes in the allowance and the reasons for those changes. The new and amended disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The adoption of ASU 2010-20 did not have a material impact on the Company s consolidated results of operations and financial condition.

Effective April 1, 2010, the Company adopted ASU 2009-13, *Multiple-Deliverable Revenue Arrangements*, which amends ASC Subtopic 650-25 Revenue Recognition Multiple-Element Arrangements to eliminate the requirement that all undelivered elements have vendor-specific objective evidence (VSOE) or third-party evidence (TPE) before an entity can recognize the portion of an overall arrangement fee that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. The overall arrangement fee will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity s estimated selling price. Additionally, the new guidance will require entities to disclose more information about their multiple-element revenue arrangements. The adoption of this ASU did not result in a material change in either the units of accounting or a change in the pattern or timing of revenue recognition. Additionally, the adoption of this ASU did not have a material impact on the Company s consolidated financial statements.

NOTE C RELATED PARTY TRANSACTIONS

During the nine months ended December 31, 2009 and 2010, the Company recorded revenue of $27,000 and $18,000 for products and services sold to an entity for which a director of the Company was formerly the executive chairman. The Company also entered into an OTA finance contract with such entity in September 2010 with future expected gross contracted revenue to the Company of $2.9 million. During the same nine month periods, the Company purchased goods and services from the same entity in the amounts of $30,000 and none. The terms and conditions of such relationship are believed to be not materially more favorable to the Company or the entity than could be obtained from an independent third party.

During the nine months ended December 31, 2009 and 2010, the Company recorded revenue of $705,000 and $183,000 for products and services sold to various entities affiliated or associated with an entity for which a director of the Company previously served as a member of the board of directors. The Company is not able to identify the respective amount of revenues attributable to specifically identifiable entities within such group of affiliated or associated entities or the extent to which any such individual entities are related to the entity on whose board of directors the Company s executive officer serves. The terms and conditions of such relationship are believed to be not materially more favorable to the Company or the entity than could be obtained from an independent third party.

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NOTE D LONG-TERM DEBT

Long-term debt as of March 31, 2010 and December 31, 2010 consisted of the following (in thousands):

	March 31, 2010	December 31, 2010
Term note	$ 1,017	$ 843
Customer equipment finance note payable		2,318
First mortgage note payable	926	872
Debenture payable	847	817
Lease obligations	7	2
Other long-term debt	921	1,027
Total long-term debt	3,718	5,879
Less: current maturities	(562)	(1,261)
Long-term debt, less current maturities	$ 3,156	$ 4,618

New Debt Arrangements

In September 2010, the Company entered into a note agreement with a financial institution that provided the Company with $2.4 million to fund completed customer contracts under the Company s OTA finance program. This note is included in the table above as customer equipment finance note payable. The note is collateralized by the OTA-related equipment and the expected future monthly payments under the supporting 57 individual OTA customer contracts. The note bears interest at 7% and matures in September 2015. The note agreement includes certain prepayment penalties and a covenant that the Company maintain at least $5 million in cash liquidity. The Company was in compliance with all covenants in the note agreement as of December 31, 2010.

In September 2010, the Company entered into a note agreement with the Wisconsin Department of Commerce that provided the Company with $0.3 million to fund the Company s rooftop solar project at its Manitowoc manufacturing facility. This note is included in the table above as other long-term debt. The note is collateralized by the related solar equipment. The note allows for two years without interest accruing or principal payments due. Beginning in June 2012, the note bears interest at 2%. The note matures in June 2017. The note agreement requires the Company to maintain a certain number of jobs at its Manitowoc facilities during the note s duration. The Company was in compliance with all covenants in the note agreement as of December 31, 2010.

Revolving Credit Agreement

On June 30, 2010, the Company entered into a new credit agreement (Credit Agreement) with JP Morgan Chase Bank, N.A. (JP Morgan). The Credit Agreement replaced the Company s former credit agreement with a different bank.

The Credit Agreement provides for a revolving credit facility (Credit Facility) that matures on June 30, 2012. Borrowings under the Credit Facility are limited to (i) $15.0 million or (ii) during periods in which the outstanding principal balance of outstanding loans under the Credit Facility is greater than $5.0 million, the lesser of (A) $15.0 million or (B) the sum of 75% of the outstanding principal balance of certain accounts receivable of the Company and 45% of certain inventory of the Company. The Credit Agreement contains certain financial covenants, including minimum unencumbered liquidity requirements and requirements that the Company maintain a total liabilities to tangible net worth ratio not to exceed 0.50 to 1.00 as of the last day of any fiscal quarter. The Credit Agreement also contains certain restrictions on the ability of the Company to make capital or lease expenditures over prescribed limits, incur additional indebtedness, consolidate or merge, guarantee obligations of third parties, make loans or advances, declare or pay any dividend or distribution on its stock, redeem or repurchase shares of its stock or pledge assets. The Company also may cause JP Morgan to issue letters of credit for the Company s account in the aggregate principal amount of up to $2.0 million, with the dollar amount of each issued letter of credit counting against the overall limit on borrowings under the Credit Facility. As of December 31, 2010, the Company had outstanding letters of credit totaling $1.7 million, primarily for securing collateral requirements under equipment

operating leases. The Company incurred $61,000 of deferred financing costs related to the Credit Agreement which will be amortized over the two-year term of the Credit Agreement. There were no borrowings by the Company under the Credit Agreement as of December 31, 2010. The Company was in compliance with all of its covenants under the Credit Agreement as of December 31, 2010.

The Credit Agreement is secured by a first lien security interest in the Company s accounts receivable, inventory and general intangibles, and a second lien priority in the Company s equipment and fixtures. All OTAs, PPAs, leases, supply agreements and/or similar agreements relating to solar photovoltaic and wind turbine systems or facilities, as well as all accounts receivable and assets of the Company related to the foregoing, are excluded from these liens.

The Company must pay a fee of 0.25% on the average daily unused amount of the Credit Facility and a fee of 2.00% on the daily average face amount of undrawn issued letters of credit. The fee on unused amounts is waived if the Company or its affiliates maintain funds on deposit with JP Morgan or its affiliates above a specified amount. The deposit threshold requirement was not met as of December 31, 2010.

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NOTE E INCOME TAXES

The income tax provision for the nine months ended December 31, 2010 was determined by applying an estimated annual effective tax rate of 57.9% to income before taxes. The estimated effective income tax rate was determined by applying statutory tax rates to pretax income adjusted for certain permanent book to tax differences and tax credits. Below is a reconciliation of the statutory federal income tax rate and the effective income tax rate:

	Nine Months Ended December 31,	
	2009	**2010**
Statutory federal tax rate	(34.0)%	(34.0)%
State taxes, net	0.2%	(5.5)%
Stock-based compensation expense	6.6%	(19.8)%
Federal tax credit	4.0%	20.0%
State tax credit	0.0%	0.0%
State valuation allowance	0.0%	(7.9)%
Permanent items	(1.1)%	(9.6)%
Other, net	0.1%	(1.1)%
Effective income tax rate	(24.2)%	(57.9)%

The Company is eligible for tax benefits associated with the excess of the tax deduction available for exercises of non-qualified stock options over the fair value determined at the grant date. The amount of the benefit is based on the ultimate deduction reflected in the applicable income tax return. Benefits of $0.1 million were recorded in fiscal 2010 as a reduction in taxes payable and a credit to additional paid in capital based on the amount that was utilized during the year. Benefits of $0.1 million and $0.2 million were recorded for the nine-month periods ended December 31, 2009 and 2010, respectively.

The Company has issued incentive stock options for which stock compensation expense is not deductible currently for tax purposes. The non-deductible expense is considered permanent in nature. A disqualifying disposition occurs when a shareholder sells shares from an option exercise within 12 months of the exercise date or within 24 months of the option grant date. In the event of a disqualifying disposition, the option and related stock compensation expense take on the characteristics of a non-qualified stock option grant, and is deductible for income tax purposes. This deduction is a permanent tax rate differential. The Company could incur significant changes in its effective tax rate in future periods based upon incentive stock option compensation expense and disqualifying disposition events. Since July 30, 2008, all stock option grants have been issued as non-qualified stock options.

As of December 31, 2010, the Company had federal net operating loss carryforwards of approximately $13.4 million, of which $6.1 million are associated with the exercise of non-qualified stock options that have not yet been recognized by the Company in its financial statements. The Company also has state net operating loss carryforwards of approximately $7.9 million, of which $3.2 million are associated with the exercise of non-qualified stock options. The Company also has federal tax credit carryforwards of approximately $712,000, but it does not currently record any state tax credit carryforwards after giving effect to its related valuation allowance of $572,000. The Company has not recorded a valuation allowance for federal loss carryforwards or tax credits. Both the net operating losses and tax credit carryforwards expire between 2014 and 2030.

In 2007, the Company s past issuances and transfers of stock caused an ownership change. As a result, the Company s ability to use its net operating loss carryforwards, attributable to the period prior to such ownership change, to offset taxable income will be subject to limitations in a particular year, which could potentially result in increased future tax liability for the Company. The Company does not believe the ownership change affects the use of the full amount of the net operating loss carryforwards.

Uncertain tax positions

As of December 31, 2010, the balance of gross unrecognized tax benefits was approximately $399,000, all of which would reduce the Company s effective tax rate if recognized. The Company does not expect this amount to change in the next 12 months as none of the issues are currently under examination, the statutes of limitations do not expire within the period, and the Company is not aware of any pending litigation. Due to the existence of net operating loss and credit carryforwards, all years since 2002 are open to examination by tax authorities.

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The Company has classified the amounts recorded for uncertain tax benefits in the balance sheet as other liabilities (non-current) to the extent that payment is not anticipated within one year. The Company recognizes penalties and interest related to uncertain tax liabilities in income tax expense. Penalties and interest are immaterial and are included in the unrecognized tax benefits. For the nine months ended December 31, 2009 and 2010, the Company had the following unrecognized tax benefit activity (in thousands):

	Nine Months Ended December 31, 2009	Nine Months Ended December 31, 2010
Unrecognized tax benefits as of beginning of period	$ 397	$ 398
Decreases relating to settlements with tax authorities		
Additions based on tax positions related to the current period positions	1	1
Unrecognized tax benefits as of end of period	$ 398	$ 399

NOTE F COMMITMENTS AND CONTINGENCIES

Operating Leases and Purchase Commitments

The Company leases vehicles and equipment under operating leases. Rent expense under operating leases was $385,000 and $483,000 for the three months ended December 31, 2009 and 2010; and $1.0 million and $1.3 million for the nine months ended December 31, 2009 and 2010. In addition, the Company enters into non-cancellable purchase commitments for certain inventory items in order to secure better pricing and ensure materials on hand, as well as for capital expenditures. As of December 31, 2010, the Company had entered into $22.7 million of purchase commitments, including $0.1 million related to the remaining capital committed for information technology improvements and other manufacturing equipment, $9.2 million for commitments under operating leases and $13.4 million for inventory purchases.

Litigation

In February and March 2008, three class action lawsuits were filed in the United States District Court for the Southern District of New York against the Company, several of its officers, all members of its then existing board of directors, and certain underwriters relating to the Company s December 2007 initial public offering (IPO). The plaintiffs claimed to represent those persons who purchased shares of the Company s common stock from December 18, 2007 through February 6, 2008. The plaintiffs alleged, among other things, that the defendants made misstatements and failed to disclose material information in the Company s IPO registration statement and prospectus. The complaints alleged various claims under the Securities Act of 1933, as amended. The complaints sought, among other relief, class certification, unspecified damages, fees, and such other relief as the court may deem just and proper.

On August 1, 2008, the court-appointed lead plaintiff filed a consolidated amended complaint in the United States District Court for the Southern District of New York. On September 15, 2008, the Company and the other director and officer defendants filed a motion to dismiss the consolidated complaint, and the underwriters filed a separate motion to dismiss the consolidated complaint on January 16, 2009. After oral argument on August 19, 2009, the court granted in part and denied in part the motions to dismiss. The plaintiff filed a second consolidated amended complaint on September 4, 2009, and the defendants filed an answer to the complaint on October 9, 2009.

In the fourth quarter of fiscal 2010, the Company reached a preliminary agreement to settle the class action lawsuits and on January 3, 2011, the court issued an order granting preliminary approval of the settlement. The court has scheduled a fairness hearing for April 14, 2011. Substantially all of the proposed preliminary settlement amount will be covered by the Company s insurance. However, for the Company s share of the proposed preliminary settlement not covered by insurance, the Company recorded an after-tax charge in the fourth quarter of fiscal 2010 of approximately $0.02 per share. The Company deposited its uninsured share of the settlement amount in escrow on February 1, 2011. If the preliminary settlement is not finally approved or the other conditions are not met, the Company will continue to defend against the lawsuits and believes that it and the other defendants have substantial legal and factual defenses to

the claims and allegations contained in the consolidated complaint. In such a case, the Company would intend to pursue these defenses vigorously. There can be no assurance, however, that the Company would be successful, and an adverse resolution of the lawsuits could have a material adverse effect on the Company s financial condition, results of operations and cash flow. In addition, although the Company carries insurance for these types of claims, a judgment significantly in excess of the Company s insurance coverage or any costs, claims or judgment which are disputed or not covered by insurance could materially and adversely affect the Company s financial condition, results of operations and cash flow. If the preliminary settlement is not finally approved or the other conditions are not met, the Company is not presently able to reasonably estimate potential costs and/or losses, if any, related to the lawsuit.

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NOTE G SHAREHOLDERS EQUITY

Employee Stock Purchase Plan

In August 2010, the Company s board of directors approved a non-compensatory employee stock purchase plan, or ESPP. The ESPP authorizes 2,500,000 million shares to be issued from treasury or authorized shares to satisfy employee share purchases under the ESPP. All full-time employees of the Company are eligible to be granted a non-transferable purchase right each calendar quarter to purchase directly from the Company up to $20,000 of the Company s common stock at a purchase price equal to 100% of the closing sale price of the Company s common stock on the NYSE Amex exchange on the last trading day of each quarter. The ESPP allows for employee loans from the Company, except for Section 16 officers, limited to 20% of an individual s annual income and no more than $250,000 outstanding at any one time. Interest on the loans is charged at the 10-year loan IRS rate and is payable at the end of each calendar year or upon loan maturity. The loans are secured by a pledge of any and all the Company s shares purchased by the participant under the ESPP and the Company has full recourse against the employee, including offset against compensation payable. The Company had the following shares issued from treasury for the first nine months of fiscal 2011:

	As of December 31, 2010				
Period	Shares Issued Under ESPP Plan	Closing Market Price	Shares Issued Under Loan Program	Dollar Value Of Loans Issued	Repayment Of Loans
Quarter Ended September 30, 2010	40,560	$ 3.17	38,202	$ 121,100	$
Quarter Ended December 31, 2010	12,274	3.34	10,898	36,400	844
Total	52,834	$ 3.21	49,100	$ 157,500	$ 844

Loans issued to employees are reflected on the Company s balance sheet as a contra-equity account.

NOTE H STOCK OPTIONS AND WARRANTS

The Company grants stock options under its 2003 Stock Option and 2004 Stock and Incentive Awards Plans (the Plans). Under the terms of the Plans, the Company has reserved 12,000,000 shares for issuance to key employees, consultants and directors. The Company s board of directors approved an increase to the number of shares available under the 2004 Stock and Incentive Awards Plan of 1,500,000 shares, and such share increase was approved by the Company s shareholders at the 2010 annual shareholders meeting and such shares are included above. The options generally vest and become exercisable ratably between one month and five years although longer vesting periods have been used in certain circumstances. Exercisability of the options granted to employees are contingent on the employees continued employment and non-vested options are subject to forfeiture if employment terminates for any reason. Options under the Plans have a maximum life of 10 years. In the past, the Company has granted both incentive stock options and non-qualified stock options, although in July 2008, the Company adopted a policy of thereafter only granting non-qualified stock options. Restricted stock awards have no vesting period and have been issued to certain non-employee directors in lieu of cash compensation pursuant to elections made under the Company s non-employee director compensation program. The Plans also provide to certain employees accelerated vesting in the event of certain changes of control of the Company as well as under other special circumstances.

For the three and nine months ended December 31, 2010, the Company granted none and 11,976 shares from the 2004 Stock and Incentive Awards Plan to certain non-employee directors who elected to receive stock awards in lieu of cash compensation. The shares were valued ranging from $2.86 to $3.46 per share, the market prices as of the grant dates.

The following amounts of stock-based compensation were recorded (in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2009	2010	2009	2010
Cost of product revenue	$ 51	$ 42	$ 163	$ 116
General and administrative	135	147	400	417
Sales and marketing	205	123	472	377
Research and development	10	9	29	21
Total	$ 401	$ 321	$ 1,064	$ 931

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As of December 31, 2010, compensation cost related to non-vested stock-based compensation amounted to $4.3 million over a remaining weighted average expected term of 6.7 years.
The following table summarizes information with respect to the Plans:

		Options Outstanding			
	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic value
Balance at March 31, 2010	569,690	3,546,249	$ 3.66	6.87	
Amendment to Plan	1,500,000				
Granted stock options	(609,077)	609,077	3.66		
Granted shares in lieu of cash compensation	(11,976)				
Forfeited	218,658	(218,658)	3.88		
Exercised		(285,020)	1.31		
Balance at December 31, 2010	1,667,295	3,651,648	$ 3.80	6.65	$ 2,080,575
Exercisable at December 31, 2010		1,748,281	$ 3.34	4.96	$ 1,581,405

The aggregate intrinsic value represents the total pre-tax intrinsic value, which is calculated as the difference between the exercise price of the underlying stock options and the fair value of the Company s closing common stock price of $3.34 as of December 31, 2010.
A summary of the status of the Company s outstanding non-vested stock options as of December 31, 2010 was as follows:

Non-vested at March 31, 2010	1,789,119
Granted	609,077
Vested	(276,171)
Forfeited	(218,658)
Non-vested at December 31, 2010	1,903,367

The Company has previously issued warrants in connection with various private placement stock offerings and services rendered. The warrants granted the holder the option to purchase common stock at specified prices for a specified period of time. No warrants were issued in fiscal 2010 or for the nine months ended December 31, 2010. Outstanding warrants are comprised of the following:

	Number of Shares	Weighted Average Exercise Price
Balance at March 31, 2010	76,240	$ 2.37
Issued		
Exercised	(16,000)	2.50
Cancelled	(15,200)	2.50

Balance at December 31, 2010	45,040	$	2.28

A summary of outstanding warrants at December 31, 2010 follows:

Exercise Price	**Number of Warrants**	**Expiration**
$2.25	38,980	Fiscal 2014
$2.50	6,060	Fiscal 2011
Total	45,040	

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NOTE I SEGMENTS

During the fiscal 2011 third quarter, certain activity of the Company s Engineered Systems division exceeded the thresholds required for segment reporting. As such, descriptions of the Company s segments and their summary financial information are presented below.

Energy Management

The Energy Management division develops, manufactures and sells commercial high intensity fluorescent, or HIF, lighting systems and energy management systems.

Engineered Systems

The Engineered Systems division sells and integrates alternative renewable energy systems, such as solar and wind, and provides technical services for the Company s sale of HIF lighting systems and energy management systems.

Corporate and Other

Corporate and Other is comprised of selling, general and administrative expenses not directly allocated to the Company s segments and adjustments to reconcile to consolidated results, which primarily include intercompany eliminations.

	Revenues For the Three Months Ended December 31,		Operating (Loss) Profit For the Three Months Ended December 31,	
(dollars in thousands)	2009	2010	2009	2010
Segments:				
Energy Management	$ 16,672	$ 19,354	$ 2,384	$ 3,262
Engineered Systems	2,623	10,317	(199)	976
Corporate and Other			(1,609)	(1,583)
	$ 19,295	$ 29,671	$ 576	$ 2,655

	Revenues For the Nine Months Ended December 31,		Operating (Loss) Profit For the Nine Months Ended December 31,	
(dollars in thousands)	2009	2010	2009	2010
Segments:				
Energy Management	$ 40,447	$ 44,696	$ 928	$ 3,698
Engineered Systems	6,095	13,378	(511)	135
Corporate and Other			(4,905)	(4,977)
	$ 46,542	$ 58,074	$ (4,488)	$ (1,144)

	Total Assets		Deferred Revenue	
(dollars in thousands)	March 31, 2010	December 31, 2010	March 31, 2010	December 31, 2010
Segments:				
Energy Management	$ 55,771	$ 70,003	$ 390	$ 1,341
Engineered Systems	3,962	12,199	134	776
Corporate and Other	43,888	33,864		
	$ 103,621	$ 116,066	$ 524	$ 2,117

The Company s revenue and long-lived assets outside the United States are insignificant.

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

The following discussion and analysis of our financial condition and results of operations should be read together with our unaudited condensed consolidated financial statements and related notes included elsewhere in the Form 10-Q. It should also be read in conjunction with our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended March 31, 2010.

Cautionary Note Regarding Forward-Looking Statements

Any statements in this Quarterly Report on Form 10-Q about our expectations, beliefs, plans, objectives, prospects, financial condition, assumptions or future events or performance are not historical facts and are forward-looking statements as that term is defined under the federal securities laws. These statements are often, but not always, made through the use of words or phrases such as believe , anticipate , should , intend , plan , will , expects , estim positioned , strategy , outlook and similar words. You should read the statements that contain these types of words carefully. Such forward-looking statements are subject to a number of risks, uncertainties and other factors that could cause actual results to differ materially from what is expressed or implied in such forward-looking statements. There may be events in the future that we are not able to predict accurately or over which we have no control. Potential risks and uncertainties include, but are not limited to, those discussed in Part I, Item 1A. Risk Factors in our 2010 Annual Report filed on Form 10-K for the year ended March 31, 2010 and elsewhere in this Quarterly Report. We urge you not to place undue reliance on these forward-looking statements, which speak only as the date of this report. We do not undertake any obligation to release publicly any revisions to such forward-looking statements to reflect events or uncertainties after the date hereof or to reflect the occurrence of unanticipated events.

Overview

We design, manufacture and implement energy management systems consisting primarily of high-performance, energy-efficient lighting systems, controls and related services.

We currently generate the substantial majority of our revenue from sales of high intensity fluorescent, or HIF, lighting systems and related services to commercial and industrial customers. We typically sell our HIF lighting systems in replacement of our customers existing high intensity discharge, or HID, fixtures. We call this replacement process a retrofit. We frequently engage our customer s existing electrical contractor to provide installation and project management services. We also sell our HIF lighting systems on a wholesale basis, principally to electrical contractors and value-added resellers that sell to their own customer bases.

We have sold and installed more than 1,972,000 of our HIF lighting systems in over 6,500 facilities from December 1, 2001 through December 31, 2010. We have sold our products to 130 Fortune 500 companies, many of which have installed our HIF lighting systems in multiple facilities. Our top direct customers by revenue in fiscal 2010 included Coca-Cola Enterprises Inc., U.S. Foodservice, SYSCO Corp., Ball Corporation, MillerCoors and Pepsico, Inc. and its affiliates.

Our fiscal year ends on March 31. We call our prior fiscal year which ended on March 31, 2010, fiscal 2010 . We call our current fiscal year, which will end on March 31, 2011, fiscal 2011. Our fiscal 2011 first quarter ended on June 30, our fiscal 2011 second quarter ended on September 30, our fiscal 2011 third quarter ended on December 31 and our fiscal 2011 fourth quarter will end on March 31.

Because of the recessed state of the global economy, especially as it relates to capital equipment manufacturers, our fiscal 2011 first half results continued to be impacted by lengthened customer sales cycles and sluggish customer capital spending. During the fiscal 2011 third quarter, capital equipment purchases were slightly improved and we continue to remain optimistic regarding customer behaviors heading into calendar year 2011. To address the economic conditions, we implemented $3.2 million of annualized cost reductions during the first quarter of fiscal 2010. These cost containment initiatives included reductions related to headcount, work hours and discretionary spending and began to show results in the second half of fiscal 2010 and the first half of fiscal 2011. During the second quarter of fiscal 2011, we identified an additional $2 million of annualized cost reductions related to decreased product costs, improved manufacturing efficiencies and reduced operating expenses. We began to realize some of these cost reductions during the fiscal 2011 third quarter through reduction in general and administrative expenses and improved product margins for our HIF lighting systems.

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Despite the recent economic challenges, we remain optimistic about our near-term and long-term financial performance. Our near- term optimism is based upon our record level of revenue and operating income for the third quarter of fiscal 2011, our increased backlog of cash orders at the end of our fiscal 2011 third quarter versus our backlog at the end of our fiscal 2010 third quarter, the increase in the number of our value-added resellers and their sales staffs and our cost reduction plans for the remainder of fiscal 2011. Our long-term optimism is based upon the considerable size of the existing market opportunity for lighting retrofits, the continued development of our new products and product enhancements, the opportunity for additional revenue from sales of renewable technologies through our Orion Engineered Systems division, the opportunity for our participation in the replacement part aftermarket and the increasing national recognition of the importance of environmental stewardship, including legislation within the State of Wisconsin passed earlier this fiscal year that recognized our solar Apollo Light Pipe as a renewable product offering and qualified it for incentives currently offered to other renewable technologies.

In August 2009, we created Orion Engineered Systems, a new operating division which has been offering our customers additional alternative renewable energy systems. In fiscal 2010, we sold and installed three solar photovoltaic, or PV, electricity generating projects, completing our test analysis on two of the three in the fiscal 2010 third quarter, and executed our first cash sale and our first Power Purchase Agreement, or PPA, as a result of the successful testing of these systems. We completed the installation and customer acceptance of the third system, a cash sale, during our fiscal 2011 first quarter. During the quarter ended September 30, 2010, we received an $8.2 million cash order for a solar PV generating system for which we recognized $6.0 million of revenue in the third quarter. Additionally, Orion Engineered Systems is responsible for our project management activities and related service revenues for both HIF lighting and renewable technology projects.

During our fiscal 2011 third quarter, revenue from our Orion Engineered Systems group exceeded the quantitative threshold for GAAP segment accounting. We have now introduced segment reporting for our Energy Management and Engineered Systems groups. Our Energy Management division develops, manufactures and sells commercial high intensity fluorescent, or HIF, lighting systems and energy management systems. Our Engineered Systems division sells and integrates alternative renewable energy systems and provides technical services for the Company s sale of HIF lighting systems and energy management systems.

In response to the constraints on our customers capital spending budgets, we have more aggressively promoted the advantages to our customers of purchasing our energy management systems through our Orion Throughput Agreement, or OTA, financing program, as well as our solar PPA, as an alternative to purchasing our systems for cash. Our OTA financing program provides for our customer s purchase of our energy management systems without an up-front capital outlay. The OTA is structured as a supply agreement in which we receive monthly rental payments over the life of the contract, typically 12 months, with an annual renewable agreement with a maximum term between two and five years. The PPA is a supply side agreement for the generation of electricity and subsequent sale to the end user. We expect that the number of customers who choose to purchase our systems by using our OTA financing program will continue to increase in future periods. While our OTA program creates a recurring revenue stream over the term of the annually renewable OTA, it results in a mis-match between the timing of our recognition of revenues and expenses under generally accepted accounting principles, or GAAP. This consequence has negatively impacted our near-term revenue and net income. Under GAAP, all of our selling, marketing and administrative expenses related to new OTAs are expensed up front as incurred, while the related OTA revenue is recognized on a monthly basis over the life of the contract. We are in the process of revising our existing OTA contract to conform to a more traditional capital lease document, eliminating the annual renewable component of the contract and replacing it with standard capital lease end-of-term contract language. Customer acceptance of this document would reduce the mis-match between revenue and expenses on our GAAP financial statements. We expect thaLIGN="bottom" WIDTH="7%"> **Cost** **Gross unrealized gains** **Gross unrealized losses** **Estimated fair value**

June 30, 2012

Certificates of deposit			
$1,500	$	$	$1,500
Certificates of deposit - restricted			
1,341			1,341
$2,841	$	$	$2,841

December 31, 2011

Certificates of deposit			
10,000			10,000
Certificates of deposit - restricted			
1,341			1,341
$11,341	$	$	$11,341

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Concentrations of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash equivalents and investments and accounts receivable.

The Company invests its excess cash principally in United States government debt securities, investment grade corporate debt securities and certificates of deposit. The Company has established guidelines relative to diversification and maturities that maintain safety and liquidity. These guidelines are periodically reviewed and modified to take advantage of trends in yields and interest rates. Except as described above, the Company has not experienced any significant losses on its cash equivalents, short-term investments or restricted investments.

As of June 30, 2012 and December 31, 2011, cash deposits held at financial institutions in excess of FDIC insured amounts of $250,000 were approximately $9.9 million and $13.1 million, respectively.

Accounts receivable from one customer was 37% and 67% of total accounts receivable at June 30, 2012 and December 31, 2011, respectively.

The Company obtains Captisol from a sole-source supplier. If this supplier was not able to supply the requested amounts of Captisol, the Company would be unable to continue to derive revenues from the sale of Captisol until it obtained an alternative source, which might take a considerable length of time.

Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts based on the best estimate of the amount of probable losses in the Company s existing accounts receivable. Accounts receivable that are outstanding longer than their contractual payment terms, ranging from 30 to 90 days, are considered past due. When determining the allowance for doubtful accounts, several factors are taken into consideration, including historical write-off experience and review of specific customer accounts for collectability. Account balances are charged off against the allowance after collection efforts have been exhausted and the potential for recovery is considered remote. There was no allowance for doubtful accounts included in the balance sheets at June 30, 2012 and December 31, 2011.

Inventory

Inventory is stated at the lower of cost or market. The Company determines cost using the first-in, first-out method. The Company analyzes its inventory levels periodically and writes down inventory to its net realizable value if it has become obsolete, has a cost basis in excess of its expected net realizable value or is in excess of expected requirements.

Other Current Assets

Other current assets consist of the following (in thousands):

	June 30, 2012	December 31, 2011
Prepaid expenses	$ 848	$ 905
Advanced manufacturing payments	56	312
Other receivables	1,121	127
	$ 2,025	$ 1,344

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Property and Equipment

Property and equipment is stated at cost and consists of the following (in thousands):

	June 30, 2012	December 31, 2011
Lab and office equipment	$ 4,392	$ 4,110
Leasehold improvements		62
Computer equipment and software	1,134	1,054
	5,526	5,226
Less accumulated depreciation and amortization	(4,882)	(4,771)
	$ 644	$ 455

Depreciation of equipment is computed using the straight-line method over the estimated useful lives of the assets, which range from three to ten years. Leasehold improvements are amortized using the straight-line method over their estimated useful lives or their related lease term, whichever is shorter.

Goodwill and Other Identifiable Intangible Assets

Goodwill and other identifiable intangible assets consist of the following (in thousands):

	June 30, 2012 (Restated)	December 31, 2011 (Restated)
Acquired in-process research and development	$ 13,036	$ 13,036
Complete technology	15,227	15,227
Trade name	2,642	2,642
Customer relationships	29,600	29,600
Goodwill	12,238	12,238
	72,743	72,743
Accumulated amortization	(3,343)	(2,179)
	$ 69,400	$ 70,564

Intangible assets related to IPR&D are considered to be indefinite-lived until the completion or abandonment of the associated research and development efforts. During the period the assets are considered to be indefinite-lived, they will not be amortized but will be tested for impairment on an annual basis and between annual tests if the Company becomes aware of any events occurring or changes in circumstances that would indicate a reduction in the fair value of the IPR&D projects below their respective carrying amounts. If and when development is complete, which generally occurs if and when regulatory approval to market a product is obtained, the associated assets would be deemed finite-lived and would then be amortized based on their respective estimated useful lives at that point in time. Amortization expense of $1.2 million and $1.3 million was recognized for the six months ended June 30, 2012 and 2011, respectively. Estimated amortization expense for the years ending December 31, 2012 through 2016 is $2.3 million per year.

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Impairment of Long-Lived Assets

Management reviews long-lived assets for impairment annually or whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value for the Company s long-lived assets is determined using the expected cash flows discounted at a rate commensurate with the risk involved. As of June 30, 2012, management does not believe there have been any events or circumstances indicating that the carrying amount of its long-lived assets may not be recoverable.

Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	June 30, 2012	December 31, 2011
Compensation	$ 682	$ 1,806
Professional fees	576	355
Other	2,970	2,893
	$ 4,228	$ 5,054

Other Long-Term Liabilities

Other long-term liabilities consist of the following (in thousands):

	June 30, 2012	December 31, 2011
Deposits	388	388
	$ 388	$ 388

Sale of Royalty Rights

The Company previously sold to third parties the rights to future royalties of certain of its products. As part of the underlying royalty agreements, the partners have the right to offset a portion of any future royalty payments owed to the Company to the extent of previous milestone payments. Accordingly, the Company deferred a portion of the revenue associated with each tranche of royalty right sold, equal to the pro-rata share of the potential royalty offset. Such amounts associated with the offset rights against future royalty payments will be recognized as revenue upon receipt of future royalties from the respective partners. As of June 30, 2012 and December 31, 2011, the Company had deferred $1.0 million and $1.2 million, respectively, of revenue related to the sale of royalty rights. As of June 30, 2012, $0.4 million is included in current portion of deferred revenue and $0.6 million is included in long-term portion of deferred revenue.

Recently Adopted Accounting Pronouncements

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220) - Presentation of Comprehensive Income*. This ASU amends Topic 220, *Comprehensive Income*, to allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU No. 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders investment. The amendments to the Codification in the ASU do not change the items that must be reported in other comprehensive

income or when an item of other comprehensive income must be reclassified to net income. The ASU was effective for fiscal years beginning after December 15, 2011 for the Company. In 2012, the Company has elected to present comprehensive income in a separate statement.

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In September 2011, the FASB issued ASU 2011-08, *Intangibles Goodwill and other: testing for goodwill impairment*, which, among other things, amends *Accounting Standards Topic 350 Intangibles Goodwill and Other*, to allow entities to use a qualitative approach to test goodwill for impairment. ASU 2011-08 permits an entity to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed two-step goodwill impairment test. Otherwise, the two-step goodwill impairment test is not required. Our adoption of this standard had no impact on our consolidated financial position, results of operations or cash flows.

In December 2011, the FASB issued ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income* in ASU 2011-12. The amendments in ASU 2011-12 defer the changes in ASU 2011-05 that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. The amendments in this ASU are effective for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011. See above for the provisions of ASU 2011-05.

2. Business Combinations

On January 24, 2011, the Company acquired CyDex Pharmaceuticals, Inc., a specialty pharmaceutical company developing products and licensing its Captisol® technology. Captisol is currently incorporated in six FDA-approved medications and marketed by three of CyDex s licensees: Pfizer, Bristol-Myers Squibb, Onyx Pharmaceuticals, Inc., and Baxter International. In addition, CyDex is supporting drug development efforts with more than 40 companies worldwide.

Under the terms of the agreement, the Company paid $32.0 million to the CyDex shareholders and issued a series of Contingent Value Rights (CVR s). Additionally, the Company assumed contingent liabilities for future milestones due to license holders. The contingent liabilities for amounts potentially due to CVR holders and former license holders was recorded at an initial fair value of $17.6 million. The initial fair value of the liability was determined using a discounted cash flow analysis incorporating the estimated future cash flows from potential milestones and revenue sharing. These cash flows were then discounted to present value using a discount rate of 21.6%. The liability will be periodically assessed based on events and circumstances related to the underlying milestones, and the change in fair value will be recorded in the Company s consolidated statements of operations. The carrying amount of the liability may fluctuate significantly and actual amounts paid under the CVR agreements may be materially different than the carrying amount of the liability. The fair value of the liability at June 30, 2012 was $13.2 million.

The Company paid the CyDex shareholders $4.3 million in January 2012, $3.5 million in July 2012 and may be required to pay up to an additional $8.0 million upon achievement of certain clinical and regulatory milestones to the CyDex CVR holders and former license holders. In addition, the Company will pay CyDex shareholders, for each respective year from 2011 through 2016, 20% of all CyDex-related revenue, but only to the extent that and beginning only when CyDex-related revenue for such year exceeds $15.0 million; plus an additional 10% of all CyDex-related revenue recognized during such year, but only to the extent that and beginning only when aggregate CyDex-related revenue for such year exceeds $35.0 million. The Company paid $0.3 million to the CyDex shareholders in March 2012 for 20% of all 2011 CyDex-related revenue in excess of $15 million.

Ligand is required by the CyDex Contingent Value Rights Agreement (CVR) to dedicate at least five experienced full-time employee equivalents per year to the acquired business and to invest at least $1.5 million per year, inclusive of such employee expenses, in the acquired business, through 2015. As of June 30, 2012, the Company estimates it has exceeded this amount.

Had the merger with CyDex been completed as of the beginning of 2011, the Company s pro forma results for the six months ended June 30, 2011 would have been as follows:

(in thousands, except per share data)	**2011 (Restated)**
Revenue	$ 11,548
Operating loss	(2,300)
Net income	9,179
Basic and diluted earnings per share:	
Continuing operations	$ 0.47
Discontinued operations	
Net income	$ 0.47

Basic and diluted weighted average shares	19,623

The primary adjustments relate to interest expense on long-term debt, the loss of interest income due to the timing of transaction related payments and amortization of intangible assets. The above pro forma information was determined based on historical results adjusted for the purchase price allocation and estimated related changes in income associated with the merger of CyDex.

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3. Financial Instruments

The Company measures certain financial assets and liabilities at fair value on a recurring basis, including available-for-sale fixed income and equity securities and other equity securities. The following table provides a summary of the assets and liabilities that are measured at fair value on a recurring basis as of June 30, 2012 (in thousands):

Fair Value Measurements at Reporting Date Using

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:	(Restated)			(Restated)
Short-term investments	$ 1,500	$ 1,500	$	$
Liabilities:				
Current portion of contingent liabilities - CyDex	$ 4,140	$	$	$ 4,140
Liability for contingent value rights - Metabasis				
Liability for contingent value rights - Neurogen	500			500
Contingent liabilities - CyDex	9,011			9,011
Total liabilities	$ 13,651	$	$	$ 13,651

The following table provides a summary of the assets and liabilities that are measured at fair value on a recurring basis as of December 31, 2011 (in thousands):

Fair Value Measurements at Reporting Date Using

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:	(Restated)			(Restated)
Short-term investments	$ 10,000	$ 10,000	$	$
Liabilities:				
Current portion of contingent liabilities - CyDex	$ 6,879	$	$	$ 6,879
Liability for contingent value rights - Metabasis	1,068	1,068		
Liability for contingent value rights - Neurogen	700			700
Contingent liabilities - CyDex	8,651			8,651
Total liabilities	$ 17,298	$ 1,068	$	$ 16,230

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The Company s short-term investments are fixed income available-for-sale securities and include Corporate Notes, Corporate Discount Commercial Paper and certificates of deposit. The fair value of the Company s short-term investments and liability for contingent value rights-Metabasis are determined using quoted market prices in active markets.

4. AVINZA Co-Promotion

In February 2003, Ligand and Organon Pharmaceuticals USA Inc. (Organon) announced that they had entered into an agreement for the co-promotion of Avinza. Subsequently in January 2006, Ligand signed an agreement with Organon that terminated the Avinza co-promotion agreement between the two companies and returned Avinza co-promotion rights to Ligand. In consideration of the early termination, Ligand agreed to make quarterly royalty payments to Organon equal to 6.5% of Avinza net sales through December 31, 2012 and thereafter 6.0% through patent expiration, currently anticipated to be November of 2017.

In February 2007, Ligand and King Pharmaceuticals, Inc., (King), executed an agreement pursuant to which King acquired all of the Company s rights in and to Avinza. King also assumed the Company s co-promote termination obligation to make royalty payments to Organon based on net sales of Avinza.

In connection with King s assumption of this obligation, Organon did not consent to the legal assignment of the co-promote termination obligation to King. Accordingly, Ligand remains liable to Organon in the event of King s default of the obligation. Therefore, Ligand recorded an asset as of February 26, 2007 to recognize King s assumption of the obligation, while continuing to carry the co-promote termination liability in the Company s consolidated financial statements to recognize Ligand s legal obligation as primary obligor to Organon. This asset represents a non-interest bearing receivable for future payments to be made by King and is recorded at its fair value. The receivable and liability will remain equal and adjusted each quarter for changes in the fair value of the obligation including for any changes in the estimate of future net Avinza product sales. This receivable will be assessed on a quarterly basis for impairment (e.g. in the event King defaults on the assumed obligation to pay Organon).

On a quarterly basis, management reviews the carrying value of the co-promote termination liability. Due to assumptions and judgments inherent in determining the estimates of future net Avinza sales through November 2017, the actual amount of net Avinza sales used to determine the current fair value of the Company s co-promote termination asset and liability may be materially different from current estimates.

A summary of the co-promote termination liability as of June 30, 2012 is as follows (in thousands):

Net present value of payments based on estimated future net AVINZA product sales as of December 31, 2011	$ 21,452
Assumed payments made by King or assignee	(1,702)
Fair value adjustments	(4,994)
Total co-promote termination liability as of June 30, 2012	14,756
Less: current portion of co-promote termination liability as of June 30, 2012	4,934
Long-term portion of co-promote termination liability as of June 30, 2012	$ 9,822

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5. Lease obligations

The Company leases office and laboratory facilities in California, Kansas, and New Jersey. These leases expire between 2014 and 2019 and are subject to annual increases which range from 3.0% and 3.5%. The Company currently subleases office and laboratory space in California and New Jersey. The following table provides a summary of operating lease obligations and payments expected to be received from sublease agreements as of June 30, 2012 (in thousands):

Operating lease obligations:	Square Footage	Lease Termination Date	Less than 1 year	1-3 years	3-5 years	More than 5 years	Total
Corporate headquarters-San Deigo, CA	16,500	July 2019	$ 550	$ 1,151	$ 1,220	$ 962	$ 3,883
Bioscience and Technology Business Center-Lawrence, KS	1,500	December 2014	57	85			142
Vacated office and research facility-San Diego, CA	52,800	July 2015	2,143	4,481	191		6,815
Vacated office and research facility-Cranbury, NJ	99,000	August 2016	2,715	5,432	3,169		11,316
Total operating lease obligations			$ 5,465	$ 11,149	$ 4,580	$ 962	$ 22,156

Sublease payments expected to be received:			Less than 1 year	1-3 years	3-5 years	More than 5 years	Total
Office and research facility-San Diego, CA	52,800	July 2015	$ 892	$ 1,866			$ 2,758
Office and research facility-Cranbury, NJ	5,100	August 2016	252	746	373		1,371
Net operating lease obligations			$ 4,321	$ 8,537	$ 4,207	$ 962	$ 18,027

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6. Segment Reporting

Under Accounting Standards Codification No. 280, Segment Reporting , or ASC 280, operating segments are defined as components of an enterprise about which separate financial information is available that is regularly evaluated by the entity s chief operating decision maker, in deciding how to allocate resources and in assessing performance. The Company has evaluated this Codification and has identified two reportable segments: the development and commercialization of drugs using Captisol technology by CyDex Pharmaceuticals, Inc. and the traditional biotech operations including drug discovery and development of Ligand Pharmaceuticals, Inc. We evaluate performance based on the operating profit (loss) of the respective business segments. The segment results may not represent actual results that would be expected if they were independent, stand-alone businesses. Segment information was as follows:

Balance Sheet Data:

	As of June 30, 2012		
	Ligand (Restated)	CyDex (Restated)	Total (Restated)
Total Assets	$ 70,987	$ 31,840	$ 102,827

	As of December 31, 2011		
	Ligand (Restated)	CyDex (Restated)	Total (Restated)
Total Assets	$ 111,437	$ 9,152	$ 120,583

Operating Data:

	For the three months Ended June 30, 2012		
	Ligand (Restated)	CyDex (Restated)	Total (Restated)
Net revenues from external customers	$ 3,929	$ 1,813	$ 5,742
Operating loss	(1,514)	(245)	(1,730)
Depreciation and amortization expense	73	605	678
Income tax expense from continuing operations	338		338
Income tax benefit from discontinuing operations	191		191
Interest expense, net	847		847

	For the six months Ended June 30, 2012		
	Ligand (Restated)	CyDex (Restated)	Total (Restated)
Net revenues from external customers	$ 8,030	$ 3,348	$ 11,378
Operating profit (loss)	(1,799)	(696)	(2,495)
Depreciation and amortization expense	128	1,212	1,340
Income tax expense (benefit) from continuing operations	303		303
Income tax expense from discontinuing operations	14		14
Interest expense	1,622		1,622

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7. Financing Arrangements

The Company has a secured term loan credit facility (secured debt). Under the terms of the secured debt, the Company will make interest only payments through March 2013. Subsequent to the interest only payments, the note will amortize with principal and interest payments through the remaining term of the loan. Additionally, the Company must also make an additional final payment equal to 6% of the total amount borrowed which is due at maturity and is being accreted over the life of the loan. The Company also has a cash-collateralized revolving credit facility under which the Company may elect to borrow up to $10 million. All outstanding amounts under the credit facility may become due and payable if the Company fails to maintain a cash balance equal to the amount outstanding under the credit facility. The carrying values and the fixed contractual coupon rates of our financing arrangements are as follows (dollars in millions):

	June 30, 2012	December 31, 2011
Bank line of credit, Prime + 2.0%, due March 29, 2013	$ 1,500	$ 10,000
Current portion notes payable, 8.64%, due August 1, 2014	4,224	
Current portion notes payable, 8.9012%, due August 1, 2014	1,582	
Total current portion of notes payable	$ 5,806	$
Long-term portion notes payable, 8.64%, due August 1, 2014	16,233	20,286
Long-term portion notes payable, 8.9012%, due August 1, 2014	5,978	
Total long-term portion of notes payable	$ 22,211	$ 20,286

8. Stockholders Equity

On May 31, 2012, the Company s stockholders approved the amendment and restatement of the Company s 2002 Stock Incentive Plan to increase the number of shares available for issuance by 1.8 million shares.

Stock Option Activity

The following is a summary of the Company s stock option plan activity and related information:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years	Aggregate Intrinsic Value (In thousands)
Balance at December 31, 2011	1,146,046	$ 14.61	7.96	$ 1,489
Granted	642,845	14.28		
Exercised	(17,003)	10.25		
Forfeited	(65,927)	10.01		
Cancelled	(12,823)	40.50		
Balance at June 30, 2012	1,693,138	14.51		
Exercisable at June 30, 2012	689,860	16.87	7.15	2,634
Options vested and expected to vest as of June 30, 2012	1,693,138	14.51	8.35	6,702

The weighted-average grant date fair value of all stock options granted during the six months ended June 30, 2012 was $8.90 per share. The total intrinsic value of all options exercised during the six months ended June 30, 2012 and 2011 was approximately $0.3 million and $2,500, respectively. As of June 30, 2012, there was $6.6 million of total unrecognized compensation cost related to nonvested stock options. That cost

is expected to be recognized over a weighted-average period of 3.1 years.

As of June 30, 2012, 1.9 million shares were available for future option grants or direct issuance under the Company s 2002 Stock Incentive Plan, as amended.

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Restricted Stock Activity

Restricted stock activity for the three months ended June 30, 2012 is as follows:

	Shares	Weighted-Average Grant Date Fair Value
Nonvested at December 31, 2011	115,506	$ 10.63
Granted	108,661	13.75
Vested	(71,406)	11.48
Forfeited	(2,917)	9.86
Nonvested at June 30, 2012	149,844	12.50

The weighted-average grant-date fair value of restricted stock granted during the six months ended June 30, 2012 was $13.75 per share. As of June 30, 2012, there was $1.4 million of total unrecognized compensation cost related to nonvested restricted stock. That cost is expected to be recognized over a weighted-average period of 2.0 years.

Employee Stock Purchase Plan

The Company s Employee Stock Purchase Plan, as amended and restated (the Amended ESPP) allows participants to purchase up to 1,250 shares of Ligand common stock during each offering period, but in no event may a participant purchase more than 1,250 shares of common stock during any calendar year. The length of each offering period is six months, and employees are eligible to participate in the first offering period beginning after their hire date.

The Amended ESPP allows employees to purchase Ligand common stock at the end of each six month period at a price equal to 85% of the lesser of fair market value on either the start date of the period or the last trading day of the period (the Lookback Provision). The 15% discount and the Lookback Provision make the Amended ESPP compensatory. There were 7,374 and 2,404 shares of common stock issued and $75,000 and $18,000 of proceeds received under the Amended ESPP during the six months ended June 30, 2012 and 2011, respectively. The Company recorded compensation expense related to the ESPP of $22,000 and $700 for the six months ended June 30, 2012 and 2011, respectively. As of June 30, 2012, 89,917 shares were available for future purchases under the Amended ESPP.

Warrants

As of June 30, 2012, 163,568 warrants with an exercise price of $179.40 per warrant and an expiration date of April 2013 were outstanding to purchase an aggregate of 129,360 shares of the Company s common stock. If exercised, these warrants are also entitled to receive $0.1 million in cash and 981,411 of each of the Company's four contingent value rights issued to Neurogen shareholders in December 2009. The series of warrants was assumed in the acquisition of Neurogen Corporation.

Share Repurchases

On June 15, 2010, the Company announced that its Board of Directors had authorized the Company to repurchase up to $10.0 million of its common stock from time to time in privately negotiated and open market transactions for a period of up to two years, subject to the Company s evaluation of market conditions, applicable legal requirements and other factors. The authority to repurchase shares of the Company s common stock expired on June 8, 2012, at which time the Company had repurchased 16,905 shares of its common stock totaling $0.1 million.

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9. Litigation

From time to time the Company is subject to various lawsuits and claims with respect to matters arising out of the normal course of its business. If, based on the Company s assessment, it is probable that a liability has been incurred and can be reasonably estimated, then such loss is accrued and charged to operations. Management believes all costs that can be reasonably estimated will not exceed the related existing accruals.

10. Common Stock Subject to Conditional Redemption - Pfizer Settlement Agreement

In April 1996, the Company and Pfizer entered into a settlement agreement with respect to a lawsuit filed in December 1994 by the Company against Pfizer. In connection with a collaborative research agreement the Company entered into with Pfizer in 1991, Pfizer purchased shares of the Company s common stock. Under the terms of the settlement agreement, at the option of either the Company or Pfizer, milestone and royalty payments owed to the Company can be satisfied by Pfizer by transferring to the Company shares of the Company s common stock at an exchange ratio of $74.25 per share, for revenue related to lasofoxifene and drolofoxifene. The remaining common stock issued and outstanding to Pfizer following the settlement was reclassified as common stock subject to conditional redemption (between liabilities and equity) since Pfizer has the option to settle milestone and royalties payments owed to the Company with the Company s shares, and such option is not within the Company s control. The remaining shares of the Company s common stock that could be redeemed totaled 112,371 and are reflected at the exchange ratio price of $74.25. Pfizer has notified Ligand that the development of the two compounds covered under the 1996 settlement agreement have been terminated and thus the Company reclassified the shares and the current carrying amount of $8.3 million to permanent equity in the first quarter of 2012.

11. Subsequent Events

Through August 8, 2012, the Company issued, pursuant to an at-the-market registered public offering, 150,000 common shares at a weighted average price of $18.19 per share. Total net proceeds to the Company after underwriting discounts and expenses were approximately $2.6 million.

12. Restatement of Financial Statements

The Company restated its previously issued consolidated financial statements as of June 30, 2012 and for the three and six months ended June 30, 2012 and 2011, to correct errors in the calculation of certain contingent liabilities related to the acquisition of CyDex. Specifically, the initial fair value of contingent liabilities was overstated by $1.6 million resulting in an initial overstatement of goodwill by $2.7 million, an understatement of intangible assets of $0.9 million, an overstatement of deferred income tax liability of $0.3 million, and an understatement of the income tax benefit of $0.1 million. As of June 30, 2012, goodwill was overstated by $2.7 million, intangible assets were understated by $0.9 million, current portion of contingent liabilities was understated by $0.3 million, long-term portion of contingent liabilities was overstated by $0.9 million and deferred income taxes were overstated by $0.3 million. As of December 31, 2011, goodwill was overstated by $2.7 million, intangible assets were understated by $0.9 million, long-term portion of contingent liabilities was overstated by $1.0 million and deferred income taxes was overstated by $0.3 million. For the three months ended June 30, 2012, decrease (increase) in contingent liabilities increased $0.3 million from $1.1 million to $1.4 million and loss from continuing operations increased $0.02 per share from $0.20 per share to $0.22 per share. For the three months ended June 30, 2011, decrease (increase) in contingent liabilities increased $0.5 million from a decrease of $0.7 million to $1.2 million and loss from continuing operations decreased $0.03 per share from $0.05 to $0.02. For the six months ended June 30, 2012, decrease (increase) in contingent liabilities increased $0.5 million from $0.4 million to $0.9 million and loss from continuing operations increased $0.03 per share from $0.23 per share to $0.26 per share. For the six months ended June 30, 2011, income tax benefit from continuing operations increased $0.1 million from $13.4 million to $13.6 million, decrease (increase) in contingent liabilities increased $0.1 million from $1.1 million to $1.1 million and income from continuing operations increased $0.01 per share from $0.46 per share to $0.47 per share.

Contingent liabilities in the accompanying balance sheets now includes amounts relating to contingent value rights and other acquired contingent liabilities. The statement of cash flows has been adjusted for the restatements for the six months ended June 30, 2012 and 2011. The only impact on the statement of cash flows is the change in the non-cash impact of contingent liabilities.

The impact of the restatement as of June 30, 2012 and December 31, 2011 and for the periods ended June 30, 2012 and 2011 is described in the table below:

	June 30, 2012 As Restated	December 31, 2011 As Restated

	As previously reported		As previously reported	
Balance sheet data:				
Goodwill	$ 14,894	$ 12,238	$ 14,894	$ 12,238
Intangible assets, net	56,273	57,162	57,437	58,326
Total assets	104,594	102,827	122,350	120,583
Current portion of contingent liabilities	3,739	4,140	6,879	6,879
Long-term portion of contingent liabilities	10,413	9,511	11,433	10,419
Deferred income taxes	2,812	2,520	2,522	2,230
Total liabilities	86,142	85,349	105,360	104,054
Accumulated deficit	(682,654)	(683,628)	(681,771)	(682,232)

	Three Months Ended June 30, 2012		Three Months Ended June 30, 2011	
	As Previously Reported	As Restated	As Previously Reported	As Restated
Statement of Operations data:				
Decrease (increase) in contingent liabilities	$ (1,153)	$ (1,415)	$ 679	$ 1,171
Net Income (loss)	(2,267)	(2,529)	(914)	(422)
Basic and diluted earnings per share:				
Income (loss) from continuing operations	$ (0.20)	$ (0.22)	$ (0.05)	$ (0.02)
Net Income (loss)	(0.11)	(0.13)	(0.05)	(0.02)
Weighted average number of common shares-basic	19,749	19,749	19,650	19,650
Weighted average number of common shares-diluted	19,749	19,749	19,650	19,650

	Six months ended June 30, 2012		Six months ended June 30, 2011	
	As Previously Reported	As Restated	As Previously Reported	As Restated
Statement of Operations data:				
Income tax benefit from continuing operations	$ (303)	$ (303)	$ 13,444	$ 13,589
Decrease (increase) in contingent liabilities	(389)	(902)	(1,057)	(1,117)
Net Income (loss)	(883)	(1,396)	9,118	9,203
Basic and diluted earnings per share:				
Income (loss) from continuing operations	$ (0.23)	$ (0.26)	$ 0.46	$ 0.47
Net Income (loss)	$ (0.04)	$ (0.07)	$ 0.46	$ 0.47
Weighted average number of common shares-basic	19,729	19,729	19,623	19,623
Weighted average number of common shares-diluted	19,729	19,729	19,623	19,623

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

Caution: This discussion and analysis may contain predictions, estimates and other forward-looking statements that involve a number of risks and uncertainties, including those discussed in Part II, Item 1A Risk Factors. This outlook represents our current judgment on the future direction of our business. These statements include those related to our royalty revenues, product returns, and product development. Actual events or results may differ materially from our expectations. For example, there can be no assurance that our revenues or expenses will meet any expectations or follow any trend(s), that we will be able to retain our key employees or that we will be able to enter into any strategic partnerships or other transactions. We cannot assure you that we will receive expected royalties to support our ongoing business or that our internal or partnered pipeline products will progress in their development, gain marketing approval or achieve success in the market. In addition, ongoing or future arbitration, or litigation or disputes with third parties may have a material adverse effect on us. Such risks and uncertainties, and others, could cause actual results to differ materially from any future performance suggested. We undertake no obligation to release publicly the results of any revisions to these forward-looking statements to reflect events or circumstances arising after the date of this quarterly report. This caution is made under the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, as amended.

Our trademarks, trade names and service marks referenced herein include Ligand. Each other trademark, trade name or service mark appearing in this quarterly report belongs to its owner.

References to Ligand Pharmaceuticals Incorporated (Ligand, the Company, we or our) include our wholly owned subsidiaries - Seragen, In (Seragen); Nexus Equity VI LLC (Nexus); Pharmacopeia, LLC; Neurogen Corporation; Metabasis Therapeutics, Inc.; and CyDex Pharmaceuticals, Inc.

Overview

We are a biotechnology company that operates with a simple business model focused on developing or acquiring revenue generating assets and coupling them to a lean corporate cost structure. Our goal is to create a sustainably profitable business and generate meaningful value for our stockholders. Since a portion of our business model is based on the goal of partnering with other pharmaceutical companies to commercialize and market our assets, a significant amount of our revenue is based largely on payments made to us by partners for royalties, milestones and license fees. We recognized the important role of the drug reformulation segment in the pharmaceutical industry and in 2011 added Captisol® to our technology portfolio. Captisol is a formulation technology that has enabled six FDA approved products, including Pfizer's Vfend® IV, Baxter International's Nexterone®, and Onyx s Kyprolis™ and is currently being used in a number of clinical-stage partner programs. In comparison to our peers, we believe we have assembled one of the largest and most diversified asset portfolios in the industry with the potential to generate significant revenue in the future. In addition, therapies in development address the unmet medical needs of patients for a broad spectrum of diseases including hepatitis, muscle wasting, Alzheimer's disease, dyslipidemia, diabetes, anemia, asthma, rheumatoid arthritis and osteoporosis. We have established multiple alliances with the world's leading pharmaceutical companies including GlaxoSmithKline, Merck, Pfizer, Baxter International, Bristol-Myers Squibb, Celgene, Onyx Pharmaceuticals, Lundbeck Inc., Eli Lilly & Company, Rib-X Pharmaceuticals, Inc., and The Medicines Company.

In February 2012, we announced that we had licensed the full world-wide rights to DARA (a Dual Acting Receptor Antagonist of Angiotension and Endothelin receptors) to Retrophin, LLC (Retrophin). Retrophin intends to develop DARA for orphan indications of severe kidney diseases including Focal Segmental Glomerulosclerosis (FSGS) as well as conduct proof-of-concept studies in resistant hypertension and diabetic nephropathy. Certain patient groups with severely compromised renal function exhibit extreme proteinuria resulting in progression to dialysis and a high mortality rate. DARA, with its unique dual blockade of angiotensin and endothelin receptors, is expected to provide meaningful clinical benefits in mitigating proteinuria in indications where there are no approved therapies. We received a net up-front payment of approximately $1 million, and may receive, net of amounts owed to third parties, over $75 million in milestones as well as 9% in royalties on potential future worldwide sales by Retrophin.

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GSK has recently completed two large Phase III studies (ENABLE 1 and 2) designed to demonstrate Promacta s value in treatment of thrombocytopenia in patients with Hepatitis C. In May 2012, GSK submitted U.S. and European regulatory applications for use of Promacta to increase platelet counts in patients with hepatitis C. In July 2012, GSK announced they had been granted priority review for this application in the U.S.

In July 2012, our licensee, Onyx Pharmaceuticals, Inc.. (Onyx), received accelerated approval from the U.S. Food and Drug Administration, or FDA, for Kyprolis (Carfilzomib) for injection. Kyprolis is formulated with Ligand s Captisol® and is used for the treatment of patients with multiple myeloma who have received at least two prior therapies, including bortezomib and an immunomodulatory agent, and have demonstrated disease progression on or within 60 days of completion of the last therapy. The indication for Kyprolis is based on response rate. Currently, no data are available for Kyprolis that demonstrate an improvement in progression-free survival or overall survival. Under our agreement with Onyx, we are entitled to receive milestones, tiered royalties ranging between 1.5% and 3% as shown in the table below, and revenue from clinical and commercial Captisol material sales.

AGGREGATE NET SALES IN EACH CALENDAR YEAR	ROYALTY RATE
Up to, and including, $250 million	1.5%
$251 million to $500 million	2.0%
$501 million to $750 million	2.5%
Above $750 million	3.0%

The royalty rates set forth above will be applied to the total Net Sales of Product falling within the applicable range of aggregate annual Net Sales during the quarter.

Metabasis Contingent Value Rights

In January 2010, we completed our acquisition of Metabasis. In addition to cash consideration, we issued four tradable Contingent Value Rights (CVRs), one CVR from each of four respective series of CVRs, for each Metabasis share. The CVRs will entitle the holder to cash payments as frequently as every six months as cash is received by us from the sale or partnering of any of the Metabasis drug development programs, among other triggering events. We have also committed to spend at least $7 million within 30 months and $8 million within 42 months, in new research and development funding on the Metabasis programs. Through June 30, 2012, we estimate that we have spent approximately $6.7 million of the committed amount.

In January 2011, we entered into a strategic relationship with Chiva Pharmaceuticals, Inc. to develop multiple assets and technology in China and potentially worldwide. Chiva was granted licenses to begin immediate development in China of two clinical-stage HepDirect programs, Pradefovir for hepatitis B and MB01733 for hepatocellular carcinoma. Additionally, we granted Chiva a non-exclusive HepDirect technology license for the discovery, development and worldwide commercialization of new compounds in hepatitis B (HepB), hepatitis C (HepC) and hepatocellular carcinoma (HCC). Under the terms of the agreement, we are entitled to milestones and royalties on potential sales. In addition, we are entitled to receive a portion of any sublicensing revenue generated from sublicensing of collaboration compounds to third parties in a major world market. We received a $0.5 million license payment in March 2011, of which $0.1 million was remitted to CVR holders.

In August 2011, we entered into an amendment to the license agreement which required that a second $0.5 million licensing fee be paid in September 2011. In addition, the amendment increased royalty rates which we may receive under the license agreement to 6% of net sales of products (other than Pradefovir) and 9% of net sales for Pradefovir. In addition, the amendment removed from the license agreement a provision that afforded us the potential to earn a 10% equity position in Chiva as a milestone payment. In September 2011, Chiva paid us the $0.5 million licensing fee called for by the amendment, of which $0.1 million was remitted to CVR holders.

Results of Operations

Three and Six Months Ended June 30, 2012 and 2011

Total revenues for the three and six months ended June 30, 2012 were $5.7 million and $11.4 million compared to $7.5 million and $11.4 million for the same periods in 2011. We reported a loss from continuing operations of $4.3 million and $5.1 million for the three and six months ending June 30, 2012, compared to a loss from continuing operations of $0.4 million and income from continuing operations of $9.2 million for the three and six months ended June 30, 2011.

Royalty Revenue

Royalty revenues were $3.0 million and $6.0 million for the three and six months ended June 30, 2012, compared to $2.2 million and $4.2 million for the same periods in 2011. The increase in royalty revenue is primarily due to an increase in Promacta royalties and royalties on CyDex licensed products offset by a decrease in Avinza royalties.

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Material Sales

We recorded material sales of $1.7 million and $2.3 million for the three and six months ended June 30, 2012, compared to $3.0 million and $4.0 million for the same periods in 2011. The decrease in material sales is due to timing of customer purchases of Captisol.

Collaborative Research and Development and Other Revenues

We recorded collaborative research and development and other revenues of $1.1 million and $3.0 million for the three and six months ended June 30, 2012, compared to $2.3 million and $3.2 million for the same periods in 2011. The decrease of $1.2 million for the three months ended June 30, 2012, compared to the same period in 2011, is primarily due to the recognition of $1.3 million of deferred revenue related to the previous sale of royalty rights for the three month period ending June 30, 2011. Additionally, license fees and milestones increased $0.1 million for the three month period ending June 30, 2012 compared to the same period in 2011. The decrease of $0.2 million for the six months ended June 30, 2012, compared to the same period in 2011 is due to the recognition of $1.3 million of deferred revenue related to the previous sale of royalty rights for the six months ending June 30, 2011, partially offset by an increase in license fees and milestones of $1.1 million for the six months ending June 30, 2012 compared to the same period in 2011.

Research and Development Expenses

Research and development expenses were $2.9 million and $5.7 million for the three and six months ended June 30, 2012, respectively, compared to $3.2 million and $5.2 million for the same periods in 2011. The decrease of $0.3 million for the three months ended June 30, 2012, compared to the same period in 2011, is primarily due to timing of costs associated with internal programs. The increase of $0.5 million for the six months ended June 30, 2012, compared to the same period in 2011, is primarily due to an increase in costs associated with internal programs.

As summarized in the table below, we are developing several proprietary products for a variety of indications. Our programs are not limited to the following, but are representative of a range of future licensing opportunities to expand our partnered asset portfolio.

Program	Disease/Indication	Development Phase
Selective Androgen Receptor Modulators (SARMs) (agonists)	Muscle wasting and frailty	Phase I
Captisol-Enabled Melphalan IV	Oncology	Pivotal
Captisol-Enabled Topiramate IV	Epilepsy/Seizures	Preclinical
Glucagon receptor antagonist	Diabetes	Preclinical

We do not provide forward-looking estimates of costs and time to complete our ongoing research and development projects as such estimates would involve a high degree of uncertainty. Uncertainties include our inability to predict the outcome of complex research, our inability to predict the results of clinical studies, regulatory requirements placed upon us by regulatory authorities such as the FDA and EMA, our inability to predict the decisions of our collaborative partners, our ability to fund research and development programs, competition from other entities of which we may become aware in future periods, predictions of market potential from products that may be derived from our research and development efforts, and our ability to recruit and retain personnel or third-party research organizations with the necessary knowledge and skills to perform certain research. Refer to Item 1A. Risk Factors for additional discussion of the uncertainties surrounding our research and development initiatives.

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General and Administrative Expenses

General and administrative expenses were $3.9 million and $7.4 million for the three and six months ended June 30, 2012, respectively, compared to $3.9 million and $7.3 million for the same periods in 2011.

Lease Exit and Termination Costs

In September 2010, we ceased use of our facility located in Cranbury, New Jersey. As a result, during the quarter ended September 30, 2010, we recorded lease exit costs of $9.7 million for costs related to the difference between the remaining lease obligations of the abandoned operating leases, which run through August 2016, and management s estimate of potential future sublease income, discounted to present value. Actual future sublease income may differ materially from our estimate, which would result in us recording additional expense or reductions in expense. In addition, we wrote-off approximately $5.4 million of property and equipment related to the facility closure and recorded approximately $1.8 million of severance related costs. We recorded $0.2 million as a reduction of lease exit and termination costs for the three and six months ending June 30, 2012. During the three and six months ended June 30, 2011, we sold certain property and equipment for $16,000 and $0.2 million, respectively, from our former facility, which was recorded as a reduction of lease termination and exit costs.

Accretion of Deferred Gain on Sale Leaseback

On November 9, 2006, we sold real property located in San Diego, California for a sale price of $47.6 million. This property included our corporate headquarter building totaling approximately 82,500 square feet, the land on which the building was situated, and two adjacent vacant lots. As part of the sale transaction, we agreed to leaseback the building for a period of 15 years. We recognized an immediate pre-tax gain on the sale transaction of $3.1 million and deferred a gain of $29.5 million on the sale of the building. The deferred gain was being recognized on a straight-line basis over the 15 year term of the lease at a rate of approximately $2.0 million per year. In August 2009, we entered into a lease termination agreement for this building. As a result, we recognized $20.4 million of accretion of deferred gain during the quarter ended September 30, 2009, and recognized the remaining balance of the deferred gain through the term of our new building lease, which expired in December 2011. The amount of the deferred gain recognized for the three and six months ended June 30, 2011 was $0.4 million and $0.9 million, and was fully amortized as of December 31, 2011.

Interest Expense

Interest expense was $0.8 million and $1.6 million, for the three and six months ended June 30, 2012, respectively, compared to $0.7 million and $1.1 million for the same period in 2011. The increases in interest expense of $0.1 million for the three month period and $0.5 million for the six month period ending June 30, 2012 were due to the increase in the outstanding balance of notes payable at June 30, 2012 compared to June 30, 2011. Additionally, the $20 million loan obtained to acquire CyDex in January 2011 was outstanding for a partial period for the six months ending June 30, 2011.

Change in contingent liabilities

We recorded an increase in contingent liabilities of $1.5 million and $0.9 million for the three and six months ended June 30, 2012, compared to a decrease in contingent liabilities of $1.2 million and an increase in contingent liabilities of $1.1 million for the three and six months ended June 30, 2011. The increase for the three months ended June 30, 2012 relates to an increase in the liability for amounts potentially due to holders of CVRs and other license holders associated with our CyDex acquisition, primarily due to the increased likelihood of approval of Kyprolis following an FDA advisory meeting, for which we owe CyDex CVR holders $3.5 million upon approval. Partially offsetting this increase, we recorded a decrease in our liability for amounts potentially due to shareholders associated with our Neurogen acquisition of $0.2 million. The increase of $0.9 million in our contingent liabilities for the six months ended June 30, 2012 is due to an increase in the liability for amounts potentially due to CyDex CVR holders and other license holders associated with our CyDex acquisition of $2.2 million, primarily due to the increased likelihood of approval of Kyprolis. Partially offsetting this increase, for the six months ended June 30, 2012, our liability for CVRs associated with our Metabasis acquisition decreased $1.1 million and our liability for CVRs associated with our Neurogen acquisition decreased $0.2 million.

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The decrease in contingent liabilities of $1.2 million for the three months ended June 30, 2011 is due to a decrease in the liability for amounts potentially due to holders of CVRs associated with our Metabasis acquisition of $0.1 million and a decrease in the liability for amounts potentially due to holders of CVRs and other contractual obligations associated with our CyDex acquisition of $1.1 million. The increase in the contingent liabilities of $1.1 million for the six months ended June 30, 2011 is due to an increase in the liability for amounts potentially due to holders of CVRs associated with our Metabasis acquisition of $1.6 million, partially offset by a decrease in contingent liabilities associated with our CyDex acquisition of $0.5 million.

Other, net

We recorded other income of $1,000 and $0.3 million for the three and six months ended June 30, 2012 compared to $32,000 and $82,000 for the three and six months ending June 30, 2011. Other income for 2012 primarily relates to income related to the release of obligations previously recorded associated with the acquisition of CyDex.

Income Taxes

We recorded income tax expense from continuing operations of $0.3 million for the three and six months ended June 30, 2012. We recorded income tax expense of $0.1 million for the three months ended June 30, 2011 and an income tax benefit of $13.6 million for the six months ended June 30, 2011. The income tax benefit for the six months ended June 30, 2011 relates to the release of a portion of our valuation allowance against deferred tax assets which can be used to offset deferred tax liabilities recorded in connection with our acquisition of CyDex in January 2011.

Discontinued Operations

Oncology Product Line

On September 7, 2006, we and Eisai Inc., a Delaware corporation, and Eisai Co., Ltd., a Japanese company (which we collectively refer to as Eisai), entered into a purchase agreement, or the Oncology Purchase Agreement, pursuant to which Eisai agreed to acquire all of our worldwide rights in and to our oncology products, including, among other things, all related inventory, equipment, records and intellectual property, and assume certain liabilities as set forth in the Oncology Purchase Agreement. The Oncology product line included our four marketed oncology drugs: Ontak, Targretin capsules, Targretin gel and Panretin gel.

During the three and six months ended June 30, 2011, we recognized $0 and $4,000, respectively, of pre-tax gains due to subsequent changes in certain estimates and liabilities recorded as of the sale date.

Avinza Product Line

On September 6, 2006, we and King entered into a purchase agreement, or the Avinza Purchase Agreement, pursuant to which King agreed to acquire all of our rights in and to Avinza in the United States, its territories and Canada, including, among other things, all Avinza inventory, records and related intellectual property, and assume certain liabilities as set forth in the Avinza Purchase Agreement, which we collectively refer to as the Transaction.

Pursuant to the terms of the Avinza Purchase Agreement, we retained the liability for returns of product from wholesalers that had been sold by us prior to the close of the Transaction. Accordingly, as part of the accounting for the gain on the sale of Avinza, we recorded a reserve for Avinza product returns.

During the three and six months ended June 30, 2012, we recognized pre-tax gains of $1.6 million and $3.7 million, respectively, due to subsequent changes in certain estimates and liabilities recorded as of the sale date.

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Income Taxes

We recorded an income tax benefit of $0.2 million and $14,000 for income taxes related to discontinued operations for the three and six month periods ended June 30, 2012. We did not record any provision for income taxes for the three and six month periods ending June 30, 2011 as we did not realize any taxable income from discontinued operations.

Liquidity and Capital Resources

We have financed our operations through offerings of our equity securities, borrowings from long-term debt, issuance of convertible notes, product sales and the subsequent sales of our commercial assets, royalties, collaborative research and development and other revenues, capital and operating lease transactions.

We have incurred significant losses since inception. At June 30, 2012, our accumulated deficit was $683.6 million and we had negative working capital of $9.7 million. We believe that cash flows from operations will improve due to consistent Captisol® sales, an increase in royalty revenues driven primarily from continued increases in Promacta sales, recent product approvals and regulatory developments as well as anticipated new license and milestone revenues. In the event revenues and operating cash flows do not meet expectations, management plans to reduce discretionary expenses. However, it is possible that we may be required to seek additional financing. There can be no assurance that additional financing will be available on terms acceptable to management, or at all. We believe our available cash, cash equivalents, and short-term investments as well as our current and future royalty, license and milestone revenues will be sufficient to satisfy our anticipated operating and capital requirements, through at least the next twelve months. Our future operating and capital requirements will depend on many factors, including, but not limited to: the pace of scientific progress in our research and development programs; the potential success of these programs; the scope and results of preclinical testing and clinical trials; the time and costs involved in obtaining regulatory approvals; the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims; competing technological and market developments; the amount of royalties on sales of the commercial products of our partners; the efforts of our collaborative partners; obligations under our operating lease agreements; and the capital requirements of any companies we acquire, including Pharmacopeia, Inc. (Pharmacopeia), Neurogen Corporation (Neurogen), Metabasis Therapeutics, Inc. (Metabasis) and CyDex Pharmaceuticals, Inc. (CyDex). Our ability to achieve our operational targets is dependent upon our ability to further implement our business plan and generate sufficient operating cash flow.

In January 2011, we entered into a $20 million secured term loan credit facility (secured debt) with Oxford Financial Group (Oxford). The loan was amended in January 2012 to increase the secured credit facility to $27.5 million. The original $20 million borrowed under the facility bears interest at a fixed rate of 8.6%. The additional $7.5 million bears interest at a fixed rate of 8.9%. Under the terms of the secured debt, we will make interest only payments through March 2013. Subsequent to the interest only payments, the note will amortize with principal and interest payments through the remaining term of the loan. Additionally, we must also make an additional final payment equal to 6% of the total amount borrowed which is due at maturity and is being accreted over the life of the loan. The maturity date of the term loan is August 1, 2014.

We also have a cash-collateralized revolving credit facility under which we may elect to borrow up to $10 million. Amounts borrowed under the revolving credit facility bear interest at a floating rate equal to 200 basis points above the prime rate. All outstanding amounts under the credit facility may become due and payable if we fails to maintain a cash balance equal to the amount outstanding under the credit facility. The maturity date of the revolving credit facility is March 29, 2013.

In October 2011, we filed a Registration Statement on Form S-3 with the Securities and Exchange Commission (SEC) for the issuance and sale of up to $30 million of equity or other securities, proceeds from which will be used for general corporate purposes. The Form S-3 provides additional financial flexibility for us to sell shares or other securties as needed at any time. As of August 8, 2012, 150,000 shares have been issued under this registration statement for total net proceeds of approximately $2.6 million.

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In connection with the acquisition of CyDex Pharmaceuticals, Inc. on January 24, 2011, we issued a series of Contingent Value Rights (CVR). We paid the CVR holders $4.3 million in January 2012 and may be required to pay up to an additional $8.0 million upon achievement of certain clinical and regulatory milestones to the CyDex CVR holders and other former license holders. In 2011, $0.9 million was paid to the CyDex Shareholders upon completion of a licensing agreement with The Medicines Company for the Captisol enabled Intravenous formulation of Clopidogrel. An additional $2 million was paid to the CyDex Shareholders upon acceptance by the FDA of the New Drug Application submitted by Onyx and an additional $3.5 million was paid upon approval by the FDA of Kyprolis for the potential treatment of patients with relapsed and refractory multiple myeloma. In addition, we will pay CyDex shareholders, for each respective year from 2011 through 2016, 20% of all CyDex-related revenue, but only to the extent that and beginning only when CyDex-related revenue for such year exceeds $15.0 million; plus an additional 10% of all CyDex-related revenue recognized during such year, but only to the extent that and beginning only when aggregate CyDex-related revenue for such year exceeds $35.0 million. We paid $0.3 million to the CyDex shareholders in March 2012 for 20% of all 2011 CyDex-related revenue in excess of $15 million. Pursuant to the CVR Agreement, the shareholders' representative on behalf of the former CyDex shareholders has recently filed a notice of objection with us regarding the calculation of payments due to the CyDex former shareholders for the first and second quarters of 2011. In addition, the shareholders' representative has claimed that we exceeded the $35 million financial indebtedness limitation contained in the CVR Agreement. We disagree with these claims and intend to work with the shareholders' representative to resolve the claims. If we and the shareholders' representative fail to agree, the claims may be resolved through arbitration.

We are also required by the CyDex CVR Agreement to dedicate at least five experienced full-time employee equivalents per year to the acquired business and to invest at least $1.5 million per year, inclusive of such employee expenses, in the acquired business, through 2015. As of June 30, 2012, we estimate we have exceeded our commitment for the year ending December 31, 2012.

Based on management s plans, including projected increases in Captisol sales and royalty revenues, as well as anticipated new license revenue and expense reductions, if necessary, we believe our currently available cash, cash equivalents, and short-term investments as well as our current and future royalty, license and milestone revenues will be sufficient to satisfy our anticipated operating and capital requirements, through at least the next twelve months. Our future operating and capital requirements will depend on many factors, including, but not limited to: the pace of scientific progress in our research and development programs; the magnitude of these programs; the scope and results of preclinical testing and clinical trials; the time and costs involved in obtaining regulatory approvals; the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims; competing technological and market developments; the amount of royalties on sales of our partners commercial products; the efforts of our collaborative partners; obligations under our operating lease agreements and lease termination agreement; and the capital requirements of any companies we may acquire, including Neurogen, Metabasis and CyDex. We believe that the actions presently being taken to generate sufficient operating cash flow provide the opportunity for us to continue as a going concern. While we believe in the viability of our strategy to generate sufficient operating cash flow and in our ability to raise additional funds, there can be no assurances to that effect. Our ability to achieve our operational targets is dependent upon our ability to further implement our business plan and generate sufficient operating cash flow.

Operating Activities

Operating activities used cash of $1.1 million for the six months ended June 30, 2012, compared to $7.1 million of cash used in operating activities for the same period in 2011.

The cash used for the six months ended June 30, 2012 reflects a net loss of $1.4 million, adjusted by $3.7 million of gain from discontinued operations and $4.9 million of non-cash items to reconcile the net loss to net cash used in operations. These reconciling items primarily reflect the non-cash change in the estimated fair value of contingent liabilities of $0.9 million, depreciation and amortization of $1.3 million, share-based compensation of $2.1 million, and the change in deferred income taxes of $0.3 million. The cash used during the six months ended June 30, 2012 is further impacted by changes in operating assets and liabilities due primarily to an increase in inventory of $0.3 million, a decrease in deferred revenue of $1.6 million, a decrease in accounts payable and accrued liabilities of $3.7 million, and an increase in other current assets of $0.7 million. Partially offset by decreases in accounts receivable of $5.3 million and other long term assets of $0.2 million. Cash used in operating activities of discontinued operations was $0.2 million for the six months ended June 30, 2012.

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The cash used for the six months ended June 30, 2011 reflects net income of $9.2 million, adjusted by $4,000 of gain from discontinued operations and $10.4 million of non-cash items to reconcile the net income to net cash used in operations. These reconciling items primarily reflect the change in deferred income taxes of $13.7 million, accretion of deferred gain on the sale leaseback of the building of $0.9 million and non-cash lease costs of $0.1 million partially offset by the change in estimated fair value of contingent liabilities of $1.1 million, depreciation and amortization of $1.3 million and share-based compensation of $1.7 million. The cash generated during the six months ended June 30, 2011 is further impacted by changes in operating assets and liabilities due primarily to a decrease in other liabilities of $1.6 million, an increase in inventory of $0.2 million, a decrease in deferred revenue of $1.2 million and a decrease in accounts payable and accrued liabilities of $8.9 million, partially offset by increases in other current assets of $4.3 million, accounts receivable of $1.2 million and other long term assets of $0.6 million. None of the cash used in operating activities for the six months ended June 30, 2011 related to discontinued operations.

Investing Activities

Investing activities provided cash of $3.7 million for the six months ended June 30, 2012, compared to $22.7 million of cash used by investing activities for the same 2011 period.

Cash provided by investing activities during the six months ended June 30, 2012 primarily reflects $8.5 million of proceeds from the sale of short-term investments, partially offset by payment to CVR holders of $4.5 million and purchases of property, equipment and building of $0.3 million. None of the cash provided by investing activities for the six months ended June 30, 2011 related to discontinued operations.

Cash used by investing activities during the six months ended June 30, 2011 primarily reflects $32.0 million of cash paid for the acquisition of CyDex and $10.0 million for purchases of short-term investments, partially offset by $19.3 million of proceeds from the sale of short-term investments. None of the cash provided by investing activities for the six months ended June 30, 2011 related to discontinued operations.

Financing Activities

Financing activities used cash of $0.8 million for the six months ended June 30, 2012, compared to cash provided by financing activities of $30 million for the same 2011 period.

Cash used by financing activities for the six months ended June 30, 2012 primarily reflects $8.5 million of repayment of debt, partially offset by proceeds from the issuance of debt of $7.5 million and proceeds from the issuance of common stock of $0.2 million.

Cash provided by financing activities for the six months ended June 30, 2011 primarily reflects $30.0 million of proceeds from the issuance of debt, partially offset by share repurchases of $0.1 million.

None of the cash used in financing activities for the six months ended June 30, 2012 and 2011 relates to discontinued operations.

Other

In connection with the acquisition of Neurogen Corporation on December 23, 2009, Neurogen security holders received CVRs under four CVR agreements. The CVRs entitle Neurogen shareholders to cash payments upon the sale or licensing of certain assets and upon the achievement of a specified clinical milestone. At June 30, 2012 and December 31, 2011, the aggregate fair values of the Aplindore, VR1 and H3 CVR s were $0.5 million and $0.7 million, respectively, and included in long-term portion of liability for contingent value rights in the accompanying balance sheets as management is unable to estimate the timing of potential future payments.

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In connection with the acquisition of Metabasis Therapeutics on January 27, 2010, Metabasis security holders received CVRs under four CVR agreements. The CVRs entitle the holders to cash payments upon the sale or licensing of certain assets and upon the achievement of specified milestones. The fair value of the liability at June 30, 2012 and December 31, 2011 was $0 and $1.1 million, respectively.

In connection with the acquisition of CyDex Pharmaceuticals, Inc. on January 24, 2011, we issued a series of Contingent Value Rights. In 2011, $0.9 million was paid to the CyDex Shareholders upon completion of a licensing agreement with The Medicines Company for the Captisol enabled Intravenous formulation of Clopidogrel. An additional $2.0 million was paid to the CyDex Shareholders upon acceptance by the FDA of Onyx s NDA Onyx and an additional $3.5 million was paid upon approval by the FDA of Kyprolis for the potential treatment of patients with relapsed and refractory multiple myeloma. We may be required to pay an additional $8.0 million upon achievement of certain clinical and regulatory milestones to the CyDex CVR holders, and former license holders. In addition, we will pay CyDex shareholders, for each respective year from 2011 through 2016, 20% of all CyDex-related revenue, but only to the extent that and beginning only when CyDex-related revenue for such year exceed $15.0 million; plus an additional 10% of all CyDex-related revenue recognized during such year, but only to the extent that and beginning only when aggregate CyDex-related revenue for such year exceeds $35.0 million. We paid $0.3 million to the CyDex shareholders in March 2012 related to 2011 CyDex-related revenue. The estimated fair value of the liability at June 30, 2012 was $13.7 million.

Leases and off-balance sheet arrangements

We lease our office and research facilities under operating lease arrangements with varying terms through November 2021. The agreements provide for increases in annual rents based on changes in the Consumer Price Index or fixed percentage increases ranging from 3% to 3.5%. Commencing in January 2008, we also sublease a portion of our facilities through July 2015. The sublease agreement provides for a 3% increase in annual rents. We had no off-balance sheet arrangements at June 30, 2012 and December 31, 2011.

Contractual Obligations

As of June 30, 2012, future minimum payments due under our contractual obligations are as follows (in thousands):

	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating lease obligations (1)	$ 22,156	$ 5,465	$ 11,149	$ 4,580	$ 962

(1) We currently sublease two of our facilities through their respective lease terms of July 2015 and August 2016. As of June 30, 2012, we expect to receive aggregate future minimum lease payments totaling $4.1 million (nondiscounted) over the duration of the sublease agreements as follows: less than one year, $1.1 million; one to three years, $2.6 million; and three to five years, $0.4 million.

We outsource the production of Captisol to Hovione, LLC. Under the terms of the supply agreement with Hovione, the Company has ongoing minimum annual purchase commitments and is required to purchase a total of $15 million of Captisol over the term of the supply agreement which expires in December 2019. Through June 30, 2012 we have spent approximately $14.8 million towards that commitment. Either party may terminate the Agreement for the uncured material breach or bankruptcy of the other party or an extended force majeure event. The Company may also terminate the supply agreement for extended supply interruption, regulatory action related to Captisol or other specified events.

Under the terms of our merger with Metabasis, we are committed to spend at least $7 million within 30 months following the close of the transaction and $8.0 million within 42 months in new research and development funding on the Metabasis programs. Through June 30, 2012, we estimate that we have spent approximately $6.7 million of the committed amount.

We are also required under our CyDex CVR Agreement to invest at least $1.5 million per year, inclusive of employee expenses, in the acquired business, through 2015. As of June 30, 2012, we estimate we have exceeded that amount.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

At June 30, 2012, our investment portfolio included fixed-income securities of $1.5 million. These securities are subject to interest rate risk and will decline in value if interest rates increase. However, due to the short duration of our investment portfolio, an immediate 10% change in interest rates would have no material impact on our financial condition, results of operations or cash flows. Declines in interest rates over time will, however, reduce our interest income.

We do not have a significant level of transactions denominated in currencies other than U.S. dollars and as a result we have very limited foreign currency exchange rate risk. We purchase Captisol from Hovione, located in Lisbon, Portugal. Payments to Hovione are denominated and paid in US dollars, however the unit price of Captisol contains an adjustment factor which is based on the sharing of foreign currency risk between the two parties. The effect of an immediate 10% change in foreign exchange rates would have no material impact on our financial condition, results of operations or cash flows.

We are exposed to market risk involving rising interest rates. To the extent interest rates rise, our interest costs could increase. An increase in interest costs of 10% would have no material impact on our financial condition, results of operations, or cash flows.

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ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, as of the end of the period covered by this report, which we refer to as the Evaluation Date.

As a result of material weaknesses in our internal control over financial reporting relating to the accounting for significant non-routine transactions and the controls over the determination of fair value of contingent liabilities, our management has reassessed the effectiveness of our disclosure controls and procedures and have determined that our disclosure controls and procedures were not effective as of June 30, 2012. Despite the material weaknesses in our internal control, management believes no material inaccuracies or omissions of fact exist in this quarterly report.

Remediation Plan. As a result of the material weaknesses associated with acquisition-related accounting, we have added a corporate controller to our finance and accounting staff. While we had processes to identify and intelligently apply accounting standards to complex transactions, we did not have adequate numbers of highly skilled accountants to provide for a detail analysis, documentation and review of the acquisition of CyDex, which closed on January 24, 2011. Additionally, we plan to enhance our controls over the determination of fair value of contingent liabilities by including a formal review of mathematical calculations and completeness of such calculations. These material weaknesses prevented us from properly reporting the financial information for previous interim and annual periods, and we have filed restated 10-Q and 10-K reports for the applicable periods. Management will continue to review and make necessary changes to the overall design of its internal control environment, as well as to policies and procedures to improve the overall effectiveness of internal control over financial reporting.

The material weaknesses will not be remediated until the applicable remedial procedures are tested and management has concluded that the procedures and controls are operating effectively.

Changes in Internal Controls. Except as described above, there have been no changes during the last fiscal quarter in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time we are subject to various lawsuits and claims with respect to matters arising out of the normal course of our business. Due to the uncertainty of the ultimate outcome of these matters, the impact on future financial results is not subject to reasonable estimates.

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ITEM 1A. RISK FACTORS

The following is a summary description of some of the many risks we face in our business. You should carefully review these risks in evaluating our business, including the businesses of our subsidiaries. You should also consider the other information described in this report.

Risks Related To Us and Our Business.

Our business has recently undergone a significant change, and we may not be successful in integrating the Captisol technology and CyDex s other development product candidates into our existing operations or in realizing the planned results from our recently expanded product portfolio and pipeline.

In January 2011, we completed our merger with CyDex, in which we obtained the Captisol technology, in addition to other product candidates. We will need to overcome significant challenges in order to realize the benefits from this acquisition. These challenges will include the timely, efficient and successful execution of a number of tasks, including the following:

- integrating CyDex into our existing operations;
- integrating CyDex s developmental product candidates and successfully managing the development and regulatory processes; and
- coordinating with CyDex s and our collaborative partners concerning the development, manufacturing, regulatory and intellectual property protection strategies for Captisol and new development product candidates.

In addition, we rely on our collaborative partners for many aspects of our developmental and commercialization activities, and we are subject to risks related to their financial stability and solvency. We may not succeed in addressing these risks or any other problems encountered in connection with the acquisition of CyDex.

Furthermore, all of CyDex s products and product candidates, as well as the technology that it outlicenses, are based on Captisol. In addition, CyDex or its partners are attempting to develop some product candidates that may contain significantly higher levels of Captisol than in any currently-approved product and has directed developers to demonstrate an adequate safety margin and specifically acceptable renal safety. If products or product candidates incorporating Captisol technology were to cause any unexpected adverse events, whether in preclinical studies, clinical trials or as commercialized products, whether as a result of Captisol or otherwise, the perception of Captisol safety could be seriously harmed. If this were to occur, we may not be able to market these products unless and until we are able to demonstrate that the adverse event was unrelated to Captisol, which we may not be able to do. Further, whether or not the adverse event was a result of Captisol, we could be required by the FDA to submit to additional regulatory reviews or approvals, including extensive safety testing or clinical testing of products using Captisol, which would be expensive and, even if we were to demonstrate that the adverse event was unrelated to Captisol, would delay our marketing of Captisol-enabled products and receipt of revenue related to those products.

Revenues based on sales of Promacta represent a substantial portion of our overall current and/or expected future revenues.

GSK is obligated to pay us royalties based on its sales of Promacta. These payments are expected to be a substantial portion of our ongoing revenues for some time. As a result, any setback that may occur with respect to Promacta could significantly impair our operating results and/or reduce the market price of our stock. Setbacks for Promacta could include problems with shipping, distribution, manufacturing, product safety, marketing, government regulation, safety issues, licenses and approvals, intellectual property rights, competition with existing or new products and physician or patient acceptance of the products, as well as higher than expected total rebates, returns or discounts.

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Revenues based on sales of Kyprolis represent a substantial portion of our overall expected future revenues.

Revenues from Onyx based on sales of Kyprolis are expected to be a substantial portion of our revenue in the future and any setbacks that occur with respect to Kyprolis could significantly impair our future operating results and/or reduce the market price of our stock. Setbacks for Kyprolis could include problems with shipping, distribution, manufacturing, product safety, marketing, government regulations, safety issues, licenses and approvals, intellectual property rights, competition with existing or new products and physician or patient acceptance of the products, as well as higher than expected total rebates, returns or discounts.

Our product candidates face significant development and regulatory hurdles prior to marketing which could delay or prevent sales and/or milestone revenue.

Before we or our partners obtain the approvals necessary to sell any of our potential products, we must show through preclinical studies and human testing that each product is safe and effective. We and our partners have a number of products moving toward or currently awaiting regulatory action. Failure to show any product s safety and effectiveness could delay or prevent regulatory approval of a product and could adversely affect our business. The clinical trials process is complex and uncertain. For example, the results of preclinical studies and initial clinical trials may not necessarily predict the results from later large-scale clinical trials. In addition, clinical trials may not demonstrate a product s safety and effectiveness to the satisfaction of the regulatory authorities. Recently, a number of companies have suffered significant setbacks in advanced clinical trials or in seeking regulatory approvals, despite promising results in earlier trials. The FDA may also require additional clinical trials after regulatory approvals are received. Such additional trials may be expensive and time-consuming, and failure to successfully conduct those trials could jeopardize continued commercialization of a product.

The rates at which we complete our clinical trials depends on many factors, including, but are not limited to, our ability to obtain adequate supplies of the products to be tested and patient enrollment. Patient enrollment is a function of many factors, including the size of the patient population, the proximity of patients to clinical sites and the eligibility criteria for the trial. Delays in patient enrollment for our trials may result in increased costs and longer development times. For example, the trial entitled Eltrombopag To Reduce The Need For Platelet Transfusion In Subjects With Chronic Liver Disease And Thrombocytopenia Undergoing Elective Invasive Procedures (ELEVATE) was suspended in October 2009 in accordance with an IDMC Recommendation. GSK terminated the ELEVATE study. In addition, our collaborative partners have rights to control product development and clinical programs for products developed under the collaborations. As a result, these collaborative partners may conduct these programs more slowly or in a different manner than expected. Moreover, even if clinical trials are completed, we or our collaborative partners still may not apply for FDA approval in a timely manner or the FDA still may not grant approval.

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We rely heavily on collaborative relationships, and any disputes or litigation with our collaborative partners or termination or breach of any of the related agreements could reduce the financial resources available to us, including milestone payments and future royalty revenues.

Our strategy for developing and commercializing many of our potential products, including products aimed at larger markets, includes entering into collaborations with corporate partners and others. These collaborations have provided us with funding and research and development resources for potential products for the treatment of a variety of diseases. However, the funding provided to us by our existing collaborative partners for ongoing research and development under our existing collaborative agreements has ceased. These agreements also give our collaborative partners significant discretion when deciding whether or not to pursue any development program. Our existing collaborations may not continue or be successful, and we may be unable to enter into future collaborative arrangements to develop and commercialize our product candidates.

In addition, our collaborators may develop drugs, either alone or with others that compete with the types of drugs they are developing with us. This would result in increased competition for our programs. If products are approved for marketing under our collaborative programs, revenues we receive will depend on the manufacturing, marketing and sales efforts of our collaborative partners, who generally retain commercialization rights under the collaborative agreements. Generally, our current collaborative partners also have the right to terminate their collaborations under specified circumstances. If any of our collaborative partners breach or terminate their agreements with us or otherwise fail to conduct their collaborative activities successfully, for example, by not making required payments when due, or at all our product development under these agreements will be delayed or terminated. Disputes or litigation may also arise with our collaborators, including disputes or litigation over ownership rights to intellectual property, know-how or technologies developed with our collaborators. Such disputes or litigation could adversely affect our rights to one or more of our product candidates. Any such dispute or litigation could delay, interrupt or terminate the collaborative research, development and commercialization of certain potential products, create uncertainty as to ownership rights of intellectual property, or could result in litigation or arbitration. The occurrence of any of these problems could be time-consuming and expensive and could adversely affect our business.

We obtain Captisol from a sole source supplier, and if this supplier were to cease to be able to supply Captisol to us, or decline to supply Captisol to us, we would be unable to continue to derive revenue or continue to develop our product candidates until we obtained an alternative source, which could take a considerable length of time.

We currently have one supplier of Captisol, Hovione FarmaCiencia SA, or Hovione, through its agent Hovione LLC. Hovione is a major supplier of APIs and API intermediates located in Lisbon, Portugal. Hovione has other production sites in Cork, Ireland, Macau, China, and Zhejiang, China, but those sites are not yet fully qualified to make Captisol. If a major disaster were to happen at Hovione or Hovione were to suffer major production problems or were to fail to deliver Captisol to us for any other reason, there could be a significant interruption of our Captisol supply. While we carry a significant inventory of Captisol for this type of occurrence, which should permit us to satisfy our existing supply obligations through 2012 under current and anticipated demand conditions, a series of unusually large orders could rapidly deplete that inventory and cause significant problems with our licensees and disrupt our business. In addition, if we fail to supply Captisol under our supply agreements, our customers could obtain the right to have Captisol manufactured by other suppliers, which would significantly harm our business.

We rely on contract manufacturers for the manufacture of Captisol and product candidates, and if these contract manufacturers fail to perform as we expect, we will incur delays in our ability to generate revenue and substantial additional expenses in obtaining new contract manufacturers.

We do not manufacture products or product candidates, but rather contract with contract manufacturers for the manufacture of products and product candidates. With respect to any specific product or product candidate, we only contract with one contract manufacturer due to the high cost of compliance with good manufacturing practices prior to the contract manufacturer being permitted to manufacture the product or product candidate for use in humans. If a

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contract manufacturer is unable or unwilling to continue to manufacture for us in the future, we would be required to contract with a new contract manufacturer for the specific product or product candidate. In the case of products, this would cause us to lose revenue during the qualification process, and in the case of product candidates, this could cause a delay in the commercialization of the product candidate. In addition, in either case we would incur substantial additional expenses as a result of the new contract manufacturer becoming qualified. Further, if a contract manufacturer were to experience a delay in producing products or product candidates due to a failure to meet strict FDA manufacturing requirements or otherwise, we would also experience a delay in development and commercialization of the product candidate or, in the case of products, sales of the product. This risk is exacerbated in the case of manufacture of injectables, which require heightened sterility and other conditions as well as specialized facilities for preparation.

If we consume cash more quickly than expected, and if we are unable to raise additional capital, we may be forced to curtail operations.

Our operations have consumed substantial amounts of cash since inception. As of June 30, 2012, we had a negative working capital of $9.7 million. Clinical and preclinical development of drug candidates is a long, expensive and uncertain process. Also, we may acquire companies, businesses or products and the consummation of such acquisitions may consume additional cash. For example, as part of the consideration for our recent acquisition of CyDex, we distributed approximately $12.0 million of our cash to CyDex stockholders. In connection with the acquisition, we entered into a $20 million Loan and Security Agreement, or the Loan Agreement, with a lender. Under the terms of the Loan Agreement, we will make interest only payments for one year at a fixed rate of 8.64%, with an option to extend the interest only payments for an additional year, which we intend to exercise. Subsequent to the interest only payments, the note will amortize with principal and interest payments due through the remaining term of the loan. The loan term, including interest only payments, is 42 months.

In March 2011, we borrowed $5.0 million from Square 1 Bank and April 2011 we borrowed an additional $5.0 million from Square 1. All outstanding amounts under the loan bear interest at a floating rate equal to 200 basis points above the prime rate and may become immediately due and payable if we fail to maintain a cash balance at Square 1 equal to the amount outstanding under the credit facility. We paid $4.5 million on our revolving credit facility in January 2012, $4.0 million in March 2012, and the remaining $1.5 million in July 2012. On March 29, 2012, we entered into a Second Amendment to Loan and Security Agreement (the "Square 1 Second Amendment to Loan and Security Agreement"). The Square 1 Second Amendment to Loan and Security Agreement changed the maturity date of the revolving line of credit facility to March 28, 2013. The Square 1 Second Amendment to Loan and Security Agreement did not change the interest rate and interest payment schedule established in the Loan and Security Agreement.

In October 2011, we filed a Registration Statement on Form S-3 with the Securities and Exchange Commission (SEC) for the issuance and sale of up to $30 million of equity or other securities, proceeds from which will be used for general corporate purposes. The Form S-3 provides additional financial flexibility for us to sell shares or other securities as needed at any time. As of August 8, 2012, 150,000 common shares have been issued under this registration statement for total net proceeds of $2.6 million. In March 2012, we entered into a Controlled Equity Offering Sales Agreement with Cantor Fitzgerald & Co. (Cantor), as sales agent, to create an at-the-market equity program under which we may, from time to time, sell shares of common stock, par value $0.001 per share, up to an aggregate offering price of $30 million.

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We believe that our capital resources, including our currently available cash, cash equivalents, and short-term investments as well as our current and future royalty revenues, will be adequate to fund our operations at their current levels at least for the next twelve months. However, changes may occur that would cause us to consume available capital resources before that time. Examples of relevant potential changes that could impact our capital resources include:

- the costs associated with our drug research and development activities, and additional costs we may incur if our development programs are delayed or are more expensive to implement than we currently anticipate;
- changes in collaborative relationships, including the funding we receive in connection with those relationships;
- the progress of our milestone and royalty producing activities;
- acquisitions of other businesses or technologies;
- the termination of our lease agreements;
- the costs of the closure of our operations at our Cranbury, New Jersey facility;
- the purchase of additional capital equipment;
- cash payments, including CVR payments, or refunds we may be required to make pursuant to certain agreements with third parties;
- competing technological and market developments; and
- the cost of filing, prosecuting, defending and enforcing patent claims and other intellectual property rights, and the outcome of related litigation.

Additional capital may not be available on favorable terms, or at all. If additional capital is not available, we may be required to curtail operations significantly, including but not limited to reducing our current headcount, or to obtain funds by entering into arrangements with partners or other third parties that may require us to relinquish rights to certain of our technologies, products or potential markets that we would not otherwise relinquish.

Our collaborative partners may change their strategy or the focus of their development and commercialization efforts with respect to our alliance products, the success of our alliance products could be adversely affected.

If our collaborative partners terminate their collaborations with us or do not commit sufficient resources to the development, manufacture, marketing or distribution of our alliance products, we could be required to devote additional resources to our alliance products, seek new collaborative partners or abandon such alliance products, all of which could have an adverse effect on our business.

In September 2010, we received notice from GSK that it was exercising its right to terminate the Product Development and Commercialization Agreement, dated as of March 24, 2006 and as amended, among SmithKlineBeecham Corporation, doing business as GlaxoSmithKline, Glaxo Group Limited and Pharmacopeia, LLC, as successor to Pharmacopeia Drug Discovery, Inc. The termination became effective on October 7, 2010. Absent the termination by GSK, the research term under this agreement would have terminated on March 24, 2011. Following

termination, we retained rights to the current programs under this agreement and may continue to develop the programs and commercialize any products resulting from the programs, or we may elect to cease progressing the programs and/or seek other partners for further development and commercialization.

In September 2011, we received a notice from MedImmune (a subsidiary of AstraZeneca) that it was exercising its right to terminate the Collaboration and License Agreement, dated April 19, 2001. Upon termination, all materials and know-how related to the IL-9 antibody program by MedImmune was returned to us. MedImmune is required to discuss the granting of a royalty-bearing license to intellectual property with respect to the product licensed under the agreement. However, MedImmune has no obligation to grant such a license or retain the ability to grant such a license. The termination became effective on November 30, 2011.

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In October 2011, we received notice from Merck that it was exercising its right to terminate the Collaboration and License Agreement, dated November 24, 2003. The collaboration and licensing program was related to the physiology, pharmacology, chemistry, and potential therapeutic applications and potential clinical utilities related to Vanilloid Receptors, subtype 1, also known as TRPV1. Upon termination, Merck is required to transfer and/or disclose specified materials and know-how to us (which is under an obligation to transfer certain specified materials to Merck). In addition, we will receive an exclusive, perpetual, irrevocable, royalty-free (but subject to any third party royalty obligations), fully-paid, worldwide license, with right to sub-license, under specified patents and technology for the research, development or commercialization of specified compounds and products in a limited field of use. We will also receive a non-exclusive license to all other know-how Merck deems necessary to sell the specified compounds or products. The termination became effective on April 18, 2012.

We are currently dependent upon outlicensing business and we may not be successful in entering into additional out-license agreements on favorable terms, which may adversely affect our liquidity or require us to alter development plans on our products.

We have entered into several out-licensing agreements for the development and commercialization of our products. We currently depend on our arrangements with our outlicensees to sell products using our Captisol technology. These agreements generally provide that outlicensees may terminate the agreements at will. If our outlicensees discontinue sales of products using our Captisol technology, fail to obtain regulatory approval for their products using our Captisol technology, fail to satisfy their obligations under their agreements with us, or otherwise choose to utilize a generic form of Captisol should it become available, or if we are unable to establish new licensing and marketing relationships, our financial results and growth prospects would be materially affected. Further, under most of our Captisol outlicenses, the amount of royalties we receive will be reduced or will cease when the relevant patent expires. While we have other more recent patents relating to Captisol with later expiration dates (for example, our high purity patent, U.S. Patent No. 7,635,773 is not expected to expire until 2029 and our morphology patent, U.S. Patent No. 7,629,331 is not expected to expire until 2025), the initially filed patents relating to Captisol expired in 2010 and 2011 in the U.S. and are expected to expire between 2012 and 2016 in most countries outside the U.S. If our other intellectual property rights are not sufficient to prevent a generic form of Captisol from coming to market and if in such case our outlicensees choose to terminate their agreements with us, the source of the vast majority of our Captisol revenue may cease to exist.

Although we expend considerable resources on internal research and development for our proprietary programs, we may not be successful in entering into additional out-licensing agreements under favorable terms due to several factors including:

- the difficulty in creating valuable product candidates that target large market opportunities;
- research and spending priorities of potential licensing partners;
- willingness of and the resources available to pharmaceutical and biotechnology companies to in-license product candidates for their clinical pipelines; or
- differences of opinion with potential partners on the valuation of products we are seeking to out-license.

The inability to enter into out-licensing agreements under favorable terms and to earn milestone payments, license fees and/or upfront fees may adversely affect our liquidity and may force us to curtail or delay development of some or all of our proprietary programs, which in turn may harm our business and the value of our stock.

Third party intellectual property may prevent us or our partners from developing our potential products and we may owe a portion of any payments we receive from our collaborative partners to one or more third parties.

Our success will depend on our ability and the ability of our collaborative partners to avoid infringing the proprietary rights of others, both in the United States and in foreign countries. In addition, disputes with licensors under our license agreements may arise which could result in additional financial liability or loss of important technology and potential products and related revenue, if any. Further, the manufacture, use or sale of our potential products or our collaborative partners products or potential products may infringe the patent rights of others. This could impact Captisol, Avinza, Promacta, Viviant and Conbriza (bazedoxifene), Fablyn, LGD-4665, and any other products or potential products.

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Several drug companies and research and academic institutions have developed technologies, filed patent applications or received patents for technologies that may be related to our business. Others have filed patent applications and received patents that conflict with patents or patent applications we have licensed for our use, either by claiming the same methods or compounds or by claiming methods or compounds that could dominate those licensed to us. In addition, we may not be aware of all patents or patent applications that may impact our ability to make, use or sell any of our potential products. For example, US patent applications may be kept confidential while pending in the United States Patent and Trademark Office and patent applications filed in foreign countries are often first published six months or more after filing.

Disagreements or litigation with our collaborative partners could delay our ability and the ability of our collaborative partners to achieve milestones or our receipt of other payments. In addition, other possible disagreements or litigation could delay, interrupt or terminate the research, development and commercialization of certain potential products being developed by either our collaborative partners or by us. The occurrence of any of the foregoing problems could be time-consuming and expensive and could adversely affect our business.

Third parties have not directly threatened an action or claim against us, although we do periodically receive other communications or have other conversations with the owners of other patents or other intellectual property. If others obtain patents with conflicting claims, we may be required to obtain licenses to those patents or to develop or obtain alternative technology. We may not be able to obtain any such licenses on acceptable terms, or at all. Any failure to obtain such licenses could delay or prevent us from pursuing the development or commercialization of our potential products.

In general, litigation claims can be expensive and time consuming to bring or defend against and could result in settlements or damages that could significantly impact our results of operations and financial condition. We cannot predict or determine the outcome of these matters or reasonably estimate the amount or range of amounts of any fines or penalties that might result from a settlement or an adverse outcome. However, a settlement or an adverse outcome could have a material adverse effect on our financial position, liquidity and results of operations.

Expirations of, challenges to or failure to secure patents and other proprietary rights may significantly hurt our business.

The initially filed patents relating to Captisol expired in 2010 and 2011 in the U.S. and are expected to expire between 2012 and 2016 in most countries outside the U.S. We have also obtained patent protection in the U.S. through 2025 on one or more Agglomerated forms of Captisol and through 2029 on one or more High Purity form of Captisol. We have obtained patent protection on a number of combinations of APIs and Captisol through three combination patents in the U.S., and we have applied for six additional combination patents in the U.S. relating to the combination of Captisol with specific APIs. Our U.S. combination patent relating to Fosphenytoin expires June 12, 2018 and our U.S. combination patent relating to Amiodarone expires May 4, 2022. Our U.S. combination patent relating to one of our early-stage product candidates expires March 19, 2022. There is no guarantee that these patents will be sufficient to prevent competitors from creating a generic form of Captisol after 2010 and competing against us, or from developing combination patents for products that will prevent us from developing products using those APIs. In addition, most of the agreements in our Captisol outlicensing business, including our agreements with Pfizer relating to Geodon IM, Vfend IV and Cerenia, provide that once the relevant patent expires, the amount of royalties we receive will be reduced or eliminated.

Generally, our success will depend on our ability and the ability of our licensors to obtain and maintain patents and proprietary rights for our potential products both in the United States and in foreign countries. Patents may not be issued from any of these applications currently on file, or, if issued, may not provide sufficient protection. Our patent position, like that of many biotechnology and pharmaceutical companies, is uncertain and involves complex legal and technical questions for which important legal principles are unresolved. We may not develop or obtain rights to products or processes that are patentable. Even if we do obtain patents, such patents may not adequately protect the technology we own or have licensed. In addition, others may challenge, seek to invalidate, infringe or circumvent any patents we own or license and rights we receive under those patents may not provide competitive advantages to us. For example, our European patent related to Agglomerated forms of Captisol is currently being opposed.

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Any conflicts resulting from the patent rights of others could significantly reduce the coverage of our patents and limit our ability to obtain meaningful patent protection. We have had and will continue to have discussions with our current and potential collaborative partners regarding the scope and validity of our patents and other proprietary rights. If a collaborative partner or other party successfully establishes that our patent rights are invalid, we may not be able to continue our existing collaborations beyond their expiration. Any determination that our patent rights are invalid also could encourage our collaborative partners to seek early termination of our agreements. Such invalidation could adversely affect our ability to enter into new collaborations.

We may also need to initiate litigation, which could be time-consuming and expensive, to enforce our proprietary rights or to determine the scope and validity of others rights. If litigation occurs, a court may find our patents or those of our licensors invalid or may find that we have infringed on a competitor s rights. In addition, if any of our competitors have filed patent applications in the United States which claim technology we also have invented, the United States Patent and Trademark Office may require us to participate in expensive interference proceedings to determine who has the right to a patent for the technology.

We also rely on unpatented trade secrets and know-how to protect and maintain our competitive position. We require our employees, consultants, collaborative partners and others to sign confidentiality agreements when they begin their relationship with us. These agreements may be breached, and we may not have adequate remedies for any breach. In addition, our competitors may independently discover our trade secrets.

Our product development involves a number of uncertainties, and we may never generate sufficient collaborative payments and royalties from the development of products to become profitable.

We were founded in 1987. We have incurred significant losses since our inception. As of June 30, 2012, our accumulated deficit was $683.6 million.

Most of our products in development will require extensive additional development, including preclinical testing and human studies, as well as regulatory approvals, before they can be marketed. We cannot predict if or when any of the products we are developing or those being developed with our partners will be approved for marketing. There are many reasons why we or our collaborative partners may fail in our efforts to develop our potential products, including the possibility that: preclinical testing or human studies may show that our potential products are ineffective or cause harmful side effects; the products may fail to receive necessary regulatory approvals from the FDA or foreign authorities in a timely manner, or at all; the products, if approved, may not be produced in commercial quantities or at reasonable costs; the products, if approved, may not achieve commercial acceptance; regulatory or governmental authorities may apply restrictions to our products, which could adversely affect their commercial success; or the proprietary rights of other parties may prevent us or our partners from marketing the products.

Any product development failures for these or other reasons, whether with our products or our partners products, may reduce our expected revenues, profits, and stock price.

Any future material weaknesses or deficiencies in our internal control over financial reporting could harm stockholder and business confidence on our financial reporting, our ability to obtain financing and other aspects of our business.

As described in Item 4, we identified material weaknesses as a result of improper accounting for significant non-routine transactions and the controls over the determination of fair value of contingent liabilities. Our Audit Committee, after consultation with management has determined that the material weaknesses were a result of inadequate staffing and review processes. As a result of the material weaknesses associated with acquisition-related accounting, we have added a corporate controller to our finance and accounting staff. While we had processes to identify and apply accounting standards to complex transactions, we enhanced these processes with the addition of a resource with the ability to research and understand the nuances of complex accounting standards. Additionally, we plan to enhance our controls over the determination of fair value of contingent liabilities by including a formal review of mathematical calculations and completeness of such calculations. Given the material weaknesses, our Audit Committee, after consultation with management determined that we did not maintain effective internal control over financial reporting. The existence of one or more material weakness or significant deficiency could result in future errors in our consolidated financial statements. Substantial costs and resources may be required to rectify any internal control deficiencies. If we fail to achieve and maintain the adequacy of our internal controls in accordance with applicable standards, we may be unable to conclude on an ongoing basis that we have effective internal controls over financial reporting. If we cannot produce reliable financial reports, our business and financial condition could be harmed, investors could lose confidence in our reported financial information, or the market price of our stock could decline significantly. In addition, our ability to obtain additional financing to operate and expand our business, or obtain additional financing on favorable terms, could be materially and adversely affected, which, in turn, could materially and adversely affect our business, our financial condition and the market value of our securities. Moreover, our reputation with customers, lenders, investors, securities analysts and others may be adversely affected.

We may undertake strategic acquisitions in the future and any difficulties from integrating such acquisitions could adversely affect our stock price, operating results and results of operations.

We may acquire companies, businesses and products that complement or augment our existing business. We may not be able to integrate any acquired business successfully or operate any acquired business profitably. Integrating any newly acquired business could be expensive and time-consuming. Integration efforts often take a significant amount of time, place a significant strain on managerial, operational and financial resources and could prove to be more difficult or expensive than we predict. The diversion of our management s attention and any delay or difficulties encountered in connection with any future acquisitions we may consummate could result in the disruption of our on-going business or inconsistencies in standards and controls that could negatively affect our ability to maintain third-party relationships. Moreover, we may need to raise additional funds through public or private debt or equity financing, or issue additional shares, to acquire any businesses or products, which may result in dilution for stockholders or the incurrence of indebtedness.

As part of our efforts to acquire companies, business or product candidates or to enter into other significant transactions, we conduct business, legal and financial due diligence with the goal of identifying and evaluating material risks involved in the transaction. Despite our efforts, we ultimately may be unsuccessful in ascertaining or evaluating all such risks and, as a result, might not realize the intended advantages of the transaction. If we fail to realize the expected benefits from acquisitions we may consummate in the future, whether as a result of unidentified risks, integration difficulties, regulatory setbacks and other events, our business, results of operations and financial condition could be adversely affected. If we acquire product candidates, we will also need to make certain assumptions about, among other things, development costs, the likelihood of receiving regulatory approval and the market for such product candidates. Our assumptions may prove to be incorrect, which could cause us to fail to realize the anticipated benefits of these transactions.

In addition, we will likely experience significant charges to earnings in connection with our efforts, if any, to consummate acquisitions. For transactions that are ultimately not consummated, these charges may include fees and expenses for investment bankers, attorneys, accountants and other advisors in connection with our efforts. Even if our efforts are successful, we may incur, as part of a transaction, substantial charges for closure costs associated with elimination of duplicate operations and facilities and acquired IPR&D charges. In either case, the incurrence of these charges could adversely affect our results of operations for particular quarterly or annual periods.

Revenues based on sales of Avinza represent a substantial portion of our overall current and/or expected future revenues.

Pfizer, as successor to King, is obligated to pay us royalties based on the sales of Avinza. These payments are expected to be a substantial portion of our ongoing revenues for some time. As a result, any setback that may occur with respect to Avinza could significantly impair our operating results and/or reduce the market price of our stock. Setbacks for Avinza could include problems with shipping, distribution, manufacturing, product safety, marketing, government regulation, licenses and approvals, intellectual property rights, competition with existing or new products and physician or patient acceptance of the products, as well as higher than expected total rebates, returns or discounts.

Avinza could also face regulatory action and product safety issues. For example, the FDA previously requested expanded warnings on the Avinza label to alert doctors and patients to the dangers of using Avinza with alcohol. Changes were subsequently made to the label. The FDA also requested clinical studies to investigate the risks associated with taking Avinza with alcohol. Any additional warnings, studies and any farther regulatory action could have significant adverse effects on Avinza sales.

In September 2007, King reported that Actavis, a manufacturer of generic pharmaceutical products headquartered in Iceland, had filed with the FDA an Abbreviated New Drug Application, or ANDA, with a Paragraph IV Certification pertaining to Avinza, the rights to which were acquired by King from us in February 2007. According to the report, Actavis s Paragraph IV Certification sets forth allegations that U.S. Patent No. 6,066,339, or the 339 patent, which pertains to Avinza, and which is listed in the FDA s Approved Drug Products With Therapeutic Equivalence Evaluations, will not be infringed by Actavis s manufacture, use, or sale of the product for which the ANDA was submitted. The expiration date for this patent is November 2017. King, King Pharmaceuticals Research and Development, Inc., Elan Corporation, plc, or Elan, and Elan Pharma International Ltd. jointly filed suit in federal district court in New Jersey on October 18, 2007 against Actavis, Inc. and Actavis Elizabeth LLC for patent infringement under the 339 patent. The lawsuit was settled and dismissed without prejudice in July 2011.

On July 21,2009, King, King Pharmaceuticals Research and Development, Inc., Elan and Elan Pharma International Ltd. jointly filed suit in federal district court in New Jersey against Sandoz Inc., or Sandoz, for patent infringement under the 339 patent. According to the complaint, Sandoz filed an ANDA for morphine sulfate extended release capsules and, in connection with the ANDA filing, Sandoz provided written certification to the FDA alleging that the claims of the 339 patent are invalid, unenforceable and/or will not be infringed by the manufacture, use or sale of Sandoz s proposed morphine product. The case was dismissed on consent of the parties in July 2012.

We may not be able to hire and/or retain key employees.

If we are unable to hire and/or retain key employees, we may not have sufficient resources to successfully manage our assets or our business, and we may not be able to perform our obligations under various contracts and commitments. Furthermore, there can be no assurance that we will be able to retain all of our key management and scientific personnel. If we fail to retain such key employees, we may not realize the

anticipated benefits of our mergers. Either of these could have substantial negative impacts on our business and our stock price.

If plaintiffs bring product liability lawsuits against us or our partners, we or our partners may incur substantial liabilities and may be required to limit commercialization of our approved products and product candidates, and we may be subject to other liabilities related to the sale of our prior commercial product lines.

We and our partners face an inherent risk of product liability as a result of the clinical testing of our product candidates in clinical trials and face an even greater risk for commercialized products. Although we are not currently a party to product liability litigation, if we are sued, we may be held liable if any product or product candidate we

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develop causes injury or is found otherwise unsuitable during product testing, manufacturing, marketing or sale. Regardless of merit or eventual outcome, liability claims may result in decreased demand for any product candidates or products that we may develop, injury to our reputation, discontinuation of clinical trials, costs to defend litigation, substantial monetary awards to clinical trial participants or patients, loss of revenue and the inability to commercialize any products that we develop. We have product liability insurance that covers our clinical trials up to a $5.0 million annual limit. We intend to expand product liability insurance coverage to include the sale of commercial products if we obtain marketing approval for any products that we may develop. However, this insurance may be prohibitively expensive, or may not fully cover our potential liabilities. Inability to obtain sufficient insurance coverage at an acceptable cost or otherwise to protect against potential product liability claims could prevent or delay the commercialization of our product candidates. If we are sued for any injury caused by our product candidates or any future products, our liability could exceed our total assets.

In addition, we agreed to indemnify Eisai and King under certain circumstances pursuant to the asset purchase agreements we entered into with Eisai and King in connection with the sale of our prior commercial product lines. Some of our indemnification obligations still remain and our potential liability in certain circumstances is not limited to specific dollar amounts. We cannot predict the liabilities that may arise as a result of these matters. Any claims related to our indemnification obligations to King or Eisai could materially and adversely affect our financial condition.

In addition, King assumed our obligation to make payments to Organon based on net sales of Avinza (the fair value of which was $14.8 million as of June 30, 2012). We remain liable to Organon in the event King defaults on this obligation. Any requirement to pay a material amount to Organon, could adversely affect our business and the price of our securities.

The sale of our prior commercial product lines does not relieve us of exposure to product liability risks on products we sold prior to divesting these product lines. A successful product liability claim or series of claims brought against us may not be insured and could result in payment of significant amounts of money and divert management s attention from running our business.

If our partners do not reach the market with our alliance products before our competitors offer products for the same or similar uses, or if our partners are not effective in marketing our alliance products, our revenues from product sales, if any, will be reduced.

We face intense competition in our development activities. Our competitors might succeed in obtaining regulatory approval for competitive products more rapidly than our partners can for our products. In addition, competitors might develop technologies and products that are less expensive and perceived to be safer or more effective than those being developed by us or our partners, which could impair our product development and render our technology obsolete.

We use hazardous materials, which may expose us to significant liability.

In connection with our research and development activities, we handle hazardous materials, chemicals and various radioactive compounds. To properly dispose of these hazardous materials in compliance with environmental regulations, we are required to contract with third parties. We believe that we carry reasonably adequate insurance for toxic tort claims. However, we cannot eliminate the risk or predict the exposure of accidental contamination or injury from the handling and disposing of hazardous materials, whether by us or our third-party contractors. Any accident in the handling and disposing of hazardous materials may expose us to significant liability.

Our shareholder rights plan and charter documents may hinder or prevent change of control transactions.

Our shareholder rights plan and provisions contained in our certificate of incorporation and bylaws may discourage transactions involving an actual or potential change in our ownership. In addition, our Board of Directors may issue shares of preferred stock without any further action by the stockholders. Such restrictions and issuances may have the effect of delaying or preventing a change in our ownership. If changes in our ownership are discouraged, delayed or prevented, it would be more difficult for our current Board of Directors to be removed and replaced, even if you or our other stockholders believe that such actions are in the best interests of us and our stockholders.

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We may lose some or all of the value of some of our short-term investments.

We engage one or more third parties to manage some of our cash consistent with an investment policy that allows a range of investments and maturities. The investments are intended to maintain safety of principal while providing liquidity adequate to meet projected cash requirements. Risks of principal loss are to be minimized through diversified short and medium term investments of high quality, but the investments are not in every case guaranteed or fully insured. As a result of changes in the credit market, one of our short-term investments in commercial paper was in default. As a result, we were unable to recoup all of our investment in the commercial paper. In addition, from time to time we may suffer other losses on our short-term investment portfolio.

We may require additional funds to run our business and may be required to raise these funds on terms which are not favorable to us or which reduce our stock price.

We may need to complete additional equity or debt financings to fund our operations. Our inability to obtain additional financing could adversely affect our business. Financings may not be available at all or on terms favorable to us. In addition, these financings, if completed, may not meet our capital needs and could result in substantial dilution to our stockholders.

In October 2011, we filed a Registration Statement on Form S-3 with the Securities and Exchange Commission (SEC) for the issuance and sale of up to $30 million of equity or other securities, proceeds from which will be used for general corporate purposes. The Form S-3 provides additional financial flexibility for us to sell shares as needed at any time. As of August 8, 2012, 150,000 securities have been issued under this registration statement for total net proceeds of $2.6 million.

If adequate funds are not available, we may be required to delay, reduce the scope of or eliminate one or more of our research or drug development programs. We may also be required to liquidate our business or file for bankruptcy protection. Alternatively, we may be forced to attempt to continue development by entering into arrangements with collaborative partners or others that require us to relinquish some or all of our rights to technologies or drug candidates that we would not otherwise relinquish.

Our drug development programs will require substantial additional future funding which could hurt our operational and financial condition.

Our drug development programs require substantial additional capital to successfully complete them, arising from costs to: conduct research, preclinical testing and human studies; establish pilot scale and commercial scale manufacturing processes and facilities; and establish and develop quality control, regulatory, marketing, sales and administrative capabilities to support these programs.

Our future operating and capital needs will depend on many factors, including: the pace of scientific progress in our research and development programs and the magnitude of these programs; the scope and results of preclinical testing and human studies; the time and costs involved in obtaining regulatory approvals; the time and costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims; competing technological and market developments; our ability to establish additional collaborations; changes in our existing collaborations; the cost of manufacturing scale-up; and the effectiveness of our commercialization activities.

We expect our research and development expenditures over the next three years to continue to be significant. However, we base our outlook regarding the need for funds on many uncertain variables. Such uncertainties include regulatory approvals, the timing of events outside our direct control such as product launches by partners and the success of such product launches, negotiations with potential strategic partners, possible sale of assets or other transactions and other factors. Any of these uncertain events can significantly change our cash requirements.

While we expect to fund our research and development activities from cash generated from royalties and royalties and milestones from our partners in various past and future collaborations to the extent possible, if we are unable to do so, we may need to complete additional equity or debt financings or seek other external means of

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financing. These financings could depress our stock price. If additional funds are required to support our operations and we are unable to obtain them on terms favorable to us, we may be required to cease or reduce further development or commercialization of our products, to sell some or all of our technology or assets or to merge with another entity.

Our results of operations and liquidity needs could be materially negatively affected by market fluctuations and economic downturn.

Our results of operations could be materially negatively affected by economic conditions generally, both in the U.S. and elsewhere around the world. Continuing concerns over inflation, energy costs, geopolitical issues, the availability and cost of credit, the U.S. mortgage market and a declining residential real estate market in the U.S. have contributed to increased volatility and diminished expectations for the economy and the markets going forward. These factors, combined with volatile oil prices, declining business and consumer confidence and increased unemployment, have precipitated an economic recession and fears of a possible depression. Domestic and international equity markets continue to experience heightened volatility and turmoil. These events and the continuing market upheavals may have an adverse effect on us. In the event of a continuing market downturn, our results of operations could be adversely affected by those factors in many ways, including making it more difficult for us to raise funds if necessary, and our stock price may further decline.

Our investment securities consist primarily of money market funds, corporate debt obligations and U.S. government agency securities. We do not have any auction rate securities. Recently, there has been concern in the credit markets regarding the value of a variety of mortgage-backed securities and the resultant effects on various securities markets. We cannot provide assurance that our investments are not subject to adverse changes in market value. If our investments experience adverse changes in market value, we may have less capital to fund our operations.

Our stock price has been volatile and could experience a sudden decline in value.

Our common stock has experienced significant price and volume fluctuations and may continue to experience volatility in the future. As a result, you may not be able to sell your shares quickly or at the latest market price if trading in our stock is not active or the volume is low. In November 2010, we effected a 1-for-6 reverse stock split. We believe the reverse stock split will have the effect of increasing the per share trading price of our common stock. Many factors may have a significant impact on the market price of our common stock, including, but not limited to, the following factors: results of or delays in our preclinical studies and clinical trials; the success of our collaboration agreements; publicity regarding actual or potential medical results relating to products under development by us or others; announcements of technological innovations or new commercial products by us or others; developments in patent or other proprietary rights by us or others; comments or opinions by securities analysts or major stockholders; future sales of our common stock by existing stockholders; regulatory developments or changes in regulatory guidance; litigation or threats of litigation; economic and other external factors or other disaster or crises; the departure of any of our officers, directors or key employees; period-to-period fluctuations in financial results; and limited daily trading volume.

The Financial Industry Regulatory Authority, or FINRA, (formerly the National Association of Securities Dealers, Inc.) and the Securities and Exchange Commission, or SEC, have adopted certain new rules. If we were unable to continue to comply with the new rules, we could be delisted from trading on the NASDAQ Global Market, or Nasdaq, and thereafter trading in our common stock, if any, would be conducted through the over-the-counter market or on the Electronic Bulletin Board of FINRA. As a consequence of such delisting, an investor would likely find it more difficult to dispose of, or to obtain quotations as to the price of, our common stock. Delisting of our common stock could also result in lower prices per share of our common stock than would otherwise prevail.

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Impairment charges pertaining to goodwill, identifiable intangible assets or other long-lived assets from our mergers could have an adverse impact on our results of operations and the market value of our common stock.

The total purchase price pertaining to our mergers with Pharmacopeia, Neurogen, Metabasis and CyDex have been allocated to net tangible assets, identifiable intangible assets, in process research and development and goodwill. To the extent the value of goodwill or identifiable intangible assets or other long-lived assets become impaired, we will be required to incur material charges relating to the impairment. Any impairment charges could have a material adverse impact on our results of operations and the market value of our common stock.

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The occurrence of a catastrophic disaster could damage our facilities beyond insurance limits or we could lose key data which could cause us to curtail or cease operations.

We are vulnerable to damage and/or loss of vital data from natural disasters, such as earthquakes, tornadoes, power loss, fire, floods and similar events. If any disaster were to occur, our ability to operate our business could be seriously impaired. We have property, liability, and business interruption insurance which may not be adequate to cover our losses resulting from disasters or other similar significant business interruptions, and we do not plan to purchase additional insurance to cover such losses due to the cost of obtaining such coverage. Any significant losses that are not recoverable under our insurance policies could seriously impair our business, financial condition and prospects.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES
Not applicable.

ITEM 4. MINE SAFETY DISCLOSURES
Not appicable

ITEM 5. OTHER INFORMATION
Not applicable.

ITEM 6. EXHIBITS
The Index to Exhibits on page 49 is incorporated herein by reference as the list of exhibits required as part of this Quarterly Report.

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LIGAND PHARMACEUTICALS INCORPORATED

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 14, 2012

By: /s/ John P. Sharp
John P. Sharp
Vice President, Finance and Chief Financial Officer

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INDEX TO EXHIBITS

Exhibit Number	Description
2.1(1)	Agreement and Plan of Merger, by and among the Company, Pharmacopeia, Inc., Margaux Acquisition Corp. and Latour Acquisition, LLC, dated as of September 24, 2008 (Filed as Exhibit 2.1).
2.2(2)	Agreement and Plan of Merger, by and among the Company, Neurogen Corporation and Neon Signal, LLC, dated as of August 23, 2009 (Filed as Exhibit 10.1).
2.3(3)	Amendment to Agreement and Plan of Merger, by and among the Company, Neurogen Corporation, and Neon Signal, LLC, dated September 18, 2009 (Filed as Exhibit 10.1).
2.4(3)	Amendment No. 2 to Agreement and Plan of Merger, by and among the Company, Neurogen Corporation, and Neon Signal, LLC, dated November 2, 2009 (Filed as Exhibit 10.2).
2.5(4)	Amendment No. 3 to Agreement and Plan of Merger, by and among the Company, Neurogen Corporation, and Neon Signal, LLC, dated December 17, 2009 (Filed as Exhibit 10.1).
2.6(5)	Certificate of Merger for acquisition of Neurogen Corporation (Filed as Exhibit 2.1).
2.7(6)	Agreement and Plan of Merger, dated as of October 26, 2009, by and among the Company, Metabasis Therapeutics, Inc., and Moonstone Acquisition, Inc (Filed as Exhibit 10.1).
2.8(7)	Amendment to Agreement and Plan of Merger, by and among the Company, Metabasis Therapeutics, Inc., Moonstone Acquisition, Inc., and David F. Hale as Stockholders Representative, dated November 25, 2009 (Filed as Exhibit 10.1).
2.9(8)	Certificate of Merger for acquisition of Metabasis Therapeutics, Inc. dated January 27, 2010 (Filed as Exhibit 2.1).
2.10(9)	Certificate of Merger, dated and filed January 24, 2011 (Filed as Exhibit 2.1).
2.11(9)	Agreement and Plan of Merger, by and among the Company, CyDex Pharmaceuticals, Inc., and Caymus Acquisition, Inc., dated January 14, 2011 (Filed as Exhibit 10.1).
3.1(10)	Amended and Restated Certificate of Incorporation of the Company (Filed as Exhibit 3.1).
3.2(10)	Bylaws of the Company, as amended (Filed as Exhibit 3.3).
3.3(11)	Amended Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of the Company (Filed as Exhibit 3.3).
3.4(12)	Certificate of Amendment of the Amended and Restated Certificate of Incorporation of the Company dated June 14, 2000 (Filed as Exhibit 3.5).
3.5(13)	Certificate of Amendment of the Amended and Restated Certificate of Incorporation of the Company dated September 30, 2004 (Filed as Exhibit 3.6).
3.6(14)	Amendment of the Bylaws of the Company dated November 8, 2005 (Filed as Exhibit 3.1).
3.7(15)	Amendment of Bylaws of the Company dated December 4, 2007 (Filed as Exhibit 3.1).
4.1(16)	Specimen stock certificate for shares of Common Stock of the Company.
4.4(17)	2006 Preferred Shares Rights Agreement, by and between the Company and Mellon Investor Services LLC, dated as of October 13, 2006 (Filed as Exhibit 4.1).
10.1(18)	Second Amendment to Loan and Security Agreement, by and between the Company and Square 1 Bank, dated March 29, 2012.
10.2 (19)	Research license and option agreement, by and between the Company and Ares Trading SA, dated as of April 27, 2012
10.3(19)	Separation Agreement, by and between the Company and Dr. Syed Kazmi, dated May 4, 2012
31.1	

Certification by Principal Executive Officer, Pursuant to Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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Exhibit Number	Description
31.2	Certification by Principal Financial Officer, Pursuant to Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification by Principal Executive Officer, Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification by Principal Financial Officer, Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.1**	The following financial information from the Company s Quarterly Report on Form 10-Q/A, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations, (iii) Condensed Consolidated Statements of Comprehensive Income, (iv) Condensed Consolidated Statements of Cash Flows, and (v) the Notes to Condensed Consolidated Financial Statements, tagged as blocks of text.

(1) This exhibit was previously filed as part of, and is hereby incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on September 26, 2008.
(2) This exhibit was previously filed as part of, and is hereby incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on August 24, 2009.
(3) This exhibit was previously filed as part of, and is hereby incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on November 6, 2009
(4) This exhibit was previously filed as part of, and is being incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on December 17, 2009.
(5) This exhibit was previously filed as part of, and is hereby incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on December 24, 2009.
(6) This exhibit was previously filed as part of, and is being incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on October 28, 2009.
(7) This exhibit was previously filed as part of, and is being incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on December 1, 2009.
(8) This exhibit was previously filed as part of, and is hereby incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on January 28, 2010.
(9) This exhibit was previously filed as part of, and is hereby incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on January 26, 2011.
(10) This exhibit was previously filed as part of, and is hereby incorporated by reference to the numbered exhibit filed with the Company s Registration Statement on Form S-4 (No. 333-58823) filed on July 9, 1998.
(11) This exhibit was previously filed as part of and is hereby incorporated by reference to same numbered exhibit filed with the Company s Quarterly Report on Form 10-Q for the period ended March 31, 1999.
(12) This exhibit was previously filed as part of, and are hereby incorporated by reference to the numbered exhibit filed with the Company's Annual Report on Form 10-K for the year ended December 31, 2000.
(13) This exhibit was previously filed as part of, and is hereby incorporated by reference to the numbered exhibit filed with the Company s Quarterly Report on Form 10-Q for the period ended June 30, 2004.
(14) This exhibit was previously filed as part of, and is being incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on November 14, 2005.
(15) This exhibit was previously filed as part of, and is hereby incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on December 6, 2007.
(16) This exhibit was previously filed as part of, and is hereby incorporated by reference to the same numbered exhibit filed with the Company s Registration Statement on Form S-1 (No. 33-47257) filed on April 16, 1992 as amended.

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(17) This exhibit was previously filed as part of, and is being incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on October 17, 2006.

(18) This exhibit was previously filed as part of, and is being incorporated by reference to the numbered exhibit filed with the Company s Current Report on Form 8-K filed on April 4, 2012.

(19) This exhibit was previously filed as part of, and is being incorporated by reference to the numbered exhibit filed with the Company s Quarterly Report on Form 10-Q filed on August 8, 2012.
Confidential treatment has been granted for portions of this exhibit.

* These certifications are being furnished solely to accompany this quarterly report pursuant to 18 U.S.C. Section 1350, and are not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and are not to be incorporated by reference into any filing of Ligand Pharmaceuticals, Incorporated, whether made before or after the date hereof, regardless of any general incorporation language in such filing. Signed originals of these certifications have been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

** Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under these sections.