

LA JOLLA PHARMACEUTICAL CO

Form 10-Q

November 14, 2011

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549**

**FORM 10-Q**

**(Mark One)**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended September 30, 2011**  
**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**  
**Commission file number: 0-24274**  
**LA JOLLA PHARMACEUTICAL COMPANY**  
**(Exact name of registrant as specified in its charter)**

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

**33-0361285**  
**(I.R.S. Employer  
Identification No.)**

**4370 La Jolla Village Drive, Suite 400**  
**San Diego, CA**  
**(Address of principal executive offices)**

**92122**  
**(Zip Code)**

Registrant's telephone number, including area code: (858) 452-6600

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

The number of shares of the registrant's common stock, \$0.0001 par value per share, outstanding at November 9, 2011 was 79,141,309.



**LA JOLLA PHARMACEUTICAL COMPANY**  
**FORM 10-Q**  
**QUARTERLY REPORT**  
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(in thousands, except share and par value amounts)

|  | September 30,<br>2011<br>(Unaudited) | December 31,<br>2010<br>(See Note) |
|--|--------------------------------------|------------------------------------|
| <b>ASSETS</b>  |                                      |                                    |
| Current assets:  |                                      |                                    |
| Cash and cash equivalents  | \$ 5,502                             | \$ 6,866                           |
| Prepays and other current assets   | 9                                    | 67                                 |
| Total current assets   | 5,511                                | 6,933                              |
| Total assets   | \$ 5,511                             | \$ 6,933                           |
| <b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS (DEFICIT) EQUITY</b>   |                                      |                                    |
| Current liabilities:   |                                      |                                    |
| Accounts payable   | \$ 23                                | \$ 39                              |
| Accrued expenses   | 151                                  | 178                                |
| Accrued payroll and related expenses   | 83                                   | 85                                 |
| Derivative liabilities   | 2,372                                | 6,102                              |
| Total current liabilities  | 2,629                                | 6,404                              |
| Series C-1 <sup>1</sup> redeemable convertible preferred stock, \$0.0001 par value; 11,000 shares authorized, 5,140 and 5,573 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively (redemption value and liquidation preference in the aggregate of \$5,140 at September 30, 2011 and \$5,652 at December 31, 2010) (see Notes 1 and 5) | 5,140                                | 47                                 |
| Commitments and contingencies  |                                      |                                    |
| Stockholders (deficit) equity:   |                                      |                                    |
| Common stock   | 6                                    |                                    |
| Additional paid-in capital   | 424,042                              | 428,563                            |
| Accumulated deficit  | (426,306)                            | (428,081)                          |
| Total stockholders (deficit) equity  | (2,258)                              | 482                                |
| Total liabilities, redeemable convertible preferred stock and stockholders (deficit) equity  | \$ 5,511                             | \$ 6,933                           |

Note: The condensed consolidated balance sheet at December 31, 2010 has been derived from the audited consolidated financial statements as of that date but does not include all of the information and disclosures required by U.S. generally accepted accounting principles (see Note 1).  
See accompanying notes.

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**LA JOLLA PHARMACEUTICAL COMPANY**  
**Condensed Consolidated Statements of Operations**

(Unaudited)

(in thousands, except per share amounts)

|  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |            |
|--|-------------------------------------|-----------|------------------------------------|------------|
|  | 2011                                | 2010      | 2011                               | 2010       |
| Expenses:  |                                     |           |                                    |            |
| Research and development   | \$                                  | \$        | \$                                 | \$         |
| General and administrative   | 423                                 | 698       | 1,628                              | 3,366      |
| <br>   |                                     |           |                                    |            |
| Total expenses   | 423                                 | 702       | 1,805                              | 3,379      |
| <br>   |                                     |           |                                    |            |
| Loss from operations   | (423)                               | (702)     | (1,805)                            | (3,379)    |
| <br>   |                                     |           |                                    |            |
| Other income (expense):  |                                     |           |                                    |            |
| Fair value of derivative liabilities upon issuance                                       |                                     |           |                                    | (5,015)    |
| Adjustments to fair value of derivative liabilities                                      | 3,993                               | 480       | 3,346                              | 3,465      |
| Financing transaction costs  |                                     |           |                                    | (163)      |
| Other income (expense), net  |                                     |           | 234                                | (1)        |
| <br>   |                                     |           |                                    |            |
| Net income (loss)  | 3,570                               | (222)     | 1,775                              | (5,093)    |
| <br>   |                                     |           |                                    |            |
| Preferred stock dividends forfeited (earned)   | (3)                                 | (247)     | 75                                 | (334)      |
| <br>   |                                     |           |                                    |            |
| Net income (loss) and comprehensive income<br>(loss) attributable to common stockholders | \$ 3,567                            | \$ (469)  | \$ 1,850                           | \$ (5,427) |
| <br>   |                                     |           |                                    |            |
| Net income (loss) per basic share (Note 2 and Note 9)                                    | \$ 0.07                             | \$ (0.49) | \$ 0.08                            | \$ (6.84)  |
| <br>   |                                     |           |                                    |            |
| Net income (loss) per diluted share (Note 2 and Note 9)                                  | \$ 0.00                             | \$ (0.49) | \$ 0.00                            | \$ (6.84)  |
| <br>   |                                     |           |                                    |            |
| Shares used in computing basic net income<br>(loss) per share (Note 2 and Note 9)        | 53,341                              | 947       | 22,418                             | 793        |
| <br>   |                                     |           |                                    |            |
| Shares used in computing diluted net income<br>(loss) per share (Note 2 and Note 9)      | 1,288,000                           | 947       | 4,869,581                          | 793        |

See accompanying notes.





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**LA JOLLA PHARMACEUTICAL COMPANY**  
**Condensed Consolidated Statements of Cash Flows**  
(Unaudited)  
(in thousands)

|   | Nine Months Ended<br>September 30, |              |
|---|------------------------------------|--------------|
|   | 2011                               | 2010         |
| Operating activities:   |                                    |              |
| Net income (loss)   | \$ 1,775                           | \$ (5,093)   |
| Adjustments to reconcile net income (loss) to net cash used for operating activities: |                                    |              |
| Share-based compensation expense  | 194                                | 402          |
| Issuance of Series C-1 <sup>1</sup> Preferred Stock for services                      |                                    | 12           |
| Fair value of derivative liabilities upon issuance                                    |                                    | 5,015        |
| Gain on adjustments to fair value of derivative liabilities                           | (3,346)                            | (3,465)      |
| Change in operating assets and liabilities:   |                                    |              |
| Prepays and other current assets  | 58                                 | 423          |
| Accounts payable and accrued expenses   | (43)                               | (202)        |
| Accrued payroll and related expenses  | (2)                                | (77)         |
| <br>Net cash used for operating activities  | <br>(1,364)                        | <br>(2,985)  |
| Financing activities:   |                                    |              |
| Proceeds from issuance of derivative obligations                                      |                                    | 6,003        |
| <br>Net cash provided by financing activities   |                                    | <br>6,003    |
| <br>Net (decrease) increase in cash and cash equivalents                              | <br>(1,364)                        | <br>3,018    |
| Cash and cash equivalents at beginning of period                                      | 6,866                              | 4,254        |
| <br>Cash and cash equivalents at end of period  | <br>\$ 5,502                       | <br>\$ 7,272 |
| Supplemental schedule of noncash investing and financing activities:                  |                                    |              |
| Decrease in par value of capital stock from change in par value                       | \$                                 | \$ 651       |
| Issuance of common stock at par value, offset by paid-in capital reduction            | \$                                 | \$ 3         |
| Conversion of preferred stock into common stock                                       | \$ 748                             | \$           |
| Reclassification of preferred stock currently redeemable                              | \$ 5,532                           | \$           |
| Preferred stock dividends forfeited (earned)  | \$ 75                              | \$ (334)     |

See accompanying notes.



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**LA JOLLA PHARMACEUTICAL COMPANY**  
**Notes to Condensed Consolidated Financial Statements**  
(Unaudited)  
**September 30, 2011**

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of La Jolla Pharmaceutical Company and its formerly wholly-owned subsidiary Jewel Merger Sub, Inc. (which was sold in June 2011, as described below in Note 4) (the Company) have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 8 of Regulation S-X.

Accordingly, they do not include all of the information and disclosures required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals and valuation adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for other quarters or the year ending December 31, 2011. For more complete financial information, these unaudited condensed consolidated financial statements, and the notes thereto, should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2010 included in the Company's Form 10-K filed with the Securities and Exchange Commission on April 14, 2011.

The Company has a history of recurring losses from operations and, as of September 30, 2011, the Company had no revenue sources, an accumulated deficit of \$426,306,000 and available cash and cash equivalents of \$5,502,000 of which up to \$5,140,000 could be required to be paid upon the exercise of redemption rights under the Company's outstanding preferred securities. Such redemption was not considered probable as of September 30, 2011. These factors raise substantial doubt about the Company's ability to continue as a going concern. The accompanying unaudited condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern. This basis of accounting contemplates the recovery of the Company's assets and the satisfaction of its liabilities in the normal course of business and this does not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

In March 2011, the Company and its formerly wholly-owned subsidiary, Jewel Merger Sub, Inc. acquired the rights to compounds known as Regenerative Immunophilin Ligands (RILs or Compounds) from privately held GliMed, Inc. (GliMed). The Compounds were acquired pursuant to an Asset Purchase Agreement (the Asset Agreement) for a nominal amount, and if certain development and regulatory milestones were met, the Company would have paid GliMed additional consideration consisting of up to 8,205 shares of newly designated Series E Convertible Preferred Stock (Series E Preferred), which would have been convertible into approximately 20% of the Company's fully diluted outstanding common stock on an as-converted basis. GliMed would have also been eligible for a potential cash payment from the Company if a Compound was approved by the Food and Drug Administration, or FDA, or European Medicines Agency, or EMA, in two or more clinical indications (see Note 4).

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Also in March 2011, the Company entered into a Consent and Amendment Agreement (the Consent Agreement), dated as of March 29, 2011, with certain holders of convertible redeemable Series C-1 preferred stock (Series C-1 Preferred), in order to amend certain terms of the Company's Securities Purchase Agreement, dated as of May 24, 2010 (Securities Purchase Agreement) (see Note 5). The purpose of the Consent Agreement was to revise certain terms of the Company's outstanding preferred securities in connection with the Company's acquisition of the Compounds. Additionally, as part of the Consent Agreement, the Company designated five new series of preferred stock: its Series C-1<sup>1</sup> Convertible Preferred Stock (Series C-1<sup>1</sup> Preferred), Series C-2<sup>1</sup> Convertible Preferred Stock (Series C-2<sup>1</sup> Preferred), Series D-1<sup>1</sup> Convertible Preferred Stock (Series D-1<sup>1</sup> Preferred), Series D-2<sup>1</sup> Convertible Preferred Stock (Series D-2<sup>1</sup> Preferred) and collectively with the Series C-1<sup>1</sup> Preferred, the Series C-2<sup>1</sup> Preferred and the Series D-1<sup>1</sup> Preferred, the New Preferred Stock) and Series E Preferred. The Company exchanged on a one-for-one basis each share of its existing Series C-1 Preferred that was outstanding for a new share of Series C-1<sup>1</sup> Preferred (see Note 5). Unless otherwise indicated, references herein to Series C-1<sup>1</sup> Preferred reflect the one-for-one exchange.

Following the acquisition of the Compounds, the Company initiated a confirmatory preclinical animal study in April 2011 studying the lead RIL compound, LJP1485. This study was completed in May 2011, after which the Company received final data from Charles River Laboratories, the Company's clinical research organization (the CRO), which showed that the predetermined study endpoints, as set forth in the Asset Agreement, were not met and that the LJP1485 compound did not show statistically significant improvement in the study endpoints as compared to vehicle (placebo).

Pursuant to the Consent Agreement, the Company's existing holders of Series C-1<sup>1</sup> Preferred (the Preferred Stockholders) were not required to exercise their cash warrants (the Cash Warrants) due to the failure of the LJP1485 study. The Preferred Stockholders elected to not exercise the Cash Warrants, which then provided GliMed with the right to reacquire the Compounds through the purchase of the outstanding capital stock of Jewel Merger Sub, Inc. (which held title to the Compounds) for the same nominal consideration that GliMed received at the closing of the Company's acquisition of the Compounds.

The cost for this preclinical study, including the Company's operating costs, of approximately \$712,000 was funded through cash on hand, which was made available for this expense due to the forfeiture of dividends on the Company's outstanding Series C-1<sup>1</sup> Preferred and Series C-2<sup>1</sup> Preferred (together the Series C Preferred) for the period from November 26, 2010 to May 31, 2011 (the Forfeited Dividend), the receipt of cash from certain current investors pursuant to the Consent Agreement, and a temporary reduction in the salaries of the Company's current officers. The stockholders no longer have any rights to receive stock for their Forfeited Dividend or any consideration for the cash payment made pursuant to the Consent Agreement.

On June 30, 2011, the Company entered into an Amendment Agreement with certain holders of Series C-1<sup>1</sup> Preferred (the Holders) in order to provide the Company with additional working capital to allow the Company to more fully evaluate additional product acquisition or in-licensing opportunities. The Holders agreed to waive the dividends on their shares of Series C-1<sup>1</sup> Preferred for the period from June 1, 2011 to August 31, 2011 and agreed to provide the Company with additional working capital by July 29, 2011, in an amount to be determined. In addition, the Company's two executive officers agreed to a temporary reduction in their salaries and work hours from July 1, 2011 to August 31, 2011. As of August 24, 2011, no additional working capital had been contributed to the Company.

On August 24, 2011, the Company entered into a Second Amendment Agreement with the Holders in order to provide the Company with additional working capital to allow the Company to continue to evaluate additional product acquisition or in-licensing opportunities that are currently being investigated. The Holders agreed to extend the waived dividends and the two executive officers agreed to extend the temporary reduction in their salaries and work hours through October 31, 2011. The Holders also agreed to provide the Company with additional working capital, in an amount to be determined, by September 2, 2011 and then again by September 26, 2011, if as of such dates, the Company was continuing to pursue a Strategic Transaction. In September 2011, in accordance with the Consent Agreement, certain of the Holders agreed to waive the preferred stock conversion limits and converted 25 shares of Series C<sup>1</sup> Preferred into common stock. The conversion reduced the redemption value of the Series C-1<sup>1</sup> Preferred by \$25,000 and therefore increased working capital by the same amount. The dividends waived from June 1, 2011

through October 31, 2011 are referred to as the Waived Dividend . As of September 30, 2011, the Preferred Stockholders have the right to require the Company to redeem all outstanding shares of Series C-1<sup>1</sup> Preferred for an aggregate sum of approximately \$5,140,000. If the Preferred Stockholders exercise this redemption right, the Company would have insufficient cash to sustain its operations and the Company would likely need to wind down all activities.

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**2. Accounting Policies**

**Principles of Consolidation**

The accompanying unaudited condensed consolidated financial statements include the accounts of La Jolla Pharmaceutical Company and its formerly wholly-owned subsidiary, Jewel Merger Sub, Inc. ( Jewel Merger Sub ), which was incorporated in Delaware in December 2009. In March 2011, the Company and Jewel Merger Sub acquired assets related to certain Compounds from GliaMed. In June 2011, GliaMed repurchased the Compounds by acquiring all of the outstanding capital stock of Jewel Merger Sub for the same nominal amount that it received from the Company for the Compounds.

**Use of Estimates**

The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the unaudited condensed consolidated financial statements and disclosures made in the accompanying notes to the unaudited condensed consolidated financial statements. These include the assumptions discussed below relating to the calculation of our derivative liabilities. Actual results could differ materially from those estimates.

**Recent Accounting Pronouncements**

In May 2011, the FASB issued authoritative guidance regarding common fair value measurements and disclosure requirements in U.S. GAAP and IFRS. This newly issued accounting standard clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurements that are estimated using significant unobservable inputs. This guidance is effective on a prospective basis for annual and interim reporting periods beginning after December 15, 2011. The Company does not expect that adoption of this standard will have a material impact on its financial position or results of operations.

In June 2011, the FASB issued authoritative guidance regarding comprehensive income. This newly issued accounting standard (1) eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity; (2) requires the consecutive presentation of the statement of net income and other comprehensive income; and (3) requires an entity to present reclassification adjustments on the face of the financial statements from other comprehensive income to net income. The amendments 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 nor do the amendments affect how earnings per share is calculated or presented. This guidance is required to be applied retrospectively and is effective for fiscal years and interim periods beginning after December 15, 2011. As this accounting standard only requires enhanced disclosure, the adoption of this standard will not impact the Company's financial position or results of operations.

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**Impairment of Long-Lived Assets**

If indicators of impairment exist, the Company assesses the recoverability of the affected long-lived assets by determining whether the carrying value of such assets can be recovered through the undiscounted future operating cash flows.

As a result of the negative results in the confirmatory preclinical study of LJP1485 in May 2011, the Company discontinued the development of LJP1485 in May 2011 and in June 2011 the Company sold the Compounds back to GliMed for the same nominal amount that it had paid for them. Based on these events, the future cash flows from the patents related to the Compounds were no longer expected to exceed their carrying values and the assets became impaired as of May 31, 2011. Accordingly, during the quarter ended June 30, 2011, the Company recorded a non-cash charge of \$243,000 to general and administrative expense for the impairment of long-lived assets to write down the value of the Company's patents to their estimated fair values.

**Reverse Stock Split**

The Board of Directors approved the reverse stock split (the Reverse Stock Split) of the Company's common stock, which became effective on April 14, 2011, with an exchange ratio of 1-for-100. As a result of the Reverse Stock Split, each 100 shares of the Company's issued and outstanding common stock were automatically reclassified as and changed into one share of the Company's common stock. No fractional shares were issued in connection with the Reverse Stock Split. Stockholders who were entitled to fractional shares instead became entitled to receive a cash payment in lieu of receiving fractional shares (after taking into account and aggregating all shares of the Company's common stock then held by such stockholder) equal to the fractional share interest. The Reverse Stock Split affected all of the holders of the Company's common stock uniformly. Shares of the Company's common stock underlying outstanding options and warrants were proportionately reduced and the exercise prices of outstanding options and warrants were proportionately increased in accordance with the terms of the agreements governing such securities. Shares of the Company's common stock underlying outstanding convertible preferred stock and warrants were proportionately reduced and the conversion rates were proportionately decreased in accordance with the terms of the agreements governing such securities. All common stock share and per share information in the unaudited condensed consolidated financial statements and notes thereto included in this report have been restated to reflect retrospective application of the Reverse Stock Split for all periods presented, except for par value per share and the number of authorized shares, which were not affected by the Reverse Stock Split. The Board of Directors continues to have the authority from the Company's stockholders to implement an additional reverse stock split at a ratio of up to 1-for-100.

**Net Income (Loss) Per Share**

Basic and diluted net income (loss) per share is computed using the weighted-average number of common shares outstanding during the periods. Basic earnings per share (EPS) is calculated by dividing the net income or loss by the weighted-average number of common shares outstanding for the period, without consideration for common stock equivalents. Diluted EPS is computed by dividing the net income or loss by the weighted-average number of common shares and common stock equivalents outstanding for the period issuable upon the conversion of preferred stock and exercise of stock options and warrants. These common stock equivalents are included in the calculation of diluted EPS only if their effect is dilutive (see Note 9). There is no difference between basic and diluted net loss per share for the three and nine months ended September 30, 2010 as potentially dilutive securities have been excluded from the calculation of diluted net loss per common share because the inclusion of such securities would be antidilutive.

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**Derivative Liabilities**

In May 2010, the Company entered into definitive agreements with institutional investors and affiliates for a private placement of common stock, redeemable convertible preferred stock and warrants to purchase convertible preferred stock for initial proceeds of \$6,003,000 (the May 2010 Financing). In conjunction with the May 2010 Financing, the Company issued redeemable convertible preferred stock that contained certain embedded derivative features, as well as warrants that are accounted for as derivative liabilities (see Notes 3 and 5). These derivative liabilities were determined to be ineligible for equity classification due to certain provisions of the underlying preferred stock, which is also ineligible for equity classification, whereby redemption is outside the sole control of the Company and due to provisions that may result in an adjustment to their exercise or conversion price.

The Company's derivative liabilities were initially recorded at their estimated fair value on the date of issuance and are subsequently adjusted to reflect the estimated fair value at each period end, with any decrease or increase in the estimated fair value being recorded as other income or expense, accordingly. The fair value of these liabilities is estimated using option pricing models that are based on the individual characteristics of the common stock and preferred stock, the derivative liability on the valuation date, probabilities related to the Company's operations and clinical development (based on industry data), as well as assumptions for volatility, remaining expected life, risk-free interest rate and, in some cases, credit spread. The option pricing models are particularly sensitive to changes in the aforementioned probabilities and the closing price per share of the Company's common stock.

**3. Fair Value of Financial Instruments**

Financial assets and liabilities are measured at fair value, which is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The following is a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

As of September 30, 2011 and 2010, cash and cash equivalents were comprised of cash in checking accounts.

In conjunction with the May 2010 Financing, the Company issued redeemable convertible preferred stock with certain embedded derivative features, as well as warrants to purchase various types of convertible preferred stock and units. These instruments are accounted for as derivative liabilities (see Note 5).

The Company used Level 3 inputs for its valuation methodology for the embedded derivative liabilities and warrant derivative liabilities. The estimated fair values were determined using a binomial option pricing model based on various assumptions (see Note 5). The Company's derivative liabilities are adjusted to reflect their estimated fair value at each period end, with any decrease or increase in the estimated fair value being recorded in other income or expense accordingly, as adjustments to fair value of derivative liabilities.



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At September 30, 2011, the estimated fair values of the liabilities measured on a recurring basis are as follows (in thousands):

|                                 | <b>Fair Value Measurements at September 30, 2011</b> |   |   |  |
|---------------------------------|--|---|---|--|
|                                 | Balance at<br>September<br>30,<br>2011               | Quoted Prices<br>in<br>Active<br>Markets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Embedded derivative liabilities | \$ 3,166   | \$  | \$  | \$ 3,166   |
| Warrant derivative liabilities  | (794)  |   |   | (794)  |
| <b>Total</b>                    | <b>\$ 2,372</b>                                      | <b>\$</b>   | <b>\$</b>   | <b>\$ 2,372</b>                                    |

The following table presents the activity for liabilities measured at estimated fair value using unobservable inputs for the nine months ended September 30, 2011 (in thousands):

|  | <b>Fair Value Measurements Using Significant<br/>Unobservable Inputs (Level 3)</b> |   |                 |
|--|--|---|-----------------|
|  | <b>Embedded<br/>Derivative<br/>Liabilities</b>                                     | <b>Warrant<br/>Derivative<br/>Liabilities</b> | <b>Total</b>    |
| Beginning balance at December 31, 2010   | \$ 5,170   | \$ 932  | \$ 6,102        |
| Adjustments to estimated fair value  | (1,620)  | (1,726)                                       | (3,346)         |
| Decrease of the embedded derivative liabilities for preferred shares converted into common stock | (315)  |   | (315)           |
| Forfeited accrued dividends payable in Series C-1 <sup>1</sup> Preferred                         | (72)   |   | (72)            |
| Accrued dividends payable in Series C-1 <sup>1</sup> Preferred                                   | 3  |   | 3               |
| <b>Ending balance at September 30, 2011</b>  | <b>\$ 3,166</b>  | <b>\$ (794)</b>                               | <b>\$ 2,372</b> |

During the three and nine months ended September 30, 2011, the net decrease in the estimated fair value of derivative liabilities of \$3,993,000 and \$3,346,000, respectively, was recorded as non-cash other income in the Statement of Operations.

**4. GliaMed Asset Purchase**

In March 2011, the Company and Jewel Merger Sub acquired assets related to certain RIL compounds from GliaMed. The Compounds were acquired pursuant to the Asset Agreement for a nominal amount, and if certain milestones noted below were met, the Company would have paid GliaMed additional consideration of up to 8,205 shares of newly designated convertible Series E Preferred, which would have been convertible into approximately 20% of the Company's fully diluted outstanding common stock on an as-converted basis. The issuance of the shares was tied to the achievement of certain development and regulatory milestones. GliaMed was also eligible to receive a cash payment from the Company of \$5,000,000 if a Compound was approved by the FDA or EMA in two or more clinical indications.

In late May, 2011, the Company received final data from the Company's CRO, which showed that the predetermined study endpoints, as set forth in the Asset Agreement, were not met and that the LJP1485 compound did not show statistically significant improvement in the study endpoints as compared to vehicle (placebo).



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The purchase was originally recorded as a long-term other asset for the intangible rights received related to the Compounds equal to the nominal amount paid to Gliamed plus the asset acquisition costs incurred for legal services and due diligence related to the investigation of the underlying technology. As a result of the negative results in the confirmatory preclinical study in May 2011, the Company discontinued the development of LJP1485 in May 2011 and in June 2011 the Company sold the Compounds back to Gliamed by selling all of the outstanding capital stock of Jewel Merger Sub to Gliamed for the same nominal amount that it had paid for the Compounds.

Jewel Merger Sub had no other assets or liabilities other than those relating to the Compounds and related assets and contract rights.

**5. Securities Purchase Agreement**

On May 24, 2010, the Company entered into a Securities Purchase Agreement by and among the Company and the purchasers named therein (the Purchasers). The Purchasers included institutional investors as well as the Company's Chief Executive Officer, Chief Financial Officer and an additional Company employee. The total investment by these Company employees represented less than 3% of the proceeds received by the Company in the May 2010 Financing. Pursuant to the Securities Purchase Agreement, on May 26, 2010 (the Closing Date or Closing), for total consideration of \$6,003,000, the Purchasers purchased (i) an aggregate of 289,704 shares of the Company's Common Stock, par value \$0.0001 per share, at a contractually stated price of \$3.00 per share, and (ii) 5,134 shares of the Company's Series C-1<sup>1</sup> Preferred, par value \$0.0001 per share, at a contractually stated price of \$1,000 per share. The Purchasers also received (i) Series D-1<sup>1</sup> Warrants to purchase 5,134 shares of the Company's Series D-1<sup>1</sup> Preferred, par value \$0.0001 per share, at an exercise price of \$1,000 per share, which warrants may be exercised on a cashless basis, and (ii) Series C-2<sup>1</sup> Warrants to purchase 10,268 units, at an exercise price of \$1,000 per unit, which warrants are exercisable only in cash, with each unit consisting of one share of the Company's Series C-2<sup>1</sup> Preferred, par value \$0.0001 per share, and an additional Series D-2<sup>1</sup> Warrant to purchase one share of the Company's Series D-2<sup>1</sup> Preferred, par value \$0.0001 per share, at an exercise price of \$1,000 per share.

In March 2011, the Company entered into the Consent Agreement which amended the terms of the Securities Purchase Agreement. Under the Consent Agreement, the holders agreed to the following, among other changes: (i) a temporary suspension of dividends on Series C-1<sup>1</sup> Preferred and Series C-2<sup>1</sup> Preferred (ii) to provide an additional cash payment of approximately \$236,000 in exchange for the right to receive Series C-2<sup>1</sup> Preferred upon the achievement of certain pre-specified results in the preclinical study of one of the Compounds (the Preclinical Milestone), (iii) to increase the warrants that must be exercised for cash from 10,268 to 10,646 units, (iv) the mandatory exercise of \$7,452,000 of such warrants upon the achievement of the Preclinical Milestone, (v) the mandatory exercise of the remaining \$3,194,000 of warrants upon the achievement of a future clinical milestone and (vi) an automatic one time downward conversion price adjustment following the Reverse Stock Split.

In June 2011, the Company entered into the Amendment Agreement which amended the terms of the Securities Purchase Agreement and the Consent Agreement. Under the Amendment Agreement, the Holders agreed to the following, among other changes: (i) a temporary waiver of dividends on Series C<sup>1</sup> Preferred (ii) to provide additional working capital by July 29, 2011, in an amount to be determined, if the Requisite Holders (as defined in the Amendment Agreement) determined by July 22, 2011 that, as of such date, the Company was continuing to pursue a Strategic Transaction (as defined in the Amendment Agreement) (iii) to purchase up to all of the outstanding Series C<sup>1</sup> Preferred and certain warrants held by current and former Company employees, including the executive officers, who will have the right to require the Holder to purchase these securities for a limited period of time following the employee's termination of service with the Company.

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In August 2011, the Company entered into a Second Amendment Agreement which extended the terms of the Amendment Agreement through October 31, 2011. Under the Second Amendment Agreement, the Holders agreed to the following, among other changes: (i) to continue a temporary waiver of dividends on Series C<sup>1</sup> Preferred (ii) to provide additional working capital, in an amount to be determined, if the Requisite Holders (as defined in the Second Amendment Agreement) determine by September 2, 2011, and then again by September 26, 2011, that, as of such date, the Company was continuing to pursue a Strategic Transaction (as defined in the Second Amendment Agreement) (iii) to purchase up to all of the outstanding Series C<sup>1</sup> Preferred and certain warrants held by current and former Company employees, including the executive officers, who will have the right to require the Holder to purchase these securities for a limited period of time following the employee's termination of service with the Company. As of November 9, 2011, the Company is continuing its efforts to pursue a Strategic Transaction and is in the process of negotiating a third amendment to extend the terms of the Amendment Agreement.

**Allocation of Proceeds**

At the Closing Date, the estimated fair value of the Series C-2<sup>1</sup> Warrants for units, Series D-1<sup>1</sup> Warrants, and the embedded derivatives included within the Series C-1<sup>1</sup> Preferred exceeded the proceeds from the May 2010 Financing of \$6,003,000 (see the valuations of these derivative liabilities under the heading, "Derivative Liabilities" below). As a result, all of the proceeds were allocated to these derivative liabilities and no proceeds remained for allocation to the Common Stock and Series C-1<sup>1</sup> Preferred issued in the financing.

**Common Stock**

Pursuant to Rule 144 under the Securities Act of 1933 the Purchasers were restricted from selling the Common Stock until November 2010, which was six months after the Closing Date.

**Redeemable Preferred Stock**

As of September 30, 2011, the Company's Board of Directors is authorized to issue 8,000,000 shares of preferred stock, with a par value of \$0.0001 per share, in one or more series, of which 11,000 are designated for Series C-1<sup>1</sup> Preferred, 22,000 are designated Series C-2<sup>1</sup> Preferred, 5,134 are designated Series D-1<sup>1</sup> Preferred, 10,868 are designated Series D-2<sup>1</sup> Preferred, and 12,000 are designated Series E Preferred. As of September 30, 2011, 5,140 shares of Series C-1<sup>1</sup> Preferred Stock are issued and outstanding. There were no shares of any other series of preferred stock issued and outstanding as of September 30, 2011.

*Voting Rights*

The holders of New Preferred Stock do not have voting rights other than for general protective rights required by the Delaware General Corporation Law or as set forth below.

*Dividends*

Cumulative dividends are payable on the Series C<sup>1</sup> Preferred at an annual rate of 15% from the date of issuance through the date of conversion or redemption, payable semi-annually each November 25<sup>th</sup> and May 25<sup>th</sup> in shares of Series C<sup>1</sup> Preferred. There is no limit to the number of shares of Series C<sup>1</sup> Preferred that may be issued as dividends. Neither the Series D-1<sup>1</sup> Preferred nor the Series D-2<sup>1</sup> Preferred (if and when issued) is entitled to dividends.

As discussed in Note 1, the Company funded its confirmatory preclinical study of the RIL compounds in part through the Forfeited Dividend and is funding its current operations in part through the Waived Dividend. From June 1 through August 31, 2011, there was an accrual of five shares Series C<sup>1</sup> Preferred payable to current and former Company employees who are holders of Series C<sup>1</sup> Preferred. These holders waived their dividends as part of the Second Amendment Agreement effective after August 31, 2011.

**Table of Contents***Conversion Rights*

The New Preferred Stock was convertible into common stock, initially at a rate of 667 shares of common stock for each share of New Preferred Stock, subject to certain limitations discussed below, at the election of the holders of New Preferred Stock. The conversion rate will be adjusted for certain events, such as stock splits, stock dividends, reclassifications and recapitalizations, and the New Preferred Stock is subject to full-ratchet anti-dilution protection such that if the Company issues or grants any warrants, rights, options to subscribe or purchase common stock or common stock equivalents (the Options ) and the price per share for which the common stock issuable upon the exercise of such Options is below the effective conversion price of the New Preferred Stock at the time of such issuance, then the conversion rate of the New Preferred Stock automatically adjusts to increase the number of common shares into which it can convert. There are also limits on the amount of New Preferred Stock that can be converted and the timing of such conversions. In accordance with the Consent Agreement, after the Reverse Stock Split, the conversion ratio for the New Preferred Stock was adjusted based on the trading price of the Company's common stock over a period of time after the Reverse Stock Split was implemented. Accordingly, effective May 7, 2011, each share of New Preferred Stock is now convertible into approximately 166,667 shares of common stock. Effective with the Consent Agreement, in any week, each holder of New Preferred Stock may convert its amount of the outstanding New Preferred Stock held by the stockholder multiplied by the Conversion Cap (as defined in the Certificate of Designations for the Series C-1<sup>1</sup>, C-2<sup>1</sup>, D-1<sup>1</sup> and D-2<sup>1</sup> Preferred (the Series C<sup>1</sup>/D<sup>1</sup> Certificate ) for such week. Depending on the Closing Sales Prices (as defined in the Series C<sup>1</sup>/D<sup>1</sup> Certificate), the Conversion Cap can range from 0% to 7.2%. Moreover, holders of New Preferred Stock may not convert if such conversion would result in the holder or any of its affiliates beneficially owning more than 9.999% of the Company's then issued and outstanding shares of common stock. As of September 30, 2011, 433 shares of Series C-1<sup>1</sup> Preferred had been converted into common stock.

Upon certain redemption events, as set forth in the Securities Purchase Agreement, and as subsequently amended in the Consent Agreement, the conversion price of the New Preferred Stock decreases to 10% of the conversion price in effect immediately before such redemption event thereby increasing the number of common shares that would be issued for each share of New Preferred Stock by a factor of ten times.

*Liquidation Preference*

Upon a Liquidation Event (as defined in the Series C<sup>1</sup>/D<sup>1</sup> Certificate), no other class or series of capital stock can receive any payment unless the Preferred Stock has first received a payment in an amount equal to \$1,000 per share, plus all accrued and unpaid dividends, if applicable.

*Redemption Rights*

In the event that certain actions occur without the waiver or prior written consent of the holders of two-thirds of the then outstanding shares of New Preferred Stock (the Requisite Holders ), such as the Company's material breach of any material representation or warranty under the Securities Purchase Agreement, a suspension of the trading of the Company's common stock, the failure to timely deliver shares on conversion of the New Preferred Stock, bankruptcy reorganization or the consummation of a Change of Control (as defined in the Series C<sup>1</sup>/D<sup>1</sup> Certificate) among others, then the holders of the Series C<sup>1</sup> Preferred shall have the right, upon the delivery of a notice to the Company by the Requisite Holders, to have such shares redeemed by the Company for an amount equal to the greater of \$1,000 per share, plus accrued and unpaid dividends, or the fair market value of the underlying common stock issuable upon conversion of the Series C<sup>1</sup> Preferred, which could include a greater number of shares pursuant to the conversion reset described above under the caption Conversion Rights . As of September 30, 2011 and through the date of this filing, none of these redemption actions have occurred to the Company's knowledge.

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Since the Company failed to consummate a Strategic Transaction (as defined in the Series C<sup>1</sup>/D<sup>1</sup> Certificate) by February 26, 2011 (nine months from the May 26, 2010 Closing), the Series C<sup>1</sup> Preferred may be redeemed upon the demand of the Requisite Holders. The redemption price would be equal to \$1,000 per share, plus accrued and unpaid dividends. As of September 30, 2011, the redemption value was \$5,140,000. This redemption feature terminates upon the consummation of a Strategic Transaction, which must be first approved by the Requisite Holders. The Requisite Holders may also waive this redemption feature. If the Requisite Holders fail to demand redemption of the Series C<sup>1</sup> Preferred within two years from the date of a Redemption Event (as defined in the Series C<sup>1</sup>/D<sup>1</sup> Certificate), then the redemption rights with respect to such Redemption Event shall be irrevocably waived by the preferred stockholders. The Requisite Holders have not elected to redeem through the date of the filing of this Report, nor have they waived this right.

*Restrictions*

So long as at least 1,000 shares of New Preferred Stock remain outstanding (or at least 3,000 shares of New Preferred Stock remain outstanding if the Series C-2<sup>1</sup> Warrants have been exercised), the Company may not take a variety of actions (such as altering the rights, powers, preferences or privileges of the New Preferred Stock so as to affect the New Preferred Stock adversely, amending any provision of the Company's certificate of incorporation, entering into an agreement for a Strategic Transaction or Change of Control, consummating any financing or filing a registration statement with the Securities and Exchange Commission, or SEC ) without the prior approval of the Requisite Holders. From May 2010 through April 2011, the Company had also agreed to certain limitations on its spending per month based on predetermined budgeted amounts.

*Accounting Treatment*

At the Closing Date, the Company issued 5,134 shares of Series C-1<sup>1</sup> Preferred and recorded the par value of \$0.0001 per share with a corresponding reduction to paid-in capital, given that there was no allocated value from the proceeds to the Series C-1<sup>1</sup> Preferred.

In a separate transaction, in exchange for a first right of negotiation for a product candidate, the Company issued approximately 50 shares of Series C-1<sup>1</sup> Preferred convertible into approximately 8,333,000 shares of the Company's common stock to a Purchaser on May 26, 2010. Using the present value of the face amount of the Series C-1<sup>1</sup> Preferred at Closing, these shares were valued at \$12,000 and were fully charged to general and administrative expense during the three months ended June 30, 2010.

Under accounting guidance covering accounting for redeemable equity instruments, preferred securities that are redeemable for cash or other assets are to be classified outside of permanent equity (within the mezzanine section between liabilities and equity on the condensed consolidated balance sheets) if they are redeemable at the option of the holder or upon the occurrence of an event that is not solely within the control of the issuer. As there are redemption-triggering events related to the Series C<sup>1</sup> Preferred that are not solely within the control of the Company, the Series C-1<sup>1</sup> Preferred was classified outside of permanent equity.

As of September 30, 2011, the outstanding Series C-1<sup>1</sup> Preferred is convertible into approximately 856,676,000 shares of common stock. The Company may be required to redeem the Series C-1<sup>1</sup> Preferred if a redemption event occurs, such as the failure to consummate a Strategic Transaction. Since the Company did not consummate a Strategic Transaction by February 26, 2011, the Series C-1<sup>1</sup> Preferred is currently redeemable and therefore the Company has adjusted the carrying value of the Series C-1<sup>1</sup> Preferred to the redemption value of such shares which, as of September 30, 2011, was \$5,140,000.

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As of December 31, 2010, accrued dividends on the Series C-1<sup>1</sup> Preferred were \$6,000, which consisted of 79 shares of Series C-1<sup>1</sup> Preferred, or approximately 0.014 dividend shares per Series C-1<sup>1</sup> Preferred share outstanding, convertible into approximately 13,167,000 shares of common stock. Due to the forfeiture of dividends on the Company's outstanding Series C Preferred for the period from November 26, 2010 to May 31, 2011 as discussed in Note 1, the accrued dividends of \$6,000 as of December 31, 2010 were reversed.

As of September 30, 2011 accrued dividends on the Series C-1<sup>1</sup> Preferred were \$501, which consisted of 5 shares of Series C-1<sup>1</sup> Preferred, payable to the current and former Company employees for the period June 1, 2011 to August 31, 2011. The accrued dividends are convertible into approximately 902,000 shares of common stock. Due to the waiver of dividends as discussed in Note 1, the dividends for current and former Company employees were waived from August 31, 2011 to October 31, 2011 and the dividends for the key investors were waived from June 1, 2011 to October 31, 2011.

**Derivative Liabilities**

The Series C-1<sup>1</sup> Preferred and the underlying securities of the Series C-2<sup>1</sup> Warrants for units and Series D-1<sup>1</sup> Warrants (Series C<sup>1</sup> Preferred and Series D<sup>1</sup> Preferred) contain conversion features. In addition, the Series C-1<sup>1</sup> Preferred and the underlying securities of the Series C-2<sup>1</sup> Warrants for units (Series C<sup>1</sup> Preferred) are subject to redemption provisions that are outside of the control of the Company.

The Series C-2<sup>1</sup> Warrants and Series D-1<sup>1</sup> Warrants are exercisable starting on the issuance date and expire in three years from the date of issuance. The Series C-2<sup>1</sup> Warrants must be exercised in cash and beginning in June 2011, they are no longer subject to mandatory exercise terms. The Series D-1<sup>1</sup> Warrants may be exercised on a cashless basis and are not subject to mandatory exercise terms.

*Accounting Treatment*

The Company accounted for the conversion and redemption features embedded in the Series C-1<sup>1</sup> Preferred (the Embedded Derivatives) in accordance with accounting guidance covering derivatives. Under this accounting guidance, companies may be required to bifurcate conversion and redemption features embedded in redeemable convertible preferred stock from their host instruments and account for these embedded derivatives as free standing derivative financial instruments. If the underlying security of the embedded derivative requires net cash settlement in the event of circumstances that are not solely within the Company's control, the embedded derivative should be classified as a liability, measured at fair value at issuance and adjusted to their current fair value at each period. As there are redemption triggering events for net cash settlement for Series C<sup>1</sup> Preferred that are not solely within the Company's control, and the conversion feature is a derivative, the Embedded Derivatives are classified as liabilities and are accounted for using fair value accounting at each reporting date (also see Note 3).

The Company accounted for the Series C-2<sup>1</sup> Warrants for units and Series D-1<sup>1</sup> Warrants in accordance with accounting guidance covering derivatives. If the underlying security of the warrant, a.) requires net cash settlement in the event of circumstances that are not solely within the Company's control or if not, if they are b.) not indexed to the Company's own stock, the warrants should be classified as liabilities, measured at fair value at issuance and adjusted to their current fair value at each period. As there are redemption triggering events for Series C<sup>1</sup> Preferred that are not solely within the Company's control, and the Series D Preferred are not indexed to the Company's own stock, the Series C-2<sup>1</sup> Warrants for units and Series D-1<sup>1</sup> Warrants are classified as liabilities and are accounted for using fair value accounting at each reporting date. The Embedded Derivatives, Series C-2<sup>1</sup> Warrants for units and Series D-1<sup>1</sup> Warrants are collectively referred to as the Derivative Liabilities.

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The estimated fair values of the Derivative Liabilities as of December 31, 2010 and September 30, 2011 are summarized as follows (in thousands):

|  | <b>Fair Value Measurements at</b> |                  |
|--|-----------------------------------|------------------|
|  | <b>December</b>                   | <b>September</b> |
|  | <b>31,</b>                        | <b>30,</b>       |
|  | <b>2010</b>                       | <b>2011</b>      |
| Embedded Derivatives of Series C-1 <sup>1</sup> Preferred (including dividends paid in Series C-1 <sup>1</sup> Preferred in November 2010) | \$ 5,098                          | \$ 3,163         |
| Embedded Derivatives of accrued dividends payable in Series C-1 <sup>1</sup> Preferred   | 72                                | 3                |
| Series D-1 <sup>1</sup> Warrants   | 702                               | 167              |
| Series C-2 <sup>1</sup> Warrants for:  |                                   |                  |
| Series C-2 <sup>1</sup> Preferred  | (1,175)                           | (1,307)          |
| Series D-2 <sup>1</sup> Warrants   | 1,405                             | 346              |
|  | <b>\$ 6,102</b>                   | <b>\$ 2,372</b>  |

The Derivative Liabilities were valued using binomial option pricing models with various assumptions detailed below. Due to the six month trading restriction on the unregistered shares of common stock issued or issuable from the conversion of Preferred Stock and the weekly conversion limitation on Preferred Stock as well as the uncertainty of the Company's ability to continue as a going concern, the price per share of the Company's common stock used in the binomial option pricing models for the Derivative Liabilities was discounted from the closing market prices of \$2.60 and \$0.003 on December 31, 2010 and September 30, 2011, respectively. The expected lives that were used to value each of the Derivative Liabilities were based on the individual characteristics of the underlying Preferred Stock, which impact the expected timing of conversion into common stock. In addition, the probabilities associated with the consummation of a Strategic Transaction and the clinical development of a drug candidate based on industry data were used in each of the binomial option pricing models. The models used to value the Series C-2<sup>1</sup> Warrants and Series D-1<sup>1</sup> Warrants are particularly sensitive to such probabilities, as well as to the closing price per share of the Company's common stock. In addition, as noted above, the model included the effect of the automatic one-time downward conversion price adjustment following the Reverse Stock Split. To better estimate the fair value of the Derivative Liabilities at each reporting period, the binomial option pricing models and their inputs were refined based on information available to the Company. Such changes did not have a significant impact on amounts recorded in previous interim reporting periods.

At December 31, 2010, the total value of the Embedded Derivatives, including the estimated fair value of Embedded Derivatives related to the accrued dividends payable in Series C-1<sup>1</sup> Preferred of \$72,000 was \$5,170,000. At September 30, 2011, the total value of the Embedded Derivatives was \$3,166,000, resulting in non-cash other income on the decrease in the estimated fair value of the Embedded Derivatives for the nine months ended September 30, 2011 of \$1,620,000 (exclusive of the decrease in the liability of \$315,000 due to the conversion of 433 shares of Series C-1<sup>1</sup> Preferred into common stock and the reversal of \$72,000 for the December 31, 2010 accrued dividends that were forfeited and the accrued dividends of \$3,000 as of September 30, 2011 for current and former Company employee holders of Series C-1<sup>1</sup> Preferred). Such decrease in value was primarily due to the significant decrease in the Company's common stock price, and the updates to the assumptions used in the option pricing models.



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The Embedded Derivatives were valued at December 31, 2010 and at September 30, 2011 using a binomial option pricing model, based on the value of the Series C-1<sup>1</sup> Preferred shares with and without embedded derivative features, with the following assumptions:

|   | December<br>31,<br>2010 | September<br>30,<br>2011 |
|---|-------------------------|--------------------------|
| Closing price per share of common stock                   | \$ 2.60                 | \$ 0.003                 |
| Conversion price per share                                | \$ 1.50                 | \$ 0.006                 |
| Volatility  | 84.6%                   | 80.7%                    |
| Risk-free interest rate                                   | 2.19%                   | 0.96%                    |
| Credit spread   | 14.2%                   | 20.1%                    |
| Remaining expected lives of underlying securities (years) | 6.3                     | 5.0                      |

On December 31, 2010, the Series D-1<sup>1</sup> Warrants were recorded at estimated fair value of \$702,000. On September 30, 2011, the Series D-1<sup>1</sup> Warrants were revalued at \$167,000 resulting in non-cash other income on the decrease in the estimated fair value of the Series D-1<sup>1</sup> Warrants for the nine months ended September 30, 2011 of \$535,000. Such decrease in value was primarily due to the significant decrease in the Company's common stock price and the updates to the assumptions used in the option pricing models.

The Series D-1<sup>1</sup> Warrants were valued at December 31, 2010 and at September 30, 2011 using a binomial option pricing model with the following assumptions:

|   | December<br>31,<br>2010 | September<br>30,<br>2011 |
|---|-------------------------|--------------------------|
| Closing price per share of common stock                   | \$ 2.60                 | \$ 0.003                 |
| Conversion price per share                                | \$ 1.50                 | \$ 0.006                 |
| Volatility  | 98.9%                   | 83.6%                    |
| Risk-free interest rate                                   | 1.02%                   | 0.38%                    |
| Remaining expected lives of underlying securities (years) | 2.8                     | 2.8                      |

On December 31, 2010, the Series C-2<sup>1</sup> Warrants (which consist of rights to purchase Series C-2<sup>1</sup> Preferred and Series D-2<sup>1</sup> Warrants) were recorded at an estimated fair value of \$230,000. On September 30, 2011, the Series C-2<sup>1</sup> Warrants were revalued at a negative \$961,000, resulting in non-cash other income on the decrease in the estimated fair value of the Series C-2<sup>1</sup> Warrants for the nine months ended September 30, 2011 of \$1,191,000. Such decrease in value was primarily due to the significant decrease in the Company's common stock price and the updates to the assumptions used in the option pricing models, offset by the increase in the Series C-2<sup>1</sup> Warrants by 378 units. The fair value of the rights to purchase Series C-2<sup>1</sup> Preferred was negative as of December 31, 2010 as the Series C-2<sup>1</sup> Warrants were mandatorily exercisable at a price that was greater than the fair value of the underlying instruments. The fair value of the rights to purchase Series C-2<sup>1</sup> Preferred was negative as of September 30, 2011 as it is assumed that upon a Strategic Transaction, Series C-2<sup>1</sup> Warrants will be exercised at a price that is greater than the fair value of the underlying instruments.

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The portion of the Series C-2<sup>1</sup> Warrants that represent the rights to purchase Series C-2<sup>1</sup> Preferred were valued at December 31, 2010 and September 30, 2011 using a binomial option pricing model, discounted for the lack of dividends until the Series C-2<sup>1</sup> Warrants are exercised, with the following assumptions:

|   | December<br>31,<br>2010 | September<br>30,<br>2011 |
|---|-------------------------|--------------------------|
| Closing price per share of common stock                   | \$ 2.60                 | \$ 0.003                 |
| Conversion price per share                                | \$ 1.50                 | \$ 0.006                 |
| Volatility  | 84.6%                   | 80.7%                    |
| Risk-free interest rate                                   | 2.19%                   | 0.96%                    |
| Credit spread   | 14.2%                   | 20.1%                    |
| Remaining expected lives of underlying securities (years) | 6.3                     | 5.0                      |

The Series D-2<sup>1</sup> Warrants were valued at December 31, 2010 and at September 30, 2011 using a binomial option pricing model with the same assumptions used in the valuation of the Series D-1<sup>1</sup> Warrants. The decrease in the value of the Series D-2<sup>1</sup> Warrants was primarily due to the significant decrease in the Company's common stock price and the updates to the assumptions used in the option pricing models, offset by the increase in the Series D-2<sup>1</sup> Warrants by 378 units.

**6. Stockholders' Equity****Share-Based Compensation**

In June 1994, the Company adopted the La Jolla Pharmaceutical Company 1994 Stock Incentive Plan (the "1994 Plan"), under which, as amended, 16,400 shares of common stock were authorized for issuance. The 1994 Plan expired in June 2004 and there were 2,438 options outstanding under the 1994 Plan as of September 30, 2011.

In May 2004, the Company adopted the La Jolla Pharmaceutical Company 2004 Equity Incentive Plan (the "2004 Plan"), under which, as amended, 64,000 shares of common stock have been authorized for issuance. The 2004 Plan provides for the grant of incentive and non-qualified stock options, as well as other share-based payment awards, to employees, directors, consultants and advisors of the Company with up to a 10-year contractual life and various vesting periods as determined by the Company's Compensation Committee or the Board of Directors, as well as automatic fixed grants to non-employee directors of the Company. As of September 30, 2011, there were a total of 26,144 options outstanding under the 2004 Plan and 35,117 shares remained available for future grant.

In May 2010, the Company granted options to purchase a total of 58,000 shares of common stock to two employees. These grants were made outside of the Company's existing stockholder-approved equity compensation plans but were otherwise legally binding awards and did not require stockholder approval. These stock options are treated in all respects as if granted under the Company's 2010 Equity Incentive Plan (the "2010 Plan").

In August 2010, the Company adopted the 2010 Plan under which 1,700,000 shares of common stock have been authorized for issuance. The 2010 Plan is similar to the 2004 Plan, other than with regard to the number of shares authorized for issuance thereunder. The 2010 Plan provides for automatic increases to the number of authorized shares available for grant under the 2010 Plan and as such, in May and September 2011, the number of authorized shares were increased by 3,300 and 1,600,700 shares of common stock, respectively. As of September 30, 2011, there were a total of 3,000 options outstanding and 1,697,000 shares remained available for future grant under the 2010 Plan.

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In August 1995, the Company adopted the La Jolla Pharmaceutical Company 1995 Employee Stock Purchase Plan (the ESPP), under which, as amended, 48,499 shares of common stock are reserved for sale to eligible employees, as defined in the ESPP. Employees may purchase common stock under the ESPP every three months (up to but not exceeding 10% of each employee's base salary or hourly compensation, and any cash bonus paid, subject to certain limitations) over the offering period at 85% of the fair market value of the common stock at specified dates. The offering period may not exceed 24 months. As of September 30, 2011, 7,155 shares of common stock have been issued under the ESPP and 41,344 shares of common stock are available for future issuance.

Share-based compensation expense for the three-month periods ended September 30, 2011 and 2010 was \$63,000 and \$97,000, respectively and \$194,000 and \$402,000 for the nine months ended September 30, 2011 and 2010, respectively. As of September 30, 2011, there was \$218,000 of total unrecognized compensation cost related to non-vested share-based payment awards granted under all equity compensation plans. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures. The Company expects to recognize this compensation cost over a weighted-average period of approximately 11 months.

The following table summarizes share-based compensation expense related to employee and director stock options and ESPP purchases by expense category (in thousands):

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2011</b>                                 | <b>2010</b> | <b>2011</b>                                | <b>2010</b> |
| Research and development  | \$  | \$          | \$   | \$          |
| General and administrative                                      |   | 63          | 97   | 194         |
|   |   |             |  | 402         |
| Share-based compensation expense included in operating expenses | \$  | 63          | \$   | 97          |
|   |   |             | \$   | 194         |
|   |   |             | \$   | 402         |

The Company determines the fair value of share-based payment awards on the date of grant using the Black-Scholes option-pricing model, which is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Although the fair value of employee and director stock options granted by the Company is determined using an option-pricing model, that value may not be indicative of the fair value observed in a willing-buyer/willing-seller market transaction.

The Company estimated the fair value of each option grant and ESPP purchase right on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

|                         | <b>Three and Nine Months<br/>Ended<br/>September 30,</b> |             |
|-------------------------|--|-------------|
|                         | <b>2011</b>  | <b>2010</b> |
| <b>Options:</b>         |  |             |
| Risk-free interest rate |  | 2.6%        |
| Dividend yield          |  | 0.0%        |
| Volatility              |  | 106.5%      |
| Expected life (years)   |  | 5.8         |

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|                         | <b>Three and Nine Months<br/>Ended</b> |             |
|-------------------------|--|-------------|
|                         | <b>September 30,<br/>2011</b>          | <b>2010</b> |
| <b>ESPP:</b>            |  |             |
| Risk-free interest rate |  | 0.2%        |
| Dividend yield          |  | 0.0%        |
| Volatility              |  | 90.5%       |
| Expected life (months)  |  | 3           |

There were no option grants during the three and nine months ended September 30, 2011 or during the three months ended September 30, 2010. The weighted-average fair value of options granted for the nine months ended September 30, 2010 was \$4.48. For the ESPP, there were no purchases under the ESPP for the three and nine months ended September 30, 2011 or for the three months ended September 30, 2010. The weighted-average fair value for purchases under the ESPP for the nine months ended September 30, 2010 was \$2.21.

A summary of the Company's stock option activity and related data for the nine months ended September 30, 2011 follows:

|                               | <b>Outstanding Options</b>  |   |
|-------------------------------|-----------------------------|---|
|                               | <b>Number<br/>of Shares</b> | <b>Weighted-<br/>Average<br/>Exercise Price</b> |
| Balance at December 31, 2010  | 98,015                      | \$ 203.70                                       |
| Granted                       |                             | \$  |
| Forfeited / Expired           | (8,433)                     | \$ 443.38                                       |
| Balance at September 30, 2011 | 89,582                      | \$ 181.14                                       |

**Restricted Stock Units**

Under the 2004 Plan, the Company granted 20,209 restricted stock units ( RSUs ) to the Company's three employees on December 31, 2009, where each RSU represents a contingent right to receive one share of the Company's common stock. The RSUs were to vest upon the closing of a proposed merger with a third party (the Merger ), subject to the continued employment of the recipient through the closing date of the Merger. As a result of the termination of the Merger in March 2010, the RSUs were cancelled.

Stock-based compensation cost of RSUs is measured by the market value of the Company's common stock on the date of grant. The grant date intrinsic value of awards granted is amortized on a straight-line basis over the requisite service periods of the awards, which are the vesting periods. The weighted average grant date intrinsic value was \$17.00 per RSU. Due to their cancellation, no stock-based compensation expense related to the RSUs was recognized during the three and nine months ended September 30, 2010.

A summary of the Company's RSU activity and related data follows:

|  | <b>Number of<br/>Shares</b> | <b>Weighted-<br/>Average<br/>Grant Date<br/>Fair Value<br/>per Share</b> |
|--|-----------------------------|--|
| Restricted stock units outstanding at December 31, 2009  | 20,209                      | \$ 17.00   |
| Cancelled  | (20,209)                    | \$ 17.00   |
| Restricted stock units outstanding at September 30, 2010 |                             | \$   |



**Table of Contents****7. Retention Payments**

On December 4, 2009, the Company entered into Retention and Separation Agreements and General Release of All Claims (the Retention Agreements ) with its Chief Executive Officer and Vice President of Finance who has since been appointed as the Company's Chief Financial Officer (the Officers ). The Retention Agreements superseded the severance provisions of the employment agreements with the Officers that were effective prior to the signing of the Retention Agreements (the Prior Employment Agreements ), but otherwise the terms of the Prior Employment Agreements remained in full force and effect. The Retention Agreements did not alter the amount of severance that was to be awarded under the Prior Employment Agreements, but rather changed the events that triggered such payments.

Pursuant to the Retention Agreements, on December 18, 2009 the Company paid a total of \$269,000, less applicable withholding taxes, to the Officers (the Retention Payments ). If the Officers were to voluntarily resign their employment prior to the earlier to occur of (a) the closing of the proposed Merger and (b) March 31, 2010, they were to immediately repay the Retention Payments to the Company. The date under (a) and (b) is referred to as the Separation Date. Neither of the Officers resigned prior to March 31, 2010 and the Merger never closed, so each Officer was entitled to keep the full amount of her respective Retention Payment.

Under the Retention Agreements, each of the Officers agreed to execute an amendment to the Retention Agreements (the Amendment ) on or about the Separation Date to extend and reaffirm the promises and covenants made by them in the Retention Agreements through the Separation Date. The Retention Agreements provided for severance payments totaling \$538,000, less applicable withholding taxes (the Severance Payments ), payable in a lump sum on the eighth day after the Officers signed the Amendment.

In April 2010, the Compensation Committee of the Board confirmed that, pursuant to the terms of the Retention Agreements, the Retention Payments and Severance Payments were earned as of March 31, 2010 and agreed that the existing employment terms would remain in effect beyond March 31, 2010. The Retention Payments of \$269,000 that were paid in December 2009 were fully earned as of March 31, 2010, of which \$222,000 was charged to general and administrative expense for the quarter ended March 31, 2010. The fully-earned Severance Payments, including related employer taxes, of \$550,000, were paid during the quarter ended June 30, 2010. Of the \$550,000 that was paid as of June 30, 2010, \$456,000 was charged to general and administrative expense for the quarter ended March 31, 2010. As an incentive to retain the Officers and an additional employee to pursue a strategic transaction such as a financing, merger, license agreement, third party collaboration or wind down of the Company, in April 2010, the Compensation Committee approved retention bonuses for a total of up to approximately \$600,000, depending on the type of strategic transaction completed ( Strategic Transaction Bonus ). Upon the closing of the financing in May 2010, the officers and an additional employee were paid a Strategic Transaction Bonus totaling \$296,000 which was charged to general and administrative expense for the quarter ended June 30, 2010.

**8. 401(k) Plan**

In September 2010, the Company adopted the La Jolla Pharmaceutical Company Retirement Savings Plan (the 401(k) Plan ), which qualifies under Section 401(k) of the Internal Revenue Code of 1986, as amended (the Code ). The 401(k) Plan is a defined contribution plan established to provide retirement benefits for employees and is employee funded up to an elective annual deferral. The 401(k) Plan is available for all employees who have completed one year of service with the Company.

Following guidance in IRS Notice 98-52 related to the safe harbor 401(k) plan method, non-highly compensated employees will receive a contribution from the Company equal to 3% of their annual salaries, as defined in the Code. Such contributions vest immediately and are paid annually following each year end. These safe harbor contributions by the Company were less than \$1,500 for the nine months ended September 30, 2011.

**Table of Contents****9. Net Income (Loss) per Share**

The following table sets forth the computation of basic and diluted EPS (in thousands, except per share amounts):

|   | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---|---------------------------|-------------|--------------------------|-------------|
|   | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|   | <b>2011</b>               | <b>2010</b> | <b>2011</b>              | <b>2010</b> |
| Numerator   |                           |             |                          |             |
| Net income (loss)   | \$ 3,570                  | \$ (222)    | \$ 1,775                 | \$ (5,093)  |
| Preferred stock dividends forfeited (earned)                                    | (3)                       | (247)       | 75                       | (334)       |
| Numerator for basic EPS net income (loss) attributable to common stockholders   | 3,567                     | (469)       | 1,850                    | (5,427)     |
| Effect of dilutive securities:<br>Preferred stock dividends                     |                           |             |                          |             |
| Numerator for diluted EPS net income (loss) attributable to common stockholders | \$ 3,567                  | \$ (469)    | \$ 1,850                 | \$ (5,427)  |
| Denominator:  |                           |             |                          |             |
| Weighted-average shares outstanding:  |                           |             |                          |             |
| Basic EPS   | 53,341                    | 947         | 22,418                   | 793         |
| Effect of dilutive convertible preferred stock and warrants                     | 1,234,659                 |             | 4,847,163                |             |
| Denominator for diluted EPS   | 1,288,000                 | 947         | 4,869,581                | 793         |
| Basic EPS   | \$ 0.07                   | \$ (0.49)   | \$ 0.08                  | \$ (6.84)   |
| Diluted EPS   | \$ 0.00                   | \$ (0.49)   | \$ 0.00                  | \$ (6.84)   |

At September 30, 2011, potentially dilutive securities of approximately 129,000 shares reserved for the exercise of outstanding stock options and warrants for common stock were excluded from the diluted EPS computation because their effect was anti-dilutive.

Because the Company had incurred a net loss for the three and nine months ended September 30, 2010, common stock issuable upon the conversion of preferred stock and the exercise of stock options and warrants were not included in the computation of net loss per share because their effect was anti-dilutive. At September 30, 2010, potentially dilutive securities were approximately 5.2 billion shares reserved for the conversion of convertible preferred stock, including accrued dividends, and the exercise of outstanding stock options and warrants.

The Series C-1<sup>1</sup> Preferred was convertible into 857 million and 909 million shares of common stock at September 30, 2011 and 2010, respectively.

**10. Commitments and Contingencies**

As of September 30, 2011, there were no material operating leases, notes payable, purchase commitments or capital leases.

The Company maintains its operations in a temporary space under a short-term arrangement and expects that it will transition to permanent space under a long-term lease if and when a Strategic Transaction is consummated.





**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Forward-Looking Statements**

The forward-looking statements in this report involve significant risks, assumptions and uncertainties, and a number of factors, both foreseen and unforeseen, could cause actual results to differ materially from our current expectations. Forward-looking statements include those that express a plan, belief, expectation, estimation, anticipation, intent, contingency, future development or similar expression. Accordingly, you should not rely upon forward-looking statements as predictions of future events. The outcome of the events described in these forward-looking statements are subject to the risks, uncertainties and other factors described in Management's Discussion and Analysis of Financial Condition and Results of Operations and in the Risk Factors contained in our Annual Report on Form 10-K for the year ended December 31, 2010, and in other reports and registration statements that we file with the Securities and Exchange Commission from time to time and as updated in Part II, Item 1A. Risk Factors contained in this Quarterly Report on Form 10-Q. We expressly disclaim any intent to update forward-looking statements.

**Overview and Recent Developments**

Since our inception in May 1989, we have devoted substantially all of our resources to the research and development of technology and potential drugs to treat antibody-mediated diseases. We have never generated any revenue from product sales and have relied on public and private offerings of securities, revenue from collaborative agreements, equipment financings and interest income on invested cash balances for our working capital.

In March 2011, we acquired the rights to RIL compounds (the Compounds) from privately held GliMed, Inc. (GliMed). The RIL technology was acquired pursuant to an asset purchase agreement (Asset Agreement) for a nominal amount, and if certain milestones noted below were met, GliMed would have been eligible to receive additional consideration consisting of up to 8,205 shares of newly designated Series E Convertible Preferred Stock (Series E Preferred), which would have been convertible into approximately 20% of the Company's fully diluted outstanding common stock on an as-converted basis. The issuance of the shares was tied to the achievement of certain development and regulatory milestones. GliMed would have also been eligible for a potential cash payment if a Compound was approved by the FDA or EMA in two or more clinical indications.

Also in March 2011, we entered into a Consent and Amendment Agreement (the Consent Agreement), with certain holders of our convertible redeemable Series C-1 preferred stock (Series C-1 Preferred), in order to amend certain terms of the Company's Securities Purchase Agreement, dated as of May 24, 2010 (Securities Purchase Agreement). The purpose of the Consent Agreement was to revise certain terms of the Company's outstanding preferred securities in connection with the Company's acquisition of the Compounds. Additionally, as part of the Consent Agreement, the Company designated five new series of preferred stock: its Series C-1<sup>1</sup> Convertible Preferred Stock (Series C-1<sup>1</sup> Preferred), Series C-2 Convertible Preferred Stock (Series C-2 Preferred), Series D-1<sup>1</sup> Convertible Preferred Stock (Series D-1<sup>1</sup> Preferred), Series D-2 Convertible Preferred Stock (Series D-2 Preferred) and collectively with the Series C-1<sup>1</sup> Preferred, the Series C-2<sup>1</sup> Preferred and the Series D-1<sup>1</sup> Preferred, the New Preferred Stock) and Series E Preferred. The Company exchanged on a one-for-one basis each share of its existing Series C-1 Preferred that was outstanding for a new share of Series C-1<sup>1</sup> Preferred (see Note 5). Unless otherwise indicated, references herein to

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Series C-1<sup>1</sup> Preferred reflect the one-for-one exchange. Under the Consent Agreement, the holders agreed to the following, among other changes: (i) a temporary suspension of dividends on Series C-1<sup>1</sup> Preferred and Series C-2<sup>1</sup> Preferred (together with the Series C-1<sup>1</sup> Preferred, the Series C Preferred ), (ii) to provide an additional cash payment of \$0.2 million in exchange for the right to receive Series C-2<sup>1</sup> Preferred upon the achievement of certain pre-specified results in the preclinical study of one of the Compounds (the Preclinical Milestone ), (iii) to increase the warrants that must be exercised for cash from 10,268 to 10,646 units, (iv) the mandatory exercise of \$7.4 million of such warrants upon the achievement of the Preclinical Milestone, (v) the mandatory exercise of the remaining \$3.2 million of warrants upon the achievement of a future clinical milestone and (vi) an automatic one-time downward conversion price adjustment following the reverse stock split.

Following the acquisition of the Compounds, we initiated a confirmatory preclinical animal study in April 2011 studying the lead RIL compound, LJP1485. This study was completed in May 2011, after which we received final data from Charles River Laboratories, our clinical research organization (the CRO ), which showed that the predetermined study endpoints, as set forth on the Asset Agreement, were not met and that the LJP1485 compound did not show statistically significant improvement in the study endpoints as compared to vehicle (placebo).

Pursuant to the Consent Agreement, our existing holders of Series C-1<sup>1</sup> Preferred (the Preferred Stockholders ) were not required to exercise their cash warrants (the Cash Warrants ) due to the failure of the LJP1485 study. The Preferred Stockholders elected to not exercise the Cash Warrants, which then provided GliaMed with the right to reacquire the Compounds through the purchase of the outstanding capital stock of Jewel Merger Sub, Inc. (which held title to the Compounds) for the same nominal consideration that GliaMed received at the closing of our acquisition of the Compounds.

On June 30, 2011, we entered into an Amendment Agreement with certain holders of our Series C-1<sup>1</sup> Preferred (the Holders ) in order to provide us with additional working capital to allow us to more fully evaluate additional product acquisition or in-licensing opportunities. The Holders agreed to waive the dividends on their shares of Series C-1<sup>1</sup> Preferred for the period from June 1, 2011 to August 31, 2011 and agreed to provide us with additional working capital by July 29, 2011, in an amount to be determined. In addition, our two executive officers agreed to a temporary reduction in their salaries and work hours from July 1, 2011 to August 31, 2011. As of August 24, 2011, no additional working capital had been contributed to us.

On August 24, 2011, we entered into a Second Amendment Agreement with the Holders in order to provide us with additional working capital to allow us to continue to evaluate additional product acquisition or in-licensing opportunities that are currently being investigated. The Holders agreed to extend the waived dividends and the two executive officers agreed to extend the temporary reduction in their salaries and work hours through October 31, 2011. The Company is in the process of negotiating a third amendment to extend the terms of the Amendment Agreement. The Holders also agreed to provide us with additional working capital, in an amount to be determined, by September 2, 2011 and then again by September 26, 2011, if as of such dates, we were continuing to pursue a Strategic Transaction. In September 2011, in accordance with the Consent Agreement, certain of the Holders agreed to waive the preferred stock conversion limits and converted 25 shares of Series C<sup>1</sup> Preferred into common stock. The conversion reduced the redemption value of the Series C-1<sup>1</sup> Preferred by \$25,000 and therefore increased working capital by the same amount. The dividends waived from June 1, 2011 through October 31, 2011 are referred to as the Waived Dividend .

Since we did not consummate a strategic transaction (as defined in the Securities Purchase Agreement) by the February 26, 2011 deadline under the Securities Purchase Agreement (a Strategic Transaction ), as of September 30, 2011, the outstanding preferred stockholders have the right to demand redemption of approximately \$5.1 million of Series C-1<sup>1</sup> Preferred, although such redemption is not currently considered probable because our search for a drug candidate to develop is ongoing.

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Our current business operations are focused on maximizing the value of our assets and utilizing the expertise of our management team and Board of Directors to identify other suitable assets for development. Strategic alternatives that we are considering may include the following:

Pursue potential other strategic transactions, which could include mergers, license agreements or other collaborations, with third parties where we seek new compounds for development and seek additional capital; and/or

Develop, sell or out-license our Riquent program, although we may not receive any significant value upon such a sale or license.

Our stockholders previously approved a proposal that authorized our Board of Directors, in its discretion, to effect up to two reverse splits of our outstanding common stock, par value \$0.0001 per share subject to certain parameters. Pursuant to this authority, our Board of Directors approved and implemented one such reverse stock split, which became effective as of 5:00 p.m. (Eastern Time) on April 14, 2011, with such reverse stock split having an exchange ratio of 1-for-100 (the Reverse Stock Split). No fractional shares were issued and, instead, stockholders received the cash value of any fractional shares that would have been issued. All common stock shares and per share information in this report have been retroactively restated to reflect the Reverse Stock Split.

Previously, in May 2010, we sold approximately 290,000 shares of common stock and 5,134 shares of Series C-1<sup>1</sup> Preferred, for aggregate gross proceeds of approximately \$6.0 million in a private placement. The investors also received a three-year warrant to purchase, for cash, an additional 10,268 shares of Series C-2<sup>1</sup> Preferred for an aggregate exercise price of approximately \$10.3 million. Until June 2011, the investors were required to exercise the warrants and purchase the additional shares of Series C-2<sup>1</sup> Preferred under the Strategic Transaction described above. These warrants are no longer subject to a mandatory exercise term.

The investors also received an additional three-year warrant to purchase, for cash or on a cashless basis, an additional 5,134 shares of Series D-1<sup>1</sup> Preferred for an aggregate exercise price of approximately \$5.1 million, if exercised on a cash basis; the Company will receive no cash proceeds and will issue fewer shares if the warrants are exercised on a cashless basis. In addition, if the investors purchase the additional 10,268 shares of Series C-2<sup>1</sup> Preferred that must be purchased for cash, they will receive an additional three-year warrant to purchase, for cash or on a cashless basis, 10,268 shares of Series D-2<sup>1</sup> Preferred on the same terms as provided in the cashless warrants issued at the initial close. The Series D-1<sup>1</sup> Preferred and Series D-2<sup>1</sup> Preferred are collectively referred to as Series D Preferred.

In March 2011, the Company and the investors mutually agreed to increase both the warrants for Series C-2<sup>1</sup> Preferred that must be purchased for cash and the additional three-year warrants for Series D-2<sup>1</sup> Preferred from 10,268 to 10,646 shares each of preferred stock for an additional \$0.4 million in exercise proceeds.

Each share of New Preferred Stock was initially convertible into shares of our common stock at a conversion rate of 667 shares of common stock per share of preferred stock that is converted; effective May 7, 2011, this conversion rate increased to 166,667 shares pursuant to a one-time adjustment that was made following the Reverse Stock Split. The Series C<sup>1</sup> Preferred will bear a dividend of 15% per annum, payable semi-annually in additional shares of convertible preferred stock. The holders of Series C-1<sup>1</sup> Preferred can demand redemption. The Company is required to obtain the vote of the holders of the New Preferred Stock prior to taking certain corporate actions and, until April 2011, had also agreed to certain limitations on spending.

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**Critical Accounting Policies and Estimates**

The discussion and analysis of our financial condition and results of operations are based on our unaudited condensed consolidated financial statements, which have been prepared in accordance with United States generally accepted accounting principles. The preparation of these unaudited condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We evaluate our estimates on an ongoing basis. We base our estimates on historical experience and on other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions or conditions.

The fair value of our derivative liabilities is estimated using option pricing models that are based on the individual characteristics of the common stock and preferred stock, the derivative liability on the valuation date, probabilities related to our operations and potential clinical development (based on industry data), as well as assumptions for volatility, remaining expected life, risk-free interest rate and, in some cases, credit spread. The option pricing models of our derivative liabilities are estimates and are sensitive to changes to certain inputs used in the options pricing models. To better estimate the fair value of our derivative liabilities at each reporting period, the binomial option pricing models and their inputs were refined based on information available to the Company. Such changes did not have a significant impact on amounts recorded in previous interim reporting periods.

There have been no material changes to the critical accounting policies as previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010 filed on April 14, 2011.

**Recent Accounting Pronouncements**

In May 2011, the FASB issued authoritative guidance regarding common fair value measurements and disclosure requirements in U.S. GAAP and IFRS. This newly issued accounting standard clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurements that are estimated using significant unobservable inputs. This guidance is effective on a prospective basis for annual and interim reporting periods beginning after December 15, 2011. We do not expect that adoption of this standard will have a material impact on our financial position or results of operations.

In June 2011, the FASB issued authoritative guidance regarding comprehensive income. This newly issued accounting standard (1) eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity; (2) requires the consecutive presentation of the statement of net income and other comprehensive income; and (3) requires an entity to present reclassification adjustments on the face of the financial statements from other comprehensive income to net income. The amendments 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 nor do the amendments affect how earnings per share is calculated or presented. This guidance is required to be applied retrospectively and is effective for fiscal years and interim periods beginning after December 15, 2011. As this accounting standard only requires enhanced disclosure, the adoption of this standard will not impact our financial position or results of operations.

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**Results of Operations**

There were no revenues for the three and nine months ended September 30, 2011 and 2010.

For the nine months ended September 30, 2011, we incurred \$0.2 million in research and development expense primarily related to costs associated with the preclinical study compared to only nominal expenses for the same period in 2010.

For the three and nine months ended September 30, 2011, general and administrative expense decreased to \$0.4 million and \$1.6 million, respectively, from \$0.7 million and \$3.4 million for the same periods in 2010. The decrease of \$0.3 million for the three months ended September 30, 2011 as compared to the same period in 2010 is primarily the result of decreased salaries and wages in 2011 due to the temporary reduction in salary for the CEO and CFO, as well as lower general and patent legal fees, consulting and accounting fees, insurance premiums and board of director fees. The decrease of \$1.8 million for the nine months ended September 30, 2011 as compared to the same period in 2010 is due to lower salaries and wages as a result of bonus incentives paid for the May 2010 financing and for retention bonuses paid in the first quarter of 2010 to the remaining officers totalling \$1.0 million and the temporary reduction in salary for the CEO and CFO combined with a lower headcount in 2011 for a savings of \$0.1 million, a decrease in consulting and professional services of \$0.5 million and a decrease in stock compensation expense of \$0.2 million, partially offset by the \$0.2 million impairment charge for the GliaMed assets.

For the three and nine months ended September 30, 2011, non-operating income as a result of adjustments to the estimated fair value of derivative liabilities was \$4.0 million and \$3.3 million, respectively. The derivative liabilities issued in the May 2010 financing were remeasured at their estimated fair value as of September 30, 2011, resulting in a net decrease in value of \$4.0 million for the three months ended September 30, 2011 primarily due to the decrease in the price per share of our common stock, the conversion of 185 shares of Series C-1<sup>1</sup> Preferred into common stock and changes in other inputs to the valuation models used to estimate the liabilities. This decrease in value was recorded as non-operating income. The net decrease in the estimated fair value of derivative liabilities of \$3.3 million for the nine months ended September 30, 2011 was primarily due to the decrease in the price per share of our common stock, the conversion of 433 shares of Series C-1<sup>1</sup> Preferred into common stock, and changes in other inputs to the valuation models used to estimate the liabilities, offset by a downward adjustment to the conversion price after the Reverse Stock Split in April 2011 and the increase in the number of outstanding Series C-2<sup>1</sup> Warrants by a total of 378 units. This decrease in value was recorded as non-operating income.

The estimated fair value of derivative liabilities upon issuance for the nine months ended September 30, 2010 was \$5.0 million. Non-operating income as a result of adjustments to the estimated fair value of derivative liabilities for the three and nine months ended September 30, 2010 was \$0.5 million and \$3.5 million, respectively. The derivative liabilities issued in the May 2010 financing were remeasured at their estimated fair value as of September 30, 2010 resulting in a decrease in value from their issuance based upon changes in the inputs to the valuation models used to estimate the liabilities. This resulted in \$0.5 million and \$3.5 million of non-operating income for the three and nine months ended September 30, 2010, respectively.

The non-operating income as a result of adjustments to the estimated fair value of derivative liabilities is non-cash income. Accounting rules require that our derivative instruments be adjusted to their fair values at each reporting date, which may cause us to report significant non-cash gains or losses as our stock price moves down or up. Prior results may not be indicative of future results.

Financing transaction costs for the nine months ended September 30, 2010 were \$0.2 million. The costs directly related to completing the May 2010 financing and were primarily comprised of legal expenses. There were no such costs for the same period in 2011.

Other income and other expense, net, increased to \$0.2 million of income for the nine months ended September 30, 2011 from less than \$0.1 million of expense for the same period in 2010. The increase was due to reclassification of the \$0.2 million received from the Preferred Stockholders in April 2011 to miscellaneous income as a result of the failure of the preclinical study in May 2011, pursuant to the Consent Agreement.



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**Liquidity and Capital Resources**

From inception through September 30, 2011, we have incurred a cumulative net loss of approximately \$426.3 million and have financed our operations through public and private offerings of securities, revenues from collaborative agreements, equipment financings and interest income on invested cash balances. From inception through September 30, 2011, we have raised approximately \$417.0 million in net proceeds from sales of equity securities. At September 30, 2011, we had \$5.5 million in cash as compared to \$6.9 million of cash at December 31, 2010. Of our available cash at September 30, 2011, we could be required to pay up to \$5.1 million upon the redemption of our outstanding Series C-1<sup>1</sup> Preferred. Such redemption was not considered probable as of September 30, 2011. Our working capital was \$2.9 million at September 30, 2011, as compared to \$0.5 million at December 31, 2010 and is largely driven by our derivative liability obligations which will likely change in value in the future. The decrease in cash resulted from the use of our financial resources to fund our general corporate operations.

In March 2011, we received funding of approximately \$0.2 million from certain of our investors to defray the costs of the confirmatory preclinical study of LJP1485. In addition, we are preserving cash through the temporary forfeiture/waiver of dividends on our outstanding Series C<sup>1</sup> Preferred for the period from November 26, 2010 to October 31, 2011 (which reduces the number of shares of Series C<sup>1</sup> Preferred potentially subject to redemption), as well as through temporary reductions in the salaries of our current officers.

Our history of recurring losses from operations, our cumulative net loss as of September 30, 2011, and the absence of any current revenue sources raise substantial doubt about our ability to continue as a going concern.

In June 2011, we entered into a short-term lease for office space. No notes payable, purchase commitments, capital leases or other material operating leases existed as of September 30, 2011.

Our current business operations are focused on using our financial resources to fund our current obligations while we seek to continue to assess new assets for development and consider the feasibility of the potential further development of Riquent, as described above. In the future, it is possible that we will not have adequate resources to support continued operations and we will need to cease operations.

Our future capital uses and requirements depend on numerous forward-looking factors. These factors include but are not limited to the following:

- our ability to consummate a strategic transaction such as a merger, license agreement or other collaboration with a third party where we seek new compounds for development and seek additional capital; and
- our ability to sell, out-license or otherwise develop our Riquent program;

There can be no assurance that we will be able to enter into any strategic transactions on acceptable terms, if any, and our negotiating position may worsen as we continue to utilize our existing resources.

**Off-Balance Sheet Arrangements**

We have no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our consolidated financial condition, changes in our consolidated financial condition, expenses, consolidated results of operations, liquidity, capital expenditures or capital resources.

**Table of Contents****ITEM 4. CONTROLS AND PROCEDURES**

Our management, with the participation of our principal executive officer and principal financial officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2011. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act"), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2011, our principal executive officer and principal financial officer concluded that, as of such date, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the quarter ended September 30, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION****ITEM 1A. Risk Factors****I. RISK FACTORS RELATING TO LA JOLLA PHARMACEUTICAL COMPANY AND THE INDUSTRY IN WHICH WE OPERATE.**

The risk factors presented below update the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010 (the "Annual Report") and in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2011. The following factors, along with those in the documents noted above, should be reviewed carefully, in conjunction with the other information contained in this Report and our financial statements. These factors, among others, could cause actual results to differ materially from those currently anticipated and contained in forward-looking statements made in this Form 10-Q and presented elsewhere by our management from time to time. See Part I, Item 2 Forward-Looking Statements.

***We have only limited assets, no ongoing clinical trials and no products.***

As of September 30, 2011, we had no revenue sources, an accumulated deficit of approximately \$426.3 million and available cash and cash equivalents of \$5.5 million, of which, at that time, up to \$5.1 million could be required to be paid upon the triggering of a redemption right under our outstanding Series C-1<sup>1</sup> Preferred including accrued dividends. We also have no ongoing clinical trials and no approved products. Although we retain the rights to the Riquent patent estate, the value of the estate is uncertain and has been written down under United States generally accepted accounting principles ("GAAP") to zero. Even with the money raised in the May 2010 financing and the additional funding of \$0.2 million received in March 2011, we have only limited assets available to operate and develop our business. We are utilizing the funds received in March 2011, and a portion of the funds received in the May 2010 financing, to continue to evaluate certain product acquisition or in-licensing opportunities that are currently being investigated.



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If we are not able to acquire rights to another drug candidate for development and the investors redeem their shares of C-1<sup>1</sup> Preferred, we would have only limited cash and would likely be forced to liquidate the Company. In that event, the funds resulting from the liquidation of our assets, net of amounts payable, would likely return only a small amount, if anything, to our stockholders.

***Our financial reporting is complicated and may confuse investors.***

The securities we issued in the May 2010 financing have certain features that result in fair value accounting under *FASB Topic of Derivatives and Hedging*. These accounting rules require that our derivative instruments be adjusted to their fair values at each reporting date. The fair values are based on option pricing models and require various inputs, including our stock price, which may change from period to period. Changes in these inputs, such as increases or decreases in our stock price, will change the value of the derivative instruments, which means that we will likely report significant non-cash gains or losses in future periods. These non-cash gains and losses can be very substantial each period and may result in significant period-over-period swings in our GAAP operating results. For example, for the three and nine months ended September 30, 2011, we recorded non-cash net gains on the fair value of our derivative instruments of approximately \$4.0 million and \$3.3 million, respectively. As a result, investors are cautioned to carefully read our financial statements, the notes thereto and *Management's Discussion & Analysis of Financial Condition and Results of Operations* for a more complete understanding of our operating results. Prior results may not be indicative of future results and periods reflecting significant non-cash income under these accounting rules would not correspond to significant positive cash flows that investors may normally expect.

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**ITEM 6. EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 10.1                      | Second Amendment Agreement by and among La Jolla Pharmaceutical Company and the undersigned parties thereto, dated as of August 24, 2011 (1) |
| 31.1                      | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2                      | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1                      | Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

(1) Previously filed with the Company's Current Report on Form 8-K, filed August 25, 2011 and incorporated by reference herein.

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**SIGNATURES**

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

La Jolla Pharmaceutical Company

Date: November 10, 2011

/s/ Deirdre Y. Gillespie  
Deirdre Y. Gillespie, M.D.  
President and Chief Executive Officer  
(On behalf of the Registrant)

/s/ Gail A. Sloan  
Gail A. Sloan  
Chief Financial Officer and Secretary  
(As Principal Financial and Accounting  
Officer)