

LIGAND PHARMACEUTICALS INC

Form 10-Q

October 31, 2014

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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FORM 10-Q

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Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2014

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: 001-33093

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LIGAND PHARMACEUTICALS INCORPORATED

(Exact name of registrant as specified in its charter)

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Delaware

(State or other jurisdiction of  
incorporation or organization)

77-0160744

(I.R.S. Employer  
Identification No.)

11119 North Torrey Pines Road, Suite 200

La Jolla, CA

(Address of principal executive offices)

(858) 550-7500

(Registrant's Telephone Number, Including Area Code)

92037

(Zip Code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions 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  (Do not check if a smaller reporting company)

Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes

No

As of October 31, 2014, the registrant had 20,023,148 shares of common stock outstanding.

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Table of Contents

LIGAND PHARMACEUTICALS INCORPORATED  
QUARTERLY REPORT

FORM 10-Q

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

<u>ITEM 1. Financial Statements</u>	<u>3</u>
<u>Condensed Consolidated Balance Sheets as of September 30, 2014 and December 31, 2013 (Unaudited)</u>	<u>3</u>
<u>Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2014 and 2013 (Unaudited)</u>	<u>4</u>
<u>Condensed Consolidated Statements of Comprehensive Income (Loss) for the three and nine months ended September 30, 2014 and 2013 (Unaudited)</u>	<u>5</u>
<u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2014 and 2013 (Unaudited)</u>	<u>6</u>
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	<u>8</u>
<u>ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>30</u>
<u>ITEM 3. Quantitative and Qualitative Disclosures about Market Risk</u>	<u>39</u>
<u>ITEM 4. Controls and Procedures</u>	<u>40</u>

PART II. OTHER INFORMATION

<u>ITEM 1. Legal Proceedings</u>	<u>41</u>
<u>ITEM 1A. Risk Factors</u>	<u>42</u>
<u>ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>50</u>
<u>ITEM 3. Defaults Upon Senior Securities</u>	<u>50</u>
<u>ITEM 4. Mine Safety Disclosures</u>	<u>50</u>
<u>ITEM 5. Other Information</u>	<u>50</u>
<u>ITEM 6. Exhibits</u>	<u>50</u>
<u>SIGNATURE</u>	<u>51</u>

---

Table of Contents

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

LIGAND PHARMACEUTICALS INCORPORATED  
CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(in thousands, except share data)

	September 30, 2014	December 31, 2013
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 180,663	\$ 11,639
Short-term investments	5,925	4,340
Accounts receivable	5,812	2,222
Inventory	1,071	1,392
Capitalized expenses, VIE	2,131	—
Other current assets	1,602	959
Current debt issuance costs	793	—
Current co-promote termination payments receivable	523	4,329
Total current assets	198,520	24,881
Restricted cash and investments	1,261	1,341
Property and equipment, net	551	867
Intangible assets, net	51,317	53,099
Goodwill	12,238	12,238
Commercial license rights	4,568	4,571
Long-term co-promote termination payments receivable	—	7,417
Long-term debt issuance costs	3,598	—
Other assets	230	299
Total assets	\$ 272,283	\$ 104,713
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable (including \$2.2 million related to a VIE)	\$ 4,864	\$ 3,951
Accrued liabilities	4,311	5,337
Current contingent liabilities	4,184	1,712
Current deferred income taxes	1,574	1,574
Current note payable	337	9,109
Current co-promote termination liability	523	4,329
Current lease exit obligations	2,526	2,811
Current deferred revenue	114	116
Total current liabilities	18,433	28,939
Long-term co-promote termination liability	—	7,417
Long-term deferred revenue, net	2,085	2,085
Long-term lease exit obligations	1,133	3,071
Deferred income taxes	1,214	1,098
Long-term contingent liabilities	12,267	11,795
Long-term debt, net	193,631	—
Other long-term liabilities	737	695
Total liabilities	229,500	55,100
Commitments and Contingencies		
Stockholders' equity:		

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Common stock, \$0.001 par value; 33,333,333 shares authorized; 20,117,080 and 20,468,521 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively	20	21
Additional paid-in capital	707,180	718,017
Accumulated other comprehensive income	3,543	2,914
Accumulated deficit	(666,371	) (671,339 )
Total stockholders' equity attributable to parent	44,372	49,613
Noncontrolling interests	(1,589	) \$—
Total liabilities and stockholders' equity	\$272,283	\$104,713
See accompanying notes.		

3

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Table of ContentsLIGAND PHARMACEUTICALS INCORPORATED  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except share data)

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Revenues:				
Royalties	\$7,482	\$5,724	\$20,573	\$16,466
Material sales	6,334	6,728	15,525	12,260
Collaborative research and development and other revenues	1,157	553	5,441	5,511
Total revenues	14,973	13,005	41,539	34,237
Operating costs and expenses:				
Cost of sales	1,496	2,538	5,133	4,416
Research and development	3,021	2,414	8,842	6,900
General and administrative	6,742	4,756	17,053	13,564
Lease exit and termination costs	182	227	522	359
Write-off of in-process research and development	—	—	—	480
Total operating costs and expenses	11,441	9,935	31,550	25,719
Income from operations	3,532	3,070	9,989	8,518
Other (expense) income:				
Interest expense, net	(1,516)	(394)	(1,946)	(1,755)
(Increase) decrease in contingent liabilities	(1,620)	(532)	(4,880)	368
Other, net	505	(119)	1,128	69
Total other expense, net	(2,631)	(1,045)	(5,698)	(1,318)
Income before income taxes	901	2,025	4,291	7,200
Income tax expense	(124)	(60)	(131)	(237)
Income from continuing operations	777	1,965	4,160	6,963
Discontinued operations:				
Gain on sale of Avinza Product Line before income taxes	—	—	—	2,588
Income from discontinued operations	—	—	—	2,588
Net income including noncontrolling interests:	777	1,965	4,160	9,551
Less: Net loss attributable to noncontrolling interests	(503)	—	(809)	—
Net income	\$1,280	\$1,965	\$4,969	\$9,551
Per share amounts attributable to Ligand common shareholders:				
Basic per share amounts:				
Income from continuing operations	\$0.06	\$0.10	\$0.24	\$0.34
Income from discontinued operations	—	—	—	0.13
Net income	\$0.06	\$0.10	\$0.24	\$0.47
Diluted per share amounts:				
Income from continuing operations	\$0.06	\$0.09	\$0.23	\$0.33
Income from discontinued operations	—	—	—	0.13
Net income	\$0.06	\$0.09	\$0.23	\$0.46
Weighted-average number of common shares-basic	20,417,187	20,357,558	20,584,469	20,268,261

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Weighted-average number of common shares-diluted	21,345,311	20,843,742	21,632,521	20,562,622
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See accompanying notes.

4

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Table of Contents

LIGAND PHARMACEUTICALS INCORPORATED  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
 (Unaudited)  
 (in thousands)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Net income	\$1,280	\$1,965	\$4,969	\$9,551
Unrealized net (loss) gain on available-for-sale securities, net of tax of \$0	(1,224	) 806	1,870	2,201
Less: Reclassification of net realized (losses) gains included in net income	(274	) —	1,241	—
Comprehensive (loss) income	\$(218	) \$2,771	\$8,080	\$11,752

See accompanying notes.

Table of Contents

LIGAND PHARMACEUTICAL INCORPORATED  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)  
(in thousands)

	Nine months ended September 30,	
	2014	2013
Operating activities		
Net income including noncontrolling interests	\$4,160	\$9,551
Less: gain from discontinued operations	—	2,588
Income from continuing operations	4,160	6,963
Adjustments to reconcile net income including noncontrolling interests to net cash provided by operating activities:		
Non-cash change in estimated fair value of contingent liabilities	4,880	(368 )
Write-off of in-process research and development	—	480
Realized gain on sale of short-term investment	(1,241 )	—
Gain on write-off of assets	(16 )	—
Depreciation and amortization	1,998	2,007
Amortization of debt discount and issuance fees	1,223	—
Stock-based compensation	8,795	4,149
Non-cash upfront fee	(1,211 )	—
Deferred income taxes	116	237
Accretion of note payable	225	321
Other	—	(13 )
Changes in operating assets and liabilities:		
Accounts receivable	(3,590 )	(918 )
Inventory	321	86
Other current assets	(615 )	(683 )
Other long-term assets	(1,245 )	173
Accounts payable and accrued liabilities	(3,478 )	(2,702 )
Deferred revenue	(2 )	(434 )
Net cash provided by operating activities of continuing operations	10,320	9,298
Net cash used in operating activities of discontinued operations	—	(642 )
Net cash provided by operating activities	10,320	8,656
Investing activities		
Purchase of commercial license rights	—	(3,571 )
Payments to CVR holders and other contingency payments	(1,936 )	(100 )
Purchases of property and equipment	—	(263 )
Proceeds from sale of property and equipment	125	3
Proceeds from sale of short-term investments	1,496	—
Other, net	(1 )	(40 )
Net cash used in investing activities	(316 )	(3,971 )
Financing activities		
Repayment of debt	(9,364 )	(16,224 )
Gross proceeds from issuance of 2019 Convertible Senior Notes	245,000	—
Payment of debt issuance costs	(5,711 )	—
Proceeds from issuance of warrants	11,637	—
Purchase of convertible bond hedge	(48,143 )	—
Net proceeds from stock option exercises and ESPP	4,124	2,429



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Share repurchase	(38,523	) —
Net cash provided by (used in) financing activities	159,020	(13,795 )
Net increase (decrease) in cash and cash equivalents	169,024	(9,110 )
Cash and cash equivalents at beginning of period	11,639	12,381
Cash and cash equivalents at end of period	\$180,663	\$3,271

6

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Table of Contents

Supplemental disclosure of cash flow information		
Interest paid	\$494	\$1,566
Taxes paid	\$3	\$5
Supplemental schedule of non-cash activity		
Liability for commercial license rights	\$—	\$1,000
Accrued inventory purchases	\$—	\$227
Unrealized gain on AFS investments	\$1,870	\$2,201

See accompanying notes

7

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Table of Contents

LIGAND PHARMACEUTICALS INCORPORATED  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)

1. Basis of Presentation

Ligand Pharmaceuticals Incorporated, a Delaware corporation (the "Company" or "Ligand") is a biopharmaceutical company that develops and acquires royalty and other revenue generating assets and couples them with a lean corporate cost structure. The Company diversifies its portfolio of assets across numerous technology types, therapeutic areas, drug targets, and industry partners. The Company added Captisol® to its technology portfolio in January 2011. Captisol is a formulation technology that has enabled six FDA approved products, including Onyx's Kyprolis® and Baxter International's Nexterone®, and is currently being developed in a number of clinical-stage partner programs. The Company's therapies address the unmet medical needs of patients for a broad spectrum of diseases including hepatitis, multiple myeloma, muscle wasting, Alzheimer's disease, dyslipidemia, diabetes, anemia, asthma, Focal Segmental Glomerulosclerosis ("FSGS") and osteoporosis. Ligand has established multiple alliances with the world's leading pharmaceutical companies including GlaxoSmithKline, Onyx Pharmaceuticals (a subsidiary of Amgen, Inc.), Merck, Pfizer, Baxter International, Lundbeck Inc. and Spectrum Pharmaceuticals, Inc. The Company's principal market is the United States. The Company sold its Oncology Product Line ("Oncology") and Avinza Product Line ("Avinza") on October 25, 2006 and February 26, 2007, respectively. The operating results for Oncology and Avinza have been presented in the accompanying condensed consolidated financial statements as "Discontinued Operations."

The Company has incurred significant losses since its inception. As of September 30, 2014, the Company's accumulated deficit was approximately \$666.4 million and the Company had working capital of approximately \$180.1 million. Management believes that cash flows from operations will increase due to Captisol® sales, an increase in royalty revenues driven primarily from continued increases in Promacta® and Kyprolis® sales, and also from anticipated new license and milestone revenues. The Company expects to build cash in future months as it continues to generate significant cash flows from operations. The Company's future operating and capital requirements will depend on many factors, including, but not limited to: the pace of scientific progress in its research and development programs; the potential success of these programs; the scope and results of preclinical testing and clinical trials; the time and costs involved in obtaining regulatory approvals; the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims; competing technological and market developments; the amount of royalties on sales of the commercial products of its partners; the efforts of its collaborative partners; obligations under its operating lease agreements; and the capital requirements of any companies the Company may acquire in the future. The ability of the Company to achieve its operational targets is dependent upon the Company's ability to further implement its business goals and generate sufficient operating cash flow.

Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements include Ligand and its wholly owned subsidiaries, Ligand JVR, Allergan Ligand Retinoid Therapeutics, Seragen, Inc., Pharmacopeia, Inc. ("Pharmacopeia"), Neurogen Corporation ("Neurogen"), CyDex Pharmaceuticals, Inc. ("CyDex"), Metabasis Therapeutics, Inc. ("Metabasis") and Nexus VI, Inc. Also included is Viking Therapeutics, Inc. ("Viking"), a variable interest entity ("VIE") for which the Company is deemed under applicable accounting guidance to be the primary beneficiary. All significant intercompany accounts and transactions have been eliminated in consolidation.

Basis of Presentation

The Company's accompanying unaudited condensed consolidated financial statements as of September 30, 2014 and for the three and nine months ended September 30, 2014 and 2013 have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for annual financial statements. The Company's unaudited condensed consolidated balance sheet at December 31, 2013 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the financial position and results of operations of the Company and its subsidiaries, have been included. Operating results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. These financial statements should be read in conjunction with the consolidated financial statements and notes therein included in the Company's annual report on Form 10-K for the year ended December 31, 2013.

Table of Contents

## Use of Estimates

The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires the use of estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses, contingent assets and liabilities, definite and indefinite lived intangible assets, goodwill, co-promote termination payments receivable and co-promote termination liabilities, uncertain tax positions, deferred revenue, lease exit liability and income tax net operating loss carryforwards during the reporting period. The Company's critical accounting policies are those that are both most important to the Company's financial condition and results of operations and require the most difficult, subjective or complex judgments on the part of management in their application, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Because of the uncertainty of factors surrounding the estimates or judgments used in the preparation of the condensed consolidated financial statements, actual results may materially vary from these estimates.

## Income Per Share

Basic income per share is calculated by dividing net income by the weighted-average number of common shares and vested restricted stock units outstanding. Diluted income per share is computed by dividing net income by the weighted-average number of common shares and vested restricted stock units outstanding and the weighted-average number of dilutive common stock equivalents, including stock options, non-vested restricted stock units, convertible notes and warrants. Common stock equivalents are only included in the diluted income per share calculation when their effect is dilutive. The total number of potential common shares excluded from the computation of diluted income per share because their inclusion would have been anti-dilutive was 5.0 million and 0.9 million, as of September 30, 2014 and 2013, respectively.

The following table sets forth the computation of basic and diluted net income per share for the periods indicated (in thousands, except per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
EPS attributable to common shareholders:				
Net income from continuing operations	\$1,280	\$1,965	4,969	\$6,963
Net income from discontinued operations	—	—	—	2,588
Net income	\$1,280	\$1,965	\$4,969	\$9,551
Shares used to compute basic income per share	20,417,187	20,357,558	20,584,469	20,268,261
Dilutive potential common shares:				
Restricted stock	22,531	77,609	37,387	62,051
Stock options	905,593	408,575	1,010,665	232,310
Shares used to compute diluted income per share	21,345,311	20,843,742	21,632,521	20,562,622
Basic per share amounts:				
Income from continuing operations	\$0.06	\$0.10	\$0.24	\$0.34
Income from discontinued operations	—	—	—	0.13
Net income	\$0.06	\$0.10	\$0.24	\$0.47
Diluted per share amounts:				
Income from continuing operations	\$0.06	\$0.09	\$0.23	\$0.33

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Income from discontinued operations	—	—	—	0.13
Net income	\$0.06	\$0.09	\$0.23	\$0.46

Cash, Cash Equivalents and Short-term Investments

9

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Table of Contents

Cash and cash equivalents consist of cash and highly liquid securities with maturities at the date of acquisition of three months or less. Securities received by the Company as a result of a milestone payment from licensees are considered short-term investments and have been classified by management as available-for-sale. Such investments are carried at fair value, with unrealized gains and losses included in the statement of comprehensive income (loss). The Company determines the cost of investments based on the specific identification method.

**Restricted Cash and Investments**

Restricted cash and investments consist of certificates of deposit held with a financial institution as collateral under a facility lease and third-party service provider arrangements.

The following table summarizes the various investment categories at September 30, 2014 and December 31, 2013 (in thousands):

	Cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
September 30, 2014				
Short-term investments	\$1,426	\$4,499	\$—	\$5,925
Certificates of deposit-restricted	1,261	—	—	1,261
	\$2,687	\$4,499	\$—	\$7,186
December 31, 2013				
Short-term investments	\$1,426	\$2,914	\$—	\$4,340
Certificates of deposit-restricted	1,341	—	—	1,341
	\$2,767	\$2,914	\$—	\$5,681

**Concentrations of Credit Risk**

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

The Company invests its excess cash principally in U.S. government debt securities, investment-grade corporate debt securities and certificates of deposit. The Company has established guidelines relative to diversification and maturities that maintain safety and liquidity. These guidelines are periodically reviewed and modified to take advantage of trends in yields and interest rates. The Company did not experience any significant losses on its cash equivalents, short-term investments or restricted investments for the periods ending September 30, 2014 and December 31, 2013.

As of September 30, 2014 and December 31, 2013, cash deposits held at financial institutions in excess of FDIC insured amounts of \$250,000 were approximately \$92.8 million and \$11.1 million, respectively.

Accounts receivable from one customer was 57% of total accounts receivable at September 30, 2014. Accounts receivable from two customers was 75% of total accounts receivable at December 31, 2013.

The Company currently obtains Captisol from a single supplier. If this supplier were not able to supply the requested amounts of Captisol and the Company's existing inventory was depleted, the Company would be unable to continue to derive revenues from the sale of Captisol until it obtained an alternative source, which might take a considerable length of time. The Company maintains inventory of Captisol, which has a five year shelf life, at three geographically spread storage locations in the United States and Europe. If a disaster were to strike any of these locations, it could lead to supply interruptions.

## Inventory

Inventory is stated at the lower of cost or market value. The Company determines cost using the first-in, first-out method. The Company analyzes its inventory levels periodically and writes down inventory to its net realizable value if it has become obsolete, has a cost basis in excess of its expected net realizable value or is in excess of expected requirements. There were no write downs related to obsolete inventory recorded for the three and nine months ended September 30, 2014 and 2013.

10

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Table of Contents

## Property and Equipment

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

	September 30, 2014	December 31, 2013
Lab and office equipment	\$2,509	\$3,737
Leasehold improvements	273	387
Computer equipment and software	631	616
	3,413	4,740
Less accumulated depreciation and amortization	(2,862	) (3,873
Total property and equipment, net	\$551	\$867

Depreciation of equipment is computed using the straight-line method over the estimated useful lives of the assets, which range from three to ten years. Leasehold improvements are amortized using the straight-line method over their estimated useful lives or their related lease term, whichever is shorter. Depreciation expense recognized for the three months ended September 30, 2014 and 2013 was \$0.1 million. Depreciation expense for the nine months ended September 30, 2014 and 2013 was \$0.2 million. Depreciation expense is included in operating expenses.

## Other Current Assets

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

	September 30, 2014	December 31, 2013
Prepaid expenses	\$1,178	\$786
Other receivables	424	173
Total current assets	\$1,602	\$959

## Goodwill and Other Identifiable Intangible Assets

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

	September 30, 2014	December 31, 2013
Indefinite lived intangible assets		
Acquired in-process research and development	\$12,556	\$12,556
Goodwill	12,238	12,238
Definite lived intangible assets		
Complete technology	15,267	15,267
Less: Accumulated amortization	(2,807	) (2,235
Trade name	2,642	2,642
Less: Accumulated amortization	(487	) (387
Customer relationships	29,600	29,600
Less: Accumulated amortization	(5,454	) (4,344
Total goodwill and other identifiable intangible assets, net	\$63,555	\$65,337

The Company accounts for goodwill and other intangible assets in accordance with Accounting Standards Codification ("ASC") Topic 350 - Intangibles - Goodwill and Other which, among other things, establishes standards for goodwill acquired in a business combination, eliminates the amortization of goodwill and requires the carrying value of goodwill and certain non-

## Table of Contents

amortizing intangibles to be evaluated for impairment on an annual basis. The Company uses the income approach and the market approach, each weighted at 50%, when performing its goodwill impairment analysis. For the income approach, the Company considers the present value of future cash flows and the carrying value of its assets and liabilities, including goodwill. The market approach is based on an analysis of revenue multiples of peer public companies. If the carrying value of the assets and liabilities, including goodwill, were to exceed the Company's estimation of the fair value, the Company would record an impairment charge in an amount equal to the excess of the carrying value of goodwill over the implied fair value of the goodwill. The Company performs an evaluation of goodwill and other intangibles as of December 31 of each year, absent any indicators of earlier impairment, to ensure that impairment charges, if applicable, are reflected in the Company's financial results before December 31 of each year. When it is determined that impairment has occurred, a charge to operations is recorded. Goodwill and other intangible asset balances are included in the identifiable assets of the business segment to which they have been assigned. Any goodwill impairment, as well as the amortization of other purchased intangible assets, is charged against the respective business segments' operating income.

Amortization of definite-lived intangible assets is computed using the straight-line method over the estimated useful life of the asset of 20 years. Amortization expense of \$0.6 million and \$1.8 million was recognized for each of the three and nine months ended September 30, 2014 and 2013, respectively. Estimated amortization expense for the years ending December 31, 2014 through 2018 is \$2.4 million per year.

### Acquired In-Process Research and Development

Intangible assets related to acquired in-process research and development ("IPR&D") are considered to be indefinite-lived until the completion or abandonment of the associated research and development efforts. During the period the assets are considered to be indefinite-lived, they will not be amortized but will be tested for impairment on an annual basis and between annual tests if the Company becomes aware of any events occurring or changes in circumstances that would indicate a reduction in the fair value of the IPR&D projects below their respective carrying amounts. If and when development is complete, which generally occurs if and when regulatory approval to market a product is obtained, the associated assets would be deemed definite-lived and would then be amortized based on their respective estimated useful lives at that point in time. For the three and nine months ended September 30, 2014 and the three months ended September 30, 2013 there was no impairment of IPR&D. For the nine months ended September 30, 2013, the Company recorded a non-cash impairment charge of \$0.5 million for the write-off of IPR&D for Captisol-enabled Clopidogrel (MDCO-157). The asset was impaired upon notification from the Medicines Company that they intended to terminate the license agreement and return the rights of the compound to the Company. MDCO-157 is an intravenous option of the anti-platelet medication designed for situations where the administration of oral platelet inhibitors is not feasible or desirable.

### Impairment of Long-Lived Assets

Management reviews long-lived assets for impairment annually or whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value for the Company's long-lived assets is determined using the expected cash flows discounted at a rate commensurate with the risk involved. As of September 30, 2014, management does not believe there have been any events or circumstances indicating that the carrying amount of its long-lived assets may not be recoverable.

### Commercial license rights

Commercial license rights represent a portfolio of future milestone and royalty payment rights acquired in accordance with the Royalty Stream and Milestone Payments Purchase Agreement entered into with Selexis SA ("Selexis") in April 2013. The portfolio consists of over 15 Selexis commercial license agreement programs with various pharmaceutical-company counterparties. The purchase price was \$4.6 million, inclusive of acquisition costs. The Company paid \$3.6 million upon closing and paid an additional \$1.0 million in April 2014. Individual commercial license rights acquired under the agreement are carried at allocated cost and approximate fair value. The carrying value of the license rights will be reduced on a pro-rata basis as revenue is realized over the term of the agreement. Declines in the fair value of individual license rights below their carrying value that are deemed to be other than temporary are reflected in earnings in the period such determination is made. As of September 30, 2014, management does not believe there have been any events or circumstances indicating that the carrying amount of its commercial license rights may not be recoverable.

Table of Contents

## Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	September 30, 2014	December 31, 2013
Compensation	\$1,388	\$1,929
Professional fees	805	697
Accrued interest payable	230	—
Other	1,888	2,711
Total accrued liabilities	\$4,311	\$5,337

## Other Long-Term Liabilities

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

	September 30, 2014	December 31, 2013
Deposits	\$402	\$345
Deferred rent	335	350
Total other long-term liabilities	\$737	\$695

## Contingent Liabilities

In connection with the Company's acquisition of CyDex in January 2011, the Company recorded a \$17.6 million contingent liability, inclusive of the \$4.3 million payment made in January 2012, for amounts potentially due to holders of the CyDex contingent value rights ("CVRs") and former license holders. The liability is periodically assessed based on events and circumstances related to the underlying milestones, royalties and material sales. Any change in fair value is recorded in the Company's consolidated statements of operations. The carrying amount of the liability may fluctuate significantly and actual amounts paid under the CVR agreements may be materially different than the carrying amount of the liability. The fair value of the liability at September 30, 2014 and December 31, 2013 was \$12.9 million and \$9.3 million, respectively. The Company recorded a fair-value adjustment to increase the liability for CyDex-related contingent liabilities by \$2.8 million and \$5.6 million for the three and nine months ended September 30, 2014, respectively, and an adjustment to increase the liability by \$1.2 million and to decrease the liability by \$2.1 million for the three and nine months ended September 30, 2013, respectively. There was a revenue-sharing payment of \$1.6 million made during the nine months ended September 30, 2014, and no revenue sharing payments were made during the three months ended September 30, 2014 and three and nine months ended September 30, 2013. Other contingency payments related to the CyDex acquisition of \$0.3 million were made during the three and nine months ended September 30, 2014 and other contingency payments of \$0.1 million were made during the three and nine months ended September 30, 2013.

In connection with the Company's acquisition of Metabasis in January 2010, the Company issued to Metabasis stockholders four tradable CVRs, one CVR from each of four respective series of CVR, for each Metabasis share. The CVRs will entitle Metabasis stockholders to cash payments as frequently as every six months as cash is received by the Company from proceeds from the sale or partnering of any of the Metabasis drug development programs, among other triggering events. The fair values of the CVRs are remeasured at each reporting date through the term of the related agreement. Changes in the fair values are reported in the statement of operations as income (decreases) or expense (increases). The carrying amount of the liability may fluctuate significantly based upon quoted market prices and actual amounts paid under the agreements may be materially different than the carrying amount of the liability.

The fair value of the liability was estimated to be \$3.5 million and \$4.2 million as of September 30, 2014 and December 31, 2013, respectively. The Company recorded a decrease in the liability for Metabasis-related CVRs of \$1.2 million and an increase in the liability of \$0.7 million for the three and nine months ended September 30, 2014, respectively. The Company recorded a decrease in the liability of \$0.7 million for the three months ended September 30, 2013 and an increase in the liability of \$1.7 million for the nine months ended September 30, 2013.

## Table of Contents

### Fair Value of Financial Instruments

Fair value is defined as the exit price that would be received to sell an asset or paid to transfer a liability. Fair value is a market-based measurement that should be determined using assumptions that market participants would use in pricing an asset or liability. The Company establishes a three-level hierarchy to prioritize the inputs used in measuring fair value. The levels are described in the below with level 1 having the highest priority and level 3 having the lowest:

Level 1 - Quoted prices in active markets;

Level 2 - Inputs other than the quoted prices in active markets that are observable either directly or indirectly; and

Level 3 - Unobservable inputs in which there is little or no market data, which require the Company to develop its own assumptions.

The Company's short-term investments include investments in equity securities which the Company received as a result of event-based and upfront payments from licensees. Additionally, there is a liability related to the investment in equity securities for amounts owed to former license holders. The Metabasis CVR liability is marked-to-market at each reporting period based upon the quoted market prices of the underlying CVR. The fair value of the CyDex contingent liabilities are determined at each reporting period based upon an income valuation model. The co-promote termination payments receivable represents a non-interest-bearing receivable for future payments to be made by Pfizer related to Avinza product sales and is recorded at its fair value. The receivable and liability will remain equal, and are adjusted each quarter for changes in the fair value of the obligation including any changes in the estimate of future net Avinza product sales.

The Company evaluates its financial instruments at each reporting period to determine if any transfers between the various three-level hierarchy have occurred and appropriately reclassifies its financial instruments to the appropriate level within the hierarchy.

### Revenue Recognition

Royalties on sales of products commercialized by the Company's partners are recognized in the quarter reported by the respective partner. Generally, the Company receives royalty reports from its licensees approximately one quarter in arrears due to the fact that its agreements require partners to report product sales between 30 and 60 days after the end of the quarter. The Company recognizes royalty revenues when it can reliably estimate such amounts and collectability is reasonably assured. Under this accounting policy, the royalty revenues reported are not based upon estimates and such royalty revenues are typically reported to the Company by its partners in the same period in which payment is received.

Revenue from material sales of Captisol is recognized upon transfer of title, which normally passes upon shipment to the customer. The Company's credit and exchange policy includes provisions for the return of product between 30 to 90 days, depending on the specific terms of the individual agreement, when that product (1) does not meet specifications, (2) is damaged in shipment (in limited circumstances where title does not transfer until delivery), or (3) is exchanged for an alternative grade of Captisol.

Revenue from research funding under our collaboration agreements is earned and recognized on a percentage-of completion basis as research hours are incurred in accordance with the provisions of each agreement.

Nonrefundable, upfront license fees are recognized as revenue upon delivery of the license, if the license is determined to have standalone value that is not dependent on any future performance by the Company under the applicable collaboration agreement. Nonrefundable contingent event-based payments are recognized as revenue when the contingent event is met, which is usually the earlier of when payments are received or collections are assured, provided that it does not require future performance by the Company. The Company occasionally has sub-license obligations related to arrangements for which it receives license fees, milestones and royalties. The Company evaluates the determination of gross versus net reporting based on each individual agreement.

Sales-based contingent payments from partners are accounted for similarly to royalties, with revenue recognized upon achievement of the sales targets assuming all other revenue recognition criteria for milestones are met. Revenue from development and regulatory milestones is recognized when earned, as evidenced by written acknowledgement from the collaborator, provided that (1) the milestone event is substantive, its achievability was not reasonably assured at

the inception of the agreement, and the Company has no further performance obligations relating to that event, and (2) collectability is reasonably assured. If these criteria are not met, the milestone payment is recognized over the remaining period of the Company's performance obligations under the arrangement.

The Company analyzes its revenue arrangements and other agreements to determine whether there are multiple elements that should be separated and accounted for individually or as a single unit of accounting. For multiple element



Table of Contents

contracts, arrangement consideration is allocated at the inception of the arrangement to all deliverables on the basis of relative selling price, using a hierarchy to determine selling price. Management first considers vendor-specific objective evidence ("VSOE"), then third-party evidence ("TPE") and if neither VSOE nor TPE exist, the Company uses its best estimate of selling price.

Many of the Company's revenue arrangements involve the bundling of a license with the option to purchase manufactured product. Licenses are granted to pharmaceutical companies for the use of Captisol in the development of pharmaceutical compounds. The licenses may be granted for the use of the Captisol product for all phases of clinical trials and through commercial availability of the host drug or may be limited to certain phases of the clinical trial process. Management believes that the Company's licenses have stand-alone value at the outset of an arrangement because the customer obtains the right to use Captisol in its formulations without any additional input by the Company.

## Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts based on the best estimate of the amount of probable losses in the Company's existing accounts receivable. Accounts receivable that are outstanding longer than their contractual payment terms, ranging from 30 to 90 days, are considered past due. When determining the allowance for doubtful accounts, several factors are taken into consideration, including historical write-off experience and review of specific customer accounts for collectability. Account balances are charged off against the allowance after collection efforts have been exhausted and the potential for recovery is considered remote. There was no allowance for doubtful accounts included in the balance sheets at September 30, 2014 and December 31, 2013.

## Accounting for Stock-Based Compensation

Stock-based compensation expense for awards to employees and non-employee directors is recognized on a straight-line basis over the vesting period until the last tranche vests. Compensation cost for consultant awards is recognized over each separate tranche's vesting period. The following table summarizes stock-based compensation expense recorded as components of research and development expenses and general and administrative expenses for the periods indicated (in thousands):

	Three months ended		Nine months ended	
	September 30,	September 30,	September 30,	September 30,
	2014	2013	2014	2013
Stock-based compensation expense as a component of:				
Research and development expenses	\$1,169	\$438	\$2,814	\$1,272
General and administrative expenses	2,533	1,095	5,981	2,877
	\$3,702	\$1,533	\$8,795	\$4,149

The fair-value for options that were awarded to employees and directors was estimated at the date of grant using the Black-Scholes option valuation model with the following weighted-average assumptions:

	Three months ended		Nine months ended	
	September 30,	September 30,	September 30,	September 30,
	2014	2013	2014	2013
Risk-free interest rate	1.9%	1.8%	1.9%	1.4%
Dividend yield	—	—	—	—
Expected volatility	67%	70%	68%	70%
Expected term	6.4	6.3	6.4	6.3
Forfeiture rate	8.6%	8.8%	8.6%-9.7%	8.4%-9.8%

The risk-free interest rate is based on the U.S. Treasury yield curve at the time of the grant. The expected term of the employee and non-employee director options is the estimated weighted-average period until exercise or cancellation of vested options (forfeited unvested options are not considered) based on historical experience. The expected term for consultant awards is the remaining period to contractual expiration. Volatility is a measure of the expected amount of variability in the stock price over the expected life of an option expressed as a standard deviation. In making this assumption, the Company used the

15

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## Table of Contents

historical volatility of the Company's stock price over a period equal to the expected term. The forfeiture rate is based on historical data at the time of the grant.

### Preclinical Study and Clinical Trial Accruals

Substantial portions of the Company's preclinical studies and all of the Company's clinical trials have been performed by third-party laboratories, contract research organizations, or other vendors (collectively "CROs"). Some CROs bill monthly for services performed, while others bill based upon milestone achievement. The Company accrues for each of the agreements it has with CROs on a monthly basis. For preclinical studies, accruals are estimated based upon the percentage of work completed and the contract milestones achieved. For clinical studies, accruals are estimated based upon a percentage of work completed, the number of patients enrolled and the duration of the study. The Company monitors patient enrollment, the progress of clinical studies and related activities to the extent possible through internal reviews of data reported to it by the CROs, correspondence with the CROs and clinical site visits. The Company's estimates are dependent upon the timelines and accuracy of the data provided by its CROs regarding the status of each program and total program spending. The Company periodically evaluates its estimates to determine if adjustments are necessary or appropriate based on information it receives concerning changing circumstances, and conditions or events that may affect such estimates. No material adjustments to preclinical study and clinical trial accrued expenses have been recognized to date.

### Sale of Royalty Rights

The Company previously sold to third parties the rights to future royalties of certain of its products. As part of the underlying royalty agreements, the partners have the right to offset a portion of any future royalty payments owed to the Company to the extent of previous milestone payments. Accordingly, the Company deferred a portion of the revenue associated with each tranche of royalty right sold, equal to the pro-rata share of the potential royalty offset. Such amounts associated with the offset rights against future royalty payments will be recognized as revenue upon receipt of future royalties from the respective partners. As of September 30, 2014 there was no deferred revenue remaining related to the sale of royalty rights. As of December 31, 2013, the Company had deferred \$0.1 million of revenue related to the sale of royalty rights.

### Product Returns

In connection with the sale of the Avinza and Oncology product lines, the Company retained the obligation for returns of product that were shipped to wholesalers prior to the close of the transactions. The accruals for product returns, which were recorded as part of the accounting for the sales transactions, are based on historical experience. Any subsequent changes to the Company's estimate of product returns are accounted for as a component of discontinued operations.

### Milestone Payments

In May 2014, the Company entered into a licensing agreement and research collaboration with Omthera Pharmaceuticals. The research collaboration will target the development of novel products that utilize the proprietary Ligand-developed LTP TECHNOLOGY™ to improve lipid-lowering activity of certain omega-3 fatty acids. The Company is eligible to receive development, regulatory and event-based payments. The completion of a proof of concept under the development program would trigger a \$1.0 million payment which would represent a milestone under the milestone method of accounting as (1) it is an event that can only be achieved in part on the Company's past performance, (2) there was substantive uncertainty at the date the arrangement was entered into that the event would be achieved and (3) it results in additional payment being due to the Company. None of the other event-based payments represents a milestone under the milestone method of accounting. No event based payment or milestone was achieved during the periods presented.

Cost of Goods Sold

The Company determines cost using the first-in, first-out method. Cost of goods sold include all costs of purchase and other costs incurred in bringing the inventories to their present location and condition, including costs to store and distribute.

16

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## Table of Contents

### Research and Development

Collaborative research and development expense consists of labor, material, equipment and allocated facility costs of the Company's scientific staff who are working pursuant to the Company's collaborative agreements. From time to time, collaborative research and development expense includes costs related to research efforts in excess of those required under certain collaborative agreements. Management has the discretion to set the scope of such excess efforts and may increase or decrease the level of such efforts depending on the Company's strategic priorities. Proprietary research and development expense consists of intellectual property in-licensing costs, labor, materials, contracted services, and allocated facility costs that are incurred in connection with internally funded drug discovery and development programs.

### Income Taxes

Income taxes are accounted for under the liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of differences between the tax basis of assets or liabilities and their carrying amounts in the consolidated financial statements. A valuation allowance is provided for deferred tax assets if it is more likely than not that these items will either expire before the Company is able to realize their benefit or if future deductibility is uncertain. As of September 30, 2014, the Company had provided a full valuation allowance against its deferred tax assets as recoverability was uncertain. Developing the provision for income taxes requires significant judgment and expertise in federal and state income tax laws, regulations and strategies, including the determination of deferred tax assets and liabilities and, if necessary, any valuation allowances that may be required for deferred tax assets. The Company's judgments and tax strategies are subject to audit by various taxing authorities. While management believes the Company has provided adequately for its income tax liabilities in its consolidated financial statements, adverse determinations by these taxing authorities could have a material adverse effect on the Company's consolidated financial condition and results of operations.

The Company's ending deferred tax liability represents a future tax obligation for current tax amortization claimed on acquired IPR&D. As the Company cannot estimate when the IPR&D assets will be amortizable for financial reporting purposes, the deferred tax liability associated with the IPR&D assets cannot be used to support the realization of the Company's deferred tax assets. As a result, the Company is required to increase its valuation allowance and record a charge to deferred taxes.

### Discontinued Operations-Oncology Product Line

In September 2006, the Company and Eisai Inc. and Eisai Co., Ltd. (collectively "Eisai"), entered into a purchase agreement (the "Oncology Purchase Agreement"), pursuant to which Eisai agreed to acquire all of the Company's worldwide rights in and to its oncology products, including, among other things, all related inventory, equipment, records and intellectual property, and to assume certain liabilities as set forth in the Oncology Purchase Agreement. The Oncology product line included the Company's four marketed oncology drugs: Ontak, Targretin capsules, Targretin gel and Panretin gel.

### Discontinued Operations-Avinza Product Line

In September 2006, the Company and King Pharmaceuticals, now a subsidiary of Pfizer, entered into a purchase agreement (the "Avinza Purchase Agreement"), pursuant to which Pfizer acquired all of the rights in and to Avinza in the United States, its territories and Canada, including, among other things, all Avinza inventory, records and related intellectual property, and to assume certain liabilities as set forth in the Avinza Purchase Agreement.

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

During the three and nine months ended September 30, 2014 and the three months ended September 30, 2013 the Company did not recognize any gain or loss on the sale of the Avinza product line. The Company recognized a pre-tax gain of \$2.6 million for the nine months ended September 30, 2013, due to subsequent changes in certain estimates and liabilities recorded as of the sale date.

## Table of Contents

### Segment Reporting

Under ASC 280, Segment Reporting ("ASC 280"), operating segments are defined as components of an enterprise about which separate financial information is available that is regularly evaluated by the entity's chief operating decision maker, in deciding how to allocate resources and in assessing performance. The Company has evaluated this codification and has identified two reportable segments: the development and commercialization of drugs using Captisol technology by CyDex and the biopharmaceutical company with a business model that is based upon the concept of developing or acquiring royalty revenue generating assets and coupling them with a lean corporate cost structure.

### Comprehensive Income

Comprehensive income represents net income adjusted for the change during the periods presented in unrealized gains and losses on available-for-sale securities less reclassification adjustments for realized gains or losses included in net income. The unrealized gains or losses are reported on the consolidated statements of comprehensive income.

### Consolidation of Variable Interest Entities

The Company identifies an entity as a VIE if either: (1) the entity does not have sufficient equity investment at risk to permit the entity to finance its activities without additional subordinated financial support, or (2) the entity's equity investors lack the essential characteristics of a controlling financial interest. The Company performs ongoing qualitative assessments of its VIEs to determine whether the Company has a controlling financial interest in any VIE and therefore is the primary beneficiary. If the Company is the primary beneficiary of a VIE, it must consolidate the VIE under applicable accounting guidance. The Company determined it holds a variable interest in Viking based on management's assessment that it does not have sufficient resources to carry out its principal activities without the support of the Company. The Company's variable interests in Viking are a loan provided by the Company to Viking and a license agreement executed concurrently. As of September 30, 2014, the Company's total assets include \$2.9 million related to Viking and the Company's total liabilities include \$4.5 million related to Viking. Viking's consolidated assets are owned by Viking, and Viking's consolidated liabilities are without recourse against Ligand.

### New Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. Under ASU 2013-02, an entity is required to provide information about the amounts reclassified out of Accumulated Other Comprehensive Income ("AOCI") by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. Implementing ASU 2013-02 did not change the current requirements for reporting net income or other comprehensive income in the financial statements. The amendments in this ASU are effective for the Company for fiscal years, and interim periods within those years, beginning after January 1, 2014. The Company's adoption of this standard did not materially affect the consolidated financial statements.

In July 2013, FASB issued ASU 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. ASU 2013-11 requires the netting of unrecognized tax benefits ("UTBs") against a deferred tax asset for a loss or other carryforward that would apply in settlement of the uncertain tax positions. UTBs are required to be netted against all available same-jurisdiction loss or other tax carryforwards that would be utilized, rather than only against carryforwards that are created by the UTBs. ASU 2013-11 is effective for the Company for interim and annual periods beginning after December 15, 2013. The

Company's adoption of this standard did not materially affect the consolidated financial statements.

In April 2014, FASB issued ASU 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. ASU 2014-08 raises the threshold for a disposal to qualify as a discontinued operation and modifies the related disclosure requirements. Under the new guidance, only disposals resulting in a strategic shift that will have a major effect on an entity's operations and financial results will be reported as discontinued operations. ASU 2014-08 also removes the requirement that an entity not have any significant continuing involvement in the operations of the component after disposal to qualify for reporting of the disposal as a discontinued operation. The guidance is effective for annual and interim periods beginning after December 15, 2014, with early adoption permitted for any disposal transaction not previously reported.



## Table of Contents

Management does not believe the adoption of this guidance will have a material impact on the Company's consolidated financial statements.

In May 2014, FASB issued ASU 2014-09, Revenue from Contracts with Customers. ASU 2014-09 is effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods. The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: (1) identify the contract with the customer, (2) identify the performance obligations in the contract, (3) determine the transaction price, (4) allocate the transaction price to the performance obligations in the contract, (5) recognize revenue when (or as) the entity satisfies a performance obligation. Management is currently evaluating the effect the adoption of this standard will have on the Company's financial statements.

In June 2014, FASB issued ASU 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period. The amendments in this update require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. A reporting entity should apply existing guidance in ASC 718, Compensation - Stock Compensation, as it relates to awards with performance conditions that affect vesting to account for such awards. The amendments in this update will be effective for the Company as of January 1, 2016. Earlier adoption is permitted. Entities may apply the amendments in this update either: (1) prospectively to all awards granted or modified after the effective date; or (2) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. If a retrospective transition is adopted, the cumulative effect of applying this update as of the beginning of the earliest annual period presented in the financial statements should be recognized as an adjustment to the opening retained earnings balance at that date. In addition, if a retrospective transition is adopted, an entity may use hindsight in measuring and recognizing the compensation cost. Management is currently assessing the impact of this update, and believes that its adoption on January 1, 2016 will not have a material impact on the Company's consolidated financial statements.

In August 2014, FASB issued ASU 2014-15, Presentation of Financial Statements - Going Concern. The amendments in this update require management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically, the amendments (1) provide a definition of the term substantial doubt, (2) require an evaluation every reporting period, including interim periods, (3) provide principles for considering the mitigating effect of management's plans, (4) require certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans, (5) require an express statement and other disclosures when substantial doubt is not alleviated, and (6) require an assessment for a period of one year after the date that the financial statements are issued (or available to be issued). The amendments in this update are effective for the Company as of January 1, 2017. Early application is permitted. Management is currently assessing the impact of this update on its future discussion of its liquidity position in the Management's Discussion and Analysis.

## 2. Fair Value Measurements

The Company measures certain financial assets and liabilities at fair value on a recurring basis, including equity securities, co-promote termination payments receivable and the related liability, contingent liabilities, and the Company's convertible senior notes.

### Level 1

The fair value of the Company's investments which are classified as short-term investments is determined using quoted market prices in active markets. These securities were received by the Company in December 2012 and June 2014 as a result of an event-based payment and an upfront license payment, respectively, under licensees. Additionally, the liability for CVRs for Metabasis are determined using quoted market prices in active markets.

Level 2

The fair value of the Company's convertible senior notes is estimated by using the quoted market rate in an inactive market, which is classified as a Level 2 input.

Table of Contents

## Level 3

The co-promote termination payments receivable represents a non-interest bearing receivable for future payments to be made by Pfizer and is recorded at its fair value. The fair value is subjective and is affected by changes in inputs to the valuation model including management's assumptions regarding future Avinza product sales. The receivable and liability will remain equal, and are adjusted each reporting period for changes in the fair value of the obligation including any changes in the estimate of future net Avinza product sales. The fair value of the liabilities for CyDex contingent liabilities were determined based on the income approach using a Monte Carlo analysis. The fair value is subjective and is affected by changes in inputs to the valuation model including management's assumptions regarding revenue volatility, probability of commercialization of products, estimates of timing and probability of achievement of certain revenue thresholds and developmental and regulatory milestones which may be achieved and affect amounts owed to former license holders and CVR holders. Changes in these assumptions can materially affect the fair value estimate.

The following table provides a summary of the carrying value of assets and liabilities that are measured at fair value on a recurring basis as of September 30, 2014 (in thousands):

## Fair Value Measurements at Reporting Date Using

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Current co-promote termination payments receivable	\$ 523	\$—	\$—	\$ 523
Available-for-sale securities	5,925	5,925	—	—
Total assets	\$6,448	\$5,925	\$—	\$ 523
<b>Liabilities:</b>				
Current contingent liabilities-CyDex	\$4,184	\$—	\$—	\$4,184
Current co-promote termination liability	523	—	—	523
Long-term contingent liabilities-Metabasis	3,511	3,511	—	—
Long-term contingent liabilities-CyDex	8,755	—	—	8,755
Liability for short-term investments owed to former licensees	917	917	—	—
Total liabilities	\$17,890	\$4,428	\$—	\$13,462

Table of Contents

The following table provides a summary of the assets and liabilities that are measured at fair value on a recurring basis as of December 31, 2013 (in thousands):

## Fair Value Measurements at Reporting Date Using

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Current portion of co-promote termination payments receivable	\$4,329	\$—	\$—	\$4,329
Available-for-sale securities	4,340	4,340	—	—
Long-term portion of co-promote termination payments receivable	7,417	—	—	7,417
Total assets	\$16,086	\$4,340	\$—	\$11,746
<b>Liabilities:</b>				
Current portion of contingent liabilities-CyDex	\$1,712	\$—	\$—	\$1,712
Current portion of co-promote termination liability	4,329	—	—	4,329
Long-term portion of contingent liabilities-Metabasis	4,196	4,196	—	—
Long-term portion of contingent liabilities-CyDex	7,599	—	—	7,599
Liability for short-term investments owed to licensors	651	651	—	—
Long-term portion of co-promote termination liability	7,417	—	—	7,417
Total liabilities	\$25,904	\$4,847	\$—	\$21,057

## Other Fair Value Measurements-2019 Convertible Senior Notes

In August 2014, the Company issued \$245.0 million aggregate principal amount of convertible senior unsecured notes due 2019 (the "2019 Convertible Senior Notes"). The Company uses a quoted market rate in an inactive market, which is classified as a Level 2 input, to estimate the current fair value of its 2019 Convertible Senior Notes. The estimated fair value of the 2019 Senior Convertible Notes was \$229.8 million as of September 30, 2014. The carrying value of the notes does not reflect the market rate. See Note 7 Financing Arrangements for additional information.

The following table represents significant unobservable inputs used in determining the fair value of contingent liabilities assumed in the acquisition of CyDex:

	September 30, 2014	December 31, 2013
Range of annual revenue subject to revenue sharing (1)	\$17.9 million-\$20.5 million	\$4.2 million-\$19.8 million
Revenue volatility	25%	25%
Average of probability of commercialization	83.8%	67.6%
Sales beta	0.60	0.60
Credit rating	B	BBB
Equity risk premium	6%	6%

Revenue subject to revenue sharing represent management's estimate of the range of total annual revenue subject to (1) revenue sharing (i.e. annual revenues in excess of \$15 million) through December 31, 2016, which is the term of the CVR agreement.



Table of Contents

A reconciliation of the level 3 financial instruments as of September 30, 2014 is as follows (in thousands):

## Assets:

Fair value of level 3 financial instrument assets as of December 31, 2013	\$11,746	
Assumed payments made by Pfizer or assignee	(1,002	)
Fair value adjustments to co-promote termination liability	(10,221	)
Fair value of level 3 financial instrument assets as of September 30, 2014	\$523	

## Liabilities:

Fair value of level 3 financial instrument liabilities as of December 31, 2013	\$21,057	
Assumed payments made by Pfizer or assignee	(1,002	)
Payments to CVR and other former license holders	(1,936	)
Fair value adjustments to contingent liabilities	5,564	
Fair value adjustments to co-promote termination liability	(10,221	)
Fair value of level 3 financial instrument liabilities as of September 30, 2014	\$13,462	

## 3. Variable Interest Entities

The Company determined it holds a variable interest in Viking based on management's assessment that Viking does not have sufficient resources to carry out its principal activities without the support of the Company. The Company's variable interests in Viking are a loan provided by the Company to Viking and a license agreement executed concurrently. Additionally, the Company has a shared services and sublease agreement with Viking. The Company examines specific criteria and uses judgment when determining if the Company is the primary beneficiary of a VIE and therefore required to consolidate the investment. Factors considered in determining whether the Company is the primary beneficiary include risk and reward sharing, experience and financial condition of its partner, voting rights, involvement in day-to-day operating decisions, representation on Viking's executive committee, and level of economics between the Company and Viking.

In May 2014, the Company entered into a Master License Agreement to license rights to five programs to Viking, an unrelated clinical-stage biopharmaceutical company focused on the development of novel therapies for metabolic and endocrine disorders. As part of this transaction, the Company extended a \$2.5 million convertible loan facility to Viking that can be used to pay Viking's operating and financing-related expenses. Under the terms of the convertible loan facility, the principal amount outstanding accrues interest at a fixed rate equal to the lesser of 5% and the maximum interest rate permitted by law. The loan is due and payable in May 2016, unless the loans are converted into equity prior to such time. Upon the earlier to occur of an Initial Public Offering ("IPO") or a qualified financing event, the Company may elect to be repaid in cash or equity equal to 200% of the accrued principal and interest. The Company funded \$2.0 million towards the convertible loan facility as of September 30, 2014.

The debt conversion feature embedded in the loan is accounted for under ASC Topic 815 Derivatives and Hedging. The valuation of the bifurcated debt conversion feature was performed using Level 3 inputs, requiring Viking to make assumptions about the probability of the occurrence of an IPO or qualified financing and the loan being converted based on the applicable conversion terms.

As partial consideration for the grant of the rights and licenses under the license agreement, in the event Viking consummates an IPO or other qualified financing event, Viking will issue to the Company a certain amount of equity. At the closing of an IPO a number of shares of common stock having an aggregate value of \$29.0 million will be issued to the Company, subject to adjustment in certain circumstances. In the event Viking consummates a private financing prior to an IPO, the Company has the option to receive a number of shares of the same class and type of securities issued in the private financing having an aggregate value of \$29.0 million, subject to adjustment in certain

circumstances. The Company has the right to terminate the license agreement on or after April 30, 2015 if Viking has neither completed an IPO nor received aggregate net proceeds of at least \$20.0 million in one or more private financings. The Company also has the right to terminate the license agreement in the event of insolvency or bankruptcy of Viking. On July 1, 2014, Viking filed an initial Form S-1 with the Securities and Exchange Commission for an IPO. As of the date of this report, the filed Form S-1 has not been declared effective. As of September 30, 2014, no amounts have been recorded for the potential receipt of equity related to a financing transaction in accordance with authoritative guidance.

Table of Contents

The following table represents the consolidated assets and liabilities, which are owned by and are obligations of Viking and are with no recourse to the Company, as of September 30, 2014 (in thousands):

	September 30, 2014
Cash and cash equivalents	\$794
Other current assets	17
Capitalized IPO expenses	2,131
Total current assets	\$2,942
Other assets	1
Total assets	\$2,943
Accounts payable	\$2,225
Accrued liabilities	77
Current portion of notes payable	337
Total current liabilities	\$2,639
Long-term portion of notes payable	1,893
Total liabilities	\$4,532

The Company has recorded 100% of the losses incurred since May 21, 2014, the effective date of the transaction, as net loss attributable to noncontrolling interest due to the fact that it is considered a primary beneficiary with no equity interest in the VIE. The advances under the loan agreement are included as notes payable by Viking and are eliminated in consolidation.

#### 4. Avinza Co-Promotion

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

In January 2006, the Company and King Pharmaceuticals, now a subsidiary of Pfizer, entered into an agreement pursuant to which Pfizer acquired all of the Company's rights in and to Avinza. Pfizer also assumed the Company's co-promote termination obligation to make royalty payments to Organon based on net sales of Avinza. In connection with Pfizer's assumption of this obligation, Organon did not consent to the legal assignment of the co-promote termination obligation to Pfizer. Accordingly, the Company remains liable to Organon in the event of Pfizer's default of the obligation. Therefore, the Company recorded an asset as of February 26, 2007 to recognize Pfizer's assumption of the obligation, while continuing to carry the co-promote termination liability in the Company's consolidated financial statements to recognize the Company's legal obligation as primary obligor to Organon. This asset represents a non-interest bearing receivable for future payments to be made by Pfizer and is recorded at its fair value. The receivable and liability will remain equal, and are adjusted each reporting period for changes in the fair value of the obligation including for any changes in the estimate of future net Avinza product sales. This receivable will be assessed on a quarterly basis or when a triggering event occurs for impairment (e.g. in the event Pfizer defaults on the assumed obligation to pay Organon).



On a quarterly basis, management reviews the carrying value of the co-promote termination liability. In February 2014, Actavis launched a generic form of Avinza which resulted in a significant decrease in estimates of future net sales used to value the co-promote termination asset and liability. Due to assumptions and judgments inherent in determining the estimates of future net Avinza sales through November 2017, the actual amount of net Avinza sales used to determine the current fair value of the Company's co-promote termination asset and liability may be materially different from current estimates.

Table of Contents

A summary of the co-promote termination liability as of September 30, 2014 is as follows (in thousands):

Net present value of payments based on estimated future net Avinza product sales as of December 31, 2013	\$ 11,746
Assumed payments made by Pfizer or assignee	(1,002 )
Fair value adjustments	(10,221 )
Total co-promote termination liability as of September 30, 2014	\$ 523

## 5. Lease Obligations

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

Operating lease obligations:	Lease Termination Date	Less than 1 year	1-3 years	3-5 years	More than 5 years	Total
Corporate headquarters-San Diego, CA	July 2019	\$677	\$1,409	\$1,293	\$—	\$3,379
Bioscience and Technology Business Center-Lawrence, KS	December 2017	55	108	13	—	176
Vacated office and research facility-San Diego, CA	July 2015	1,912	—	—	—	1,912
Vacated office and research facility-Cranbury, NJ	August 2016	2,576	2,397	—	—	4,973
Total operating lease obligations		\$5,220	\$3,914	\$1,306	\$—	\$10,440
Sublease payments expected to be received:		Less than 1 year	1-3 years	3-5 years	More than 5 years	Total
Office and research facility-San Diego, CA	July 2015	\$771	\$—	\$—	\$—	\$771
Office and research facility-Cranbury, NJ	August 2014 and 2016	492	464	—	—	956
Net operating lease obligations		\$3,957	\$3,450	\$1,306	\$—	\$8,713

In 2010, the Company ceased use of its facility located in New Jersey. As a result, the Company recorded lease exit costs of \$9.7 million for costs related to the difference between the remaining lease obligations of the abandoned operating leases, which run through August 2016, and management's estimate of potential future sublease income, discounted to present value. In addition, the Company wrote-off property and equipment with a net book value of approximately \$5.4 million related to the facility closure.

As of September 30, 2014 and December 31, 2013, the Company had lease exit obligations of \$3.7 million and \$5.9 million, respectively. For the three and nine months ended September 30, 2014, the Company made cash payments, net of sublease payments received of \$0.8 million and \$2.6 million, respectively. The Company recognized

adjustments for accretion and changes in leasing assumptions of \$0.2 million and \$0.5 million for the three and nine months ended September 30, 2014, respectively. For the three and nine months ended September 30, 2013, the Company made cash payments, net of sublease payments received of \$0.9 million and \$2.8 million, respectively. The Company recognized adjustments for accretion and changes in leasing assumptions of \$0.2 million and \$0.4 million for the three and nine months ended September 30, 2013, respectively.

Table of Contents

Total rent expense under all office leases for each of the three and nine months ended September 30, 2014 and 2013 was \$0.2 million and \$0.5 million, respectively. The Company recognizes rent expense on a straight-line basis. Deferred rent at September 30, 2014 and December 31, 2013 was \$0.3 million and \$0.4 million, respectively, and is included in other long-term liabilities.

Table of Contents

## 6. Segment Reporting

The Company evaluates performance based on the operating income (loss) of the respective business segments. The segment results may not represent actual results that would be expected if they were independent, stand-alone businesses. Segment information is as follows (in thousands):

Balance Sheet Data:	As of September 30, 2014		
	Ligand	CyDex	Total
Total assets	\$203,296	\$68,987	\$272,283
	As of December 31, 2013		
	Ligand	CyDex	Total
Total assets	\$38,408	\$66,305	\$104,713
Operating Data:	For the three months ended September 30, 2014		
	Ligand	CyDex	Total
Net revenues from external customers	\$6,424	\$8,549	\$14,973
Depreciation and amortization expense	(61	) (601	) (662
Operating (loss) income	(1,683	) 5,215	3,532
Interest expense, net	(1,516	) —	(1,516
Income tax expense from continuing operations	(115	) (9	) (124
	For the three months ended September 30, 2013		
	Ligand	CyDex	Total
Net revenues from external customers	4,731	8,274	\$13,005
Depreciation and amortization expense	(62	) (606	) \$(668
Operating (loss) income	(1,142	) 4,212	\$3,070
Interest expense, net	(394	) —	\$(394
Income tax (expense) benefit from continuing operations	(70	) 10	\$(60
Gain on sale of Avinza Product Line before income taxes	—	—	\$—
	For the nine months ended September 30, 2014		
	Ligand	CyDex	Total
Net revenues from external customers	18,907	22,632	\$41,539
Depreciation and amortization expense	(194	) (1,804	) (1,998
Operating (loss) income	(2,622	) 12,611	9,989
Interest expense, net	(1,946	) —	(1,946
Income tax expense from continuing operations	(123	) (8	) (131
	For the nine months ended September 30, 2013		
	Ligand	CyDex	Total
Net revenues from external customers	\$14,789	\$19,448	\$34,237
Depreciation and amortization expense	(179	) (1,828	) (2,007
Write-off of in-process research and development	—	480	480
Operating income	(944	) 9,462	8,518
Interest expense, net	(1,755	) —	(1,755
Income tax (expense) benefit from continuing operations	(301	) 64	(237
Gain on sale of Avinza Product Line before income taxes	2,588	—	2,588



Table of Contents

7. Financing Arrangements

Term loan facility

The Company fully repaid its secured term loan credit facility on July 31, 2014. Under the terms of the secured debt, the Company made interest-only payments through February 2013. Subsequent to the interest-only payments, the note amortized with principal and interest payments through the remaining term of the loan. Additionally, the Company made an additional final payment equal to 6% of the total amount borrowed which was due at maturity and was accreted over the life of the loan.

0.75% Convertible Senior Notes Due 2019

In August 2014, the Company issued \$245.0 million aggregate principal amount of its 2019 Convertible Senior Notes, resulting in net proceeds of \$239.3 million. The 2019 Convertible Senior Notes are convertible into common stock at an initial conversion rate of 13.3251 shares per \$1,000 principal amount of convertible notes, subject to adjustment upon certain events, which is equivalent to an initial conversion price of approximately \$75.05 per share of common stock. The initial conversion price of the notes represents a premium of approximately 35% to the \$55.59 per share close price of the Company's common stock on August 12, 2014. The notes bear interest at a rate of 0.75% per year, payable semi-annually. Holders of the 2019 Convertible Senior Notes may convert the notes at any time prior to the close of business on the business day immediately preceding May 15, 2019, under any of the following circumstances: (1) during any fiscal quarter (and only during such fiscal quarter) commencing after December 31, 2014, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of the Company's common stock on such trading day is greater than 130% of the conversion price on such trading day; (2) during the five business day period immediately following any ten consecutive trading day period, in which the trading price per \$1,000 principal amount of notes was less than 98% of the product of the last reported sale price of the Company's common stock on such trading day and the conversion rate on each such trading day; or (3) upon the occurrence of certain specified corporate events as specified in the indenture governing the notes. On or after May 15, 2019 until the close of business on the second scheduled trading day immediately preceding August 15, 2019, holders of the notes may convert all or a portion of their notes at any time, regardless of the foregoing circumstances. Upon conversion, Ligand must deliver cash to settle the principal and may deliver cash or shares of common stock, at the option of the Company, to settle any premium due upon conversion.

In accordance with accounting guidance for debt related to conversion and other options, the Company separately accounted for the debt and equity components of the 2019 Convertible Senior Notes by allocating the \$245.0 million total proceeds between the debt component and the embedded conversion option, or equity component, due to Ligand's ability to settle the 2019 Convertible Senior Notes in cash for the principal portion and to settle any premium in cash or common stock, at the Company's election. The debt allocation was performed in a manner that reflected the Company's non-convertible borrowing rate for similar debt of 5.83% derived from independent valuation analysis. The initial debt value of \$192.5 million accretes at 5.83% to reach \$245.0 million at the maturity date. The equity component of the 2019 Convertible Senior Notes was recognized as a debt discount and represents the difference between the \$245.0 million proceeds at issuance of the 2019 Convertible Senior Notes and the fair value of the debt allocation on their respective issuance dates. The debt discount is amortized to interest expense using the effective interest method over the expected life of a similar liability without an equity component. The notes will have a dilutive effect to the extent the average market price per share of common stock for a given reporting period exceeds the conversion price of \$75.05. As of September 30, 2014, the "if-converted value" did not exceed the principal amount of the 2019 Convertible Senior Notes.

In connection with the issuance of the 2019 Convertible Senior Notes, the Company incurred \$5.7 million of issuance costs, which primarily consisted of underwriting, legal and other professional fees. The portions of these costs allocated to the equity components totaling \$1.2 million were recorded as a reduction to additional paid-in capital. The portions of these costs allocated to the liability components totaling \$4.5 million were recorded as assets on the balance sheet. The portions allocated to the liability components are amortized to interest expense using the effective interest method over the expected life of the 2019 Convertible Senior Notes.

The Company determined the expected life of the debt discount for the 2019 Convertible Senior Notes to be equal to the original five-year term of the notes. The carrying value of the equity component related to the 2019 Convertible Senior Notes as of September 30, 2014, net of issuance costs, was \$51.3 million.



Table of Contents

## Convertible Bond Hedge and Warrant Transactions

In August 2014, in connection with the issuance of the 2019 Convertible Senior Notes, to minimize the impact of potential dilution to the Company's common stock upon conversion of such notes, the Company entered into convertible bond hedges and sold warrants covering approximately 3,264,643 shares of its common stock. The convertible bond hedges have an exercise price of \$75.05 per share and are exercisable when and if the 2019 Convertible Senior Notes are converted. If upon conversion of the 2019 Convertible Senior Notes, the price of the Company's common stock is above the exercise price of the convertible bond hedges, the counterparties will deliver shares of common stock and/or cash with an aggregate value approximately equal to the difference between the price of common stock at the conversion date and the exercise price, multiplied by the number of shares of common stock related to the convertible bond hedge transaction being exercised. The convertible bond hedges and warrants described below are separate transactions entered into by the Company and are not part of the terms of the 2019 Convertible Senior Notes. Holders of the 2019 Convertible Senior Notes and warrants will not have any rights with respect to the convertible bond hedges. The Company paid \$48.1 million for these convertible bond hedges and recorded the amount as a reduction to additional paid-in capital.

Concurrently with the convertible bond hedge transactions, the Company entered into warrant transactions whereby it sold warrants to acquire, approximately 3,264,643 shares of common stock with an exercise price of approximately \$125.08 per share, subject to certain adjustments. The warrants have various expiration dates ranging from November 13, 2019 to April 22, 2020. The warrants will have a dilutive effect to the extent the market price per share of common stock exceeds the applicable exercise price of the warrants, as measured under the terms of the warrant transactions. The Company received \$11.6 million for these warrants and recorded this amount to additional paid-in capital. The common stock issuable upon exercise of the warrants will be in unregistered shares, and the Company does not have the obligation and does not intend to file any registration statement with the Securities and Exchange Commission registering the issuance of the shares under the warrants.

The carrying values and the fixed contractual coupon rates of the Company's financing arrangements as of September 30, 2014 and December 31, 2013 were as follows (in thousands):

	September 30, 2014	December 31, 2013
2019 Convertible Senior Notes		
Principal amount outstanding	\$245,000	\$—
Unamortized discount	(51,369)	—
Net carrying amount	193,631	—
Convertible notes payable, Viking Therapeutics, Inc.	337	—
Current portion notes payable, 8.64%, due August 1, 2014	—	6,642
Current portion notes payable, 8.9012%, due August 1, 2014	—	2,467
Total notes payable	\$193,968	\$9,109

## 8. Stockholders' Equity

The Company grants options and awards to employees, non-employee consultants, and non-employee directors. Only new shares of common stock are issued upon the exercise of stock options. Non-employee directors are accounted for as employees. Options and restricted stock granted to certain directors vest in equal monthly installments over the one-year period following the date of grant. Options granted to employees vest 1/8 on the six month anniversary of the date of grant, and 1/48 each month thereafter for 42 months. Option awards generally expire ten years from the date of grant.

Stock Option Activity

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

28

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Table of Contents

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term in Years	Aggregate Intrinsic Value (In thousands)
Balance as of December 31, 2013	1,746,709	\$16.79	7.6	\$62,705
Granted	366,184	73.81		
Exercised	(262,820 )	15.43		
Forfeited	(49,967 )	16.69		
Cancelled	(4,414 )	80.81		
Balance as of September 30, 2014	1,795,692	28.46	7.5	\$43,200
Exercisable as of September 30, 2014	1,052,706	20.00	7.5	\$30,339
Options vested and expected to vest as of September 30, 2014	1,795,692	28.46	6.8	\$43,200

The weighted-average grant date fair value of all stock options granted during the nine months ended September 30, 2014 was \$47.44 per share. The total intrinsic value of all options exercised during the nine months ended September 30, 2014 and 2013 was approximately \$14.7 million and \$3.6 million, respectively. As of September 30, 2014, there was \$14.6 million of total unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a weighted-average period of 2.3 years.

Net cash received from options exercised during the nine months ended September 30, 2014 and 2013 was approximately \$4.1 million and \$2.3 million, respectively. There is no current tax benefit related to options exercised because of net operating losses for which a full valuation allowance has been established.

As of September 30, 2014, 1.1 million shares were available for future option grants or direct issuance under the Company's 2002 Stock Incentive Plan, as amended.

#### Restricted Stock Activity

Restricted stock activity for the nine months ended September 30, 2014 was as follows:

	Shares	Weighted-Average Grant Date Fair Value
Nonvested at December 31, 2013	115,386	\$21.93
Granted	41,671	72.50
Vested	(74,312 )	25.21
Cancelled	(3,972 )	18.42
Nonvested at September 30, 2014	78,773	\$45.77

Restricted stock awards generally vest over three years. As of September 30, 2014, there was \$2.3 million of total unrecognized compensation cost related to nonvested restricted stock. That cost is expected to be recognized over a weighted-average period of 1.5 years.

#### Employee Stock Purchase Plan

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

The Amended ESPP allows employees to purchase Ligand common stock at the end of each six month period at a price equal to 85% of the lesser of fair market value on either the start date of the period or the last trading day of the period (the "Lookback Provision"). The 15% discount and the Lookback Provision make the Amended ESPP compensatory. There were 2,230 and 5,016 shares of common stock issued under the amended ESPP during the nine months ended September 30,

## Table of Contents

2014 and 2013, respectively. The Company recorded compensation expense related to the ESPP of \$43,515 and \$37,000 for the nine months ended September 30, 2014 and 2013, respectively. As of September 30, 2014, 77,285 shares were available for future purchases under the Amended ESPP.

### Public Offerings

During the three and nine months ended September 30, 2014 and 2013, the Company did not issue any common shares pursuant to its at-the-market equity issuance plan.

### Corporate Share Repurchases

In August 2014, the Company's Board of Directors authorized the Company to repurchase up to \$200.0 million of its common stock for a period of up to one year. During the three and nine months ended September 30, 2014 the Company repurchased 692,800 common shares pursuant to the repurchase program for an aggregate purchase price of approximately \$38.5 million. Subsequent to the end of the quarter through October 30, 2014, the Company repurchased an additional 110,000 common shares for an aggregate purchase price of approximately \$5.0 million.

## 9. Litigation

The Company records an estimate of a loss when the loss is considered probable and estimable. Where a liability is probable and there is a range of estimated loss and no amount in the range is more likely than any other number in the range, the Company records the minimum estimated liability related to the claim in accordance with ASC Topic 450-Contingencies. As additional information becomes available, the Company assesses the potential liability related to its pending litigation and revises its estimates. Revisions in the Company's estimates of potential liability could materially impact its results of operations.

### Securities Litigation

On June 8, 2012, a federal securities class action and shareholder derivative lawsuit was filed in the Eastern District of Pennsylvania against Genaera Corporation and its officers, directors, major shareholders and trustee ("Genaera Defendants") for allegedly breaching their fiduciary duties to Genaera shareholders. The lawsuit also names the Company and its CEO as additional defendants for allegedly aiding and abetting the Genaera Defendants' various breaches of fiduciary duties based on the Company's purchase of a licensing interest in a development-stage pharmaceutical drug program from the Genaera Liquidating Trust in May 2010 and the Company's subsequent sale of half of its interest in the transaction to Biotechnology Value Fund, Inc.

Following an amendment to the complaint and a round of motions to dismiss, the court dismissed the amended complaint with prejudice on August 12, 2013. Plaintiff appealed that dismissal on September 10, 2013, and the Third Circuit reversed on October 17, 2014. The Company intends to continue to vigorously defend against the claims against the Company and its CEO. Due to the complex nature of the legal and factual issues involved, however, the outcome of this matter is not presently determinable.

### Other Litigation

On June 19, 2014, a complaint was filed in California Superior Court seeking attorneys' fees in connection with claims related to executive compensation matters described in the Company's June 6, 2013 supplemental proxy materials. On August 1, 2014 the Company filed an answer denying all allegations in the complaint and asserting several affirmative defenses. Management believes the fees demanded by plaintiffs' counsel are excessive and the Company intends to defend itself vigorously in the litigation. Due to the complex nature of the legal and factual issues involved, however, the outcome of this matter is not presently determinable.

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

Caution: This discussion and analysis may contain predictions, estimates and other forward-looking statements that involve a number of risks and uncertainties, including those discussed in Part II, Item 1A: "Risk Factors." This outlook represents our current judgment on the future direction of our business. These statements include those related to our Captisol-related revenues, our Promacta, Kyprolis, and other product royalty revenues, product returns, and product development.

30

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## Table of Contents

Actual events or results may differ materially from our expectations. For example, there can be no assurance that our revenues or expenses will meet any expectations or follow any trend(s), that we will be able to retain our key employees or that we will be able to enter into any strategic partnerships or other transactions. We cannot assure you that we will receive expected Promacta, Kyprolis, Captisol and other product revenues to support our ongoing business or that our internal or partnered pipeline products will progress in their development, gain marketing approval or achieve success in the market. In addition, ongoing or future arbitration, or litigation or disputes with third parties may have a material adverse effect on us. Such risks and uncertainties, and others, could cause actual results to differ materially from any future performance suggested. We undertake no obligation to make any revisions to these forward-looking statements to reflect events or circumstances arising after the date of this quarterly report. This caution is made under the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act.

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

References to “Ligand Pharmaceuticals Incorporated,” “Ligand,” the “Company,” “we” or “our” include our wholly owned subsidiaries: Ligand JVR, Allergan Ligand Retinoid Therapeutics, Seragen, Inc., Pharmacopeia, Inc., or Pharmacopeia, Neurogen Corporation, or Neurogen, CyDex Pharmaceuticals, Inc., or CyDex, Metabasis Therapeutics, Inc., or Metabasis, and Nexus VI, Inc.

## Overview

We are a biotechnology company that develops and acquires revenue generating assets and coupling them with a lean corporate cost structure. Our goal is to create a sustainably profitable business and generate meaningful value for our stockholders. Since a portion of our business model is based on the goal of partnering with other pharmaceutical companies to commercialize and market our assets, a significant amount of our revenue is based largely on payments made to us by partners for royalties, milestones, event-based payments, and license fees. We recognized the important role of the drug reformulation segment in the pharmaceutical industry and in 2011 added Captisol® to our technology portfolio. Captisol is a formulation technology that has enabled seven FDA approved products, including Onyx's Kyprolis® and Baxter International's Nexterone® and is currently being developed in a number of clinical-stage partner programs. In comparison to our peers, we believe we have assembled one of the largest and most diversified asset portfolios in the industry with the potential to generate significant revenue in the future. The therapies in our development portfolio address the unmet medical needs of patients for a broad spectrum of diseases including hepatitis, multiple myeloma, muscle wasting, Alzheimer's disease, dyslipidemia, diabetes, anemia, epilepsy, FSGS and osteoporosis. We have established multiple alliances with the world's leading pharmaceutical companies including GlaxoSmithKline, Onyx Pharmaceuticals (a subsidiary of Amgen, Inc.), Merck, Pfizer, Baxter International, Lundbeck Inc., Eli Lilly and Co., and Spectrum Pharmaceuticals, Inc.

Highlights from the first nine months of 2014 include:

We received a \$1.0 million commercial sales-based contingent payment from Onyx. The payment was triggered by the achievement of over \$250.0 million of annual product sales of Kyprolis in 2013.

We received a \$1.0 million event-based payment as a result of the recent FDA approval of Merck's NOXAFIL® which is a new Captisol-enabled formulation of NOXAFIL for intravenous (IV) use. Additionally, we earned a \$0.6 million event-based payment upon approval for Captisol-enabled NOXAFIL® (posaconazole) from the European Medicines Agency ("EMA"). We will also generate revenue from Captisol material sales to Merck for this product under a commercial supply agreement.

Our partner Lundbeck LLC announced that the FDA accepted for review a New Drug Application ("NDA") for its investigational therapy intravenous carbamazepine, an intravenous formulation of the anti-epileptic drug

carbamazepine. With acceptance of the NDA filing, we earned a \$0.2 million event-based payment.

We completed the dosing of the last patient in its Glucagon Receptor Agonist Phase 1 Single Ascending Dose (SAD) clinical trial and also presented positive data from that trial at the American Diabetes Association Scientific Sessions meeting.

We received an event-based payment of \$0.2 million in connection with an amendment to our license agreement with Sage Therapeutics, Inc. for the additional of a new subfield.



## Table of Contents

We received a \$0.1 million project development fee as a result of entering into a licensing agreement and research collaboration with Omthera Pharmaceuticals. The research collaboration will target the development of novel products that utilize the proprietary Ligand-developed LTP TECHNOLOGY™ to improve lipid-lowering activity of certain omega-3 fatty acids. Under the terms of the agreement, we will be eligible to receive payments of up to \$44.5 million upon the achievement of specific events, as well as tiered royalties ranging from mid to high single digit percentages of net sales.

We entered into a master license agreement with Viking covering the following five programs: FBPase inhibitor program for type 2 diabetes, a Selective Androgen Receptor Modulator (SARM) program for muscle wasting, a Thyroid Hormone Receptor-β (TRβ) Agonist program for dyslipidemia, an Erythropoietin Receptor (EPOR) Agonist program for anemia, and an Enterocyte-Directed Diacylglycerol Acyltransferase-1 (DGAT-1) Inhibitor program for dyslipidemia. The FBPase Inhibitor program was the subject of an option originally granted to Viking in 2012. As part of the transaction, we agreed to extend a \$2.5 million convertible loan facility to Viking that will be used to pay Viking's operating and financing-related expenses.

We received 125,000 upfront shares of common stock in our partner TG Therapeutics, Inc., as a result of entering into a license agreement for the IRAK-4 Inhibitor Program. The shares were initially valued at \$1.2 million. Additionally, we entered into a research agreement with TG Therapeutics and we are currently receiving R&D service payments associated with that agreement.

We licensed our Captisol-enabled Lamotrigine program to CURx Pharmaceuticals. Under the terms of the agreement, we are eligible to receive up to \$22 million in potential milestone payments, revenue from sales of Captisol and tiered royalties on future net sales in the range of 4% to 7%.

In the third quarter we entered into new Captisol clinical-stage agreements with Avion Pharmaceuticals, Inc., Marinus Pharmaceuticals Inc, Boston Strategic Group and Amgen Inc., for Captisol-enabled programs.

We completed an offering of \$245.0 million aggregate principal amount of 0.75% convertible senior notes due 2019 in a private offering to qualified institutional buyers. The conversion rate for the notes is initially equivalent to a conversion price of approximately \$75 per share of common stock, and is subject to adjustment under the terms of the notes. Additionally, we entered into a convertible bond hedge and warrant transaction which increases the effective conversion price of the notes to approximately \$125 per share. Concurrent with the close of the transaction, we repurchased \$37.8 million of our common stock, or 680,800 shares.

## Results of Operations

Three and nine months ended September 30, 2014 and 2013

Total revenues for the three and nine months ended September 30, 2014 were \$15.0 million and \$41.5 million, respectively, compared to \$13.0 million and \$34.2 million, respectively, for the same periods in 2013. We reported income from continuing operations of \$0.8 million and \$4.2 million for the three and nine months ended September 30, 2014, respectively, compared to \$2.0 million and \$7.0 million, respectively, for the same periods in 2013.

### Royalty Revenue

Royalty revenues were \$7.5 million and \$20.6 million for the three and nine months ended September 30, 2014, respectively, compared to \$5.7 million and \$16.5 million, respectively, for the same periods in 2013. The increase in royalty revenue is primarily due to an increase in Promacta and Kyprolis royalties, partially offset by a decline in Avinza royalties as a result of generic competition entering the market in February 2014.

### Material Sales

We recorded material sales of \$6.3 million and \$15.5 million for the three and nine months ended September 30, 2014, respectively, compared to \$6.7 million and \$12.3 million, respectively, for the same periods in 2013. The decrease in material sales of \$0.4 million for the three months ended September 30, 2014 and the increase in material

sales of \$3.2 million for the nine months ended September 30, 2014 is due to timing of customer purchases.

32

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Table of Contents**Collaborative Research and Development and Other Revenues**

We recorded collaborative research and development and other revenues of \$1.2 million and \$5.4 million for the three and nine months ended September 30, 2014, respectively, compared to \$0.6 million and \$5.5 million, respectively, for the same periods in 2013. The increase of \$0.6 million for the three months ended September 30, 2014 is primarily due to an event based payment received in the third quarter of 2014 for EMA approval of Noxafil®. The decrease of \$0.1 million for the nine months ended September 30, 2014 is due to timing of event-based payments and upfront license fees earned.

**Cost of Sales**

Cost of sales were \$1.5 million and \$5.1 million for the three and nine months ended September 30, 2014, respectively, compared to \$2.5 million and \$4.4 million, respectively, for the same periods in 2013. The decrease of \$1.0 million for the three months ended September 30, 2014 is primarily due to the product mix of material sales. The increase of \$0.7 million for the nine months ended September 30, 2014 is primarily due to an increase in material sales.

**Research and Development Expenses**

Research and development expenses were \$3.0 million and \$8.8 million for the three and nine months ended September 30, 2014, respectively, compared to \$2.4 million and \$6.9 million, respectively, for the same periods in 2013. The increase of \$0.6 million and \$1.9 million for the three and nine months ended September 30, 2014, respectively, is primarily due to an increase in stock-based compensation expense and Viking related expenses.

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

Program	Disease/Indication	Development Phase
Glucagon Receptor Antagonist	Diabetes	Phase I
HepDirect™	Liver Diseases	Preclinical
Oral Human Granulocyte Colony Stimulating Factor	Neutropenia	Preclinical
LTP Technology Platform	Metabolic and Cardiovascular Disease	Preclinical

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

**General and Administrative Expenses**

General and administrative expenses were \$6.7 million and \$17.1 million for the three and nine months ended September 30, 2014, respectively, compared to \$4.8 million and \$13.6 million, respectively, for the same periods in 2013. The increase of \$1.9 million and \$3.5 million for three and nine months ended September 30, 2014,

respectively, is primarily due to an increase in stock-based compensation expense and costs associated with business development activities.

## Table of Contents

### Lease Exit and Termination Costs

In September 2010, we ceased use of our facility located in Cranbury, New Jersey. As a result, during the three months ended September 30, 2010, we recorded lease exit costs of \$9.7 million for costs related to the difference between the remaining lease obligations of the abandoned operating leases, which run through August 2016, and management's estimate of potential future sublease income, discounted to present value. Actual future sublease income may differ materially from our estimate, which would result in us recording additional expense or reductions in expense. In addition, we wrote-off approximately \$5.4 million of property and equipment related to the facility closure and recorded approximately \$1.8 million of severance related costs. Lease exit and termination costs were \$0.2 million and \$0.5 million for the three and nine months ended September 30, 2014, respectively, compared to \$0.2 million and \$0.4 million, respectively for the same periods in 2013. The increase for the nine months ended September 30, 2014 is primarily due to changes in sublease assumptions.

### Interest Expense, net

Interest expense, net was \$1.5 million and \$1.9 million for the three and nine months ended September 30, 2014, respectively, compared to \$0.4 million and \$1.8 million, respectively, for the same periods in 2013. The increase in interest expense of \$1.1 million and \$0.1 million for the three and nine months ended September 30, 2014, respectively, is due to cash interest expense and non-cash debt related costs related to the 2019 Convertible Senior Notes partially offset by interest expense related to the term loan facility which was paid off in July 2014.

### (Increase) decrease in Contingent Liabilities

We recorded an increase in contingent liabilities of \$1.6 million and \$4.9 million for the three and nine months ended September 30, 2014, respectively, compared to an increase of \$0.5 million and a decrease of \$0.4 million for the same periods in 2013. The increase for the three months ended September 30, 2014 primarily relates to an increase in the liability for amounts potentially due to holders of CVRs related to our CyDex acquisition of \$2.8 million and is partially offset by a decrease of \$1.2 million in the liability for amounts potentially due to holders of CVRs associated with our Metabasis acquisition. The increase for the nine months ended September 30, 2014 primarily relates to an increase of \$5.6 million in the liability for amounts potentially due to holders of CVRs related to our CyDex acquisition and a decrease of \$0.7 million in the liability for amounts potentially due to holders of CVRs associated with our Metabasis acquisition. The increase for the three months ended September 30, 2013 relates to an increase in the liability for amounts potentially due to holders of CVRs and former license holders associated with our CyDex acquisition of \$1.2 million and is partially offset by a decrease in amounts potentially due to holders of CVRs associated with our Metabasis acquisition of \$0.7 million. The decrease for the nine months ended September 30, 2013 is primarily due to a decrease in amounts potentially due to CyDex CVR holders and former license holders of \$2.1 million related to Captisol-enabled Clopidogrel, and is partially offset by an increase in Metabasis CVRs of \$1.7 million.

### Income Tax Expense

We recorded income tax expense from continuing operations of \$0.1 million for each of the three and nine months ended September 30, 2014, compared to income tax expense from continuing operations of \$0.1 million and \$0.2 million, for the three and nine months ended September 30, 2013, respectively. Our estimated annual effective rate of 3.4% is primarily attributable to deferred taxes associated with the amortization of acquired IPR&D assets for tax purposes.

### Discontinued Operations

#### Avinza Product Line

In September 2006, we and King Pharmaceuticals, now a subsidiary of Pfizer, entered into a purchase agreement, or the Avinza Purchase Agreement, pursuant to which Pfizer acquired all of our rights in and to Avinza in the United States, its territories and Canada, including, among other things, all Avinza inventory, records and related intellectual

property, and assume certain liabilities as set forth in the Avinza Purchase Agreement.

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

During the three and nine months ended September 30, 2014, there were no pre-tax gains or losses recognized on the sale of the Avinza product line due to subsequent changes in certain estimates and liabilities recorded as of the sale date. During the three months ended September 30, 2013 we did not recognize a gain or loss on the sale of the Avinza product line.

## Table of Contents

During the nine months ended September 30, 2013 we recognized a pre-tax gain of \$2.6 million, as a result of subsequent changes in certain estimates and liabilities recorded as of the sale date.

### Liquidity and Capital Resources

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

We have incurred significant losses since inception. At September 30, 2014, our accumulated deficit was \$666.4 million and we had working capital of \$180.1 million. We believe that our currently available cash, cash equivalents and short-term investments, as well as our current and future royalty, license and milestone revenues and Captisol material sales will be sufficient to fund our anticipated operating and capital requirements, at a minimum, for the next twelve months. However, our projected revenue may decrease or our expenses may increase, which could lead to our resources being consumed earlier than expected. Although we do not believe that we will need to raise additional funds to finance our current operations through the next twelve months, if we are required to seek additional financing, there can be no assurance that such financing will be available on terms acceptable to management, or at all. We believe that cash flows from operations will increase due to Captisol sales, an increase in royalty revenues driven primarily from continued increases in Promacta and Kyprolis sales, recent product approvals and regulatory developments, as well as revenues from new licenses and event-based payments. We expect to build cash in future months as we continue to generate significant cash flows from operations. Our future operating and capital requirements will depend on many factors, including, but not limited to: the pace of scientific progress in our research and development programs; the potential success of these programs; the scope and results of preclinical testing and clinical trials; the time and costs involved in obtaining regulatory approvals; the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims; competing technological and market developments; the amount of royalties on sales of the commercial products of our partners; the efforts of our collaborative partners; obligations under our operating lease agreements; and the capital requirements of any companies we acquire. While we believe in the viability of our strategy to generate sufficient operating cash flow and in our ability to raise additional funds, there can be no assurances to that effect. Our ability to achieve our operational targets is dependent upon our ability to further implement our business plan and generate sufficient operating cash flow.

### Investments

We invest our excess cash principally in U.S. government debt securities, investment-grade corporate debt securities and certificates of deposit. We have established guidelines relative to diversification and maturities that maintain safety and liquidity. These guidelines are periodically reviewed and modified to take advantage of trends in yields and interest rates. Additionally, we own certain securities which are classified as short-term investments which we received in December 2012 and June 2014 as a result of an event-based payment and an upfront license payment, respectively, under licensees.

### Borrowings and Other Liabilities

#### Term Loan Facility

In January 2011, we entered into a \$20.0 million secured term loan credit facility with Oxford Financial Group. The loan was amended in January 2012 to increase the secured credit facility to \$27.5 million. The original \$20.0 million borrowed under the facility bore interest at a fixed rate of 8.6%. The additional \$7.5 million bore interest at a fixed rate of 8.9%. Under the terms of the secured debt, we made interest-only payments through February 2013. Subsequent to the interest-only payments, the note amortized with principal and interest payments through the

remaining term of the loan. We were required to make an additional final payment equal to 6% of the total amount borrowed at maturity, which was accreted over the life of the loan. The maturity date of the term loan was August 1, 2014, and we fully repaid the loan as of July 31, 2014.

In March 2013, we prepaid \$7.0 million of the secured term loan credit facility. Additionally, we paid a prepayment fee of 1% of the prepayment amount, or \$0.1 million, and a prorated final-payment fee of 6% of the final payment, or \$0.4 million.

#### 0.75% Convertible Senior Notes Due 2019

We have convertible debt outstanding as of September 30, 2014 related to our 2019 Convertible Senior Notes. In August 2014, we issued \$245.0 million aggregate principal amount of convertible senior unsecured notes. The Notes are

35

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## Table of Contents

convertible into common stock upon satisfaction of certain conditions. Interest of 0.75% per year is payable semi-annually on August 15th and February 15th through the maturity of the notes in August 2019.

### Repurchases of Common Stock

In August 2014, our Board of Directors authorized us to repurchase up to \$200.0 million of our common stock for a period of up to one year. During the three and nine months ended September 30, 2014 we repurchased 692,800 common shares pursuant to the repurchase program for an aggregate purchase price of approximately \$38.5 million. Subsequent to the end of the quarter through October 30, 2014, the Company repurchased an additional 110,000 common shares for an aggregate purchase price of approximately \$5.0 million.

### Public Offerings

In October 2013, we filed a universal shelf registration statement with the Securities and Exchange Commission, or the SEC, that was automatically declared effective due to our status as a well-known seasoned issuer. This registration statement provides additional financial flexibility for us to sell shares of common stock or other equity or debt securities as needed at any time, including through our at-the-market equity issuance program. During the three and nine months ended September 30, 2014, we did not issue any common shares through this at-the-market equity issuance program.

### Cash Flows

#### Operating Activities

Operating activities generated cash of \$10.3 million for the nine months ended September 30, 2014, compared to \$8.7 million for the same period in 2013.

The cash generated for the nine months ended September 30, 2014 reflects net income of \$4.2 million, adjusted by \$14.8 million of non-cash items to reconcile net income to net cash generated from operations. These reconciling items primarily reflect an increase in the estimated fair value of contingent liabilities of \$4.9 million, depreciation and amortization of \$2.0 million, stock-based compensation of \$8.8 million, amortization of debt discount and issuance fees of \$1.2 million, deferred income taxes of \$0.1 million and accretion of notes payable of \$0.2 million, partially offset by a non-cash upfront fee received of \$1.2 million and a realized gain on investments of \$1.2 million. The cash generated during the nine months ended September 30, 2014 is further impacted by changes in operating assets and liabilities due primarily to an increase in accounts receivable of \$3.6 million, an increase in other current assets of \$0.6 million, an increase in other long-term assets of \$1.2 million and an increase in accounts payable and accrued liabilities of \$3.5 million, partially offset by a decrease in inventory of \$0.3 million.

The cash generated for the nine months ended September 30, 2013 reflects net income of \$9.6 million, adjusted by \$2.6 million of gain from discontinued operations and \$6.8 million of non-cash items to reconcile the net income to net cash generated in operations. These reconciling items primarily reflect depreciation and amortization of \$2.0 million, share-based compensation of \$4.1 million, the change in deferred income taxes of \$0.2 million, write-off of IPR&D of \$0.5 million, and accretion of note payable of \$0.3 million, partially offset by the decrease in the estimated fair value of contingent liabilities of \$0.4 million. The cash generated during the nine months ended September 30, 2013 is further impacted by changes in operating assets and liabilities due primarily to an increase in accounts receivable of \$0.9 million, increase in other current assets of \$0.7 million, decrease in accounts payable and accrued liabilities of \$2.3 million, decrease in other liabilities of \$0.4 million, and a decrease in deferred revenue of \$0.4 million, partially offset by a decrease in cash paid for inventory of \$0.1 million and a decrease in other long term assets of \$0.2 million. Cash used in operating activities of discontinued operations was \$0.6 million for the nine months ended September 30, 2013.

### Investing Activities

Investing activities used cash of \$0.3 million for the nine months ended September 30, 2014, compared to \$4.0 million for the same period in 2013.

Cash used by investing activities during the nine months ended September 30, 2014 primarily reflects payments to CVR holders and other contingency payments of \$1.9 million, partially offset by proceeds from short-term investments of \$1.5 million and proceeds from the sale of equipment of \$0.1 million.

## Table of Contents

Cash used by investing activities during the nine months ended September 30, 2013 primarily reflects the purchase of commercial license rights of \$3.6 million.

### Financing Activities

Financing activities provided cash of \$159.0 million for the nine months ended September 30, 2014, compared to use of cash of \$13.8 million for the same period in 2013.

Cash used by financing activities for the nine months ended September 30, 2014 primarily reflects gross proceeds received from the issuance of the 2019 Convertible Senior Notes of \$245.0 million, proceeds from issuance of warrants of \$11.6 million, and \$4.1 million of proceeds received from stock option exercises and our employee stock purchase plan, partially offset by repayment of debt of \$9.4 million, purchase of convertible bond hedge of \$48.1 million, payment for share repurchases of \$38.5 million and payment of debt issuance costs of \$5.7 million.

Cash used by financing activities for the nine months ended September 30, 2013 primarily reflects \$16.2 million of repayment of debt, partially offset by proceeds from stock option exercises and our employee stock purchase plan of \$2.4 million.

### Other

In connection with the acquisition of Metabasis in January 2010, Metabasis security holders received CVRs under four CVR agreements. The CVRs entitle the holders to cash payments upon the sale or licensing of certain assets and upon the achievement of specified milestones. The fair value of the liability at September 30, 2014 was \$3.5 million, and as of December 31, 2013 was \$4.2 million.

In connection with the acquisition of CyDex in January 2011, we issued a series of CVRs and also assumed certain contingent liabilities. In 2011, \$0.9 million was paid to the CyDex shareholders upon completion of a licensing agreement with the Medicines Company for the Captisol-enabled Intravenous formulation of Clopidogrel. An additional \$2.0 million was paid to the CyDex shareholders upon acceptance by the FDA of Onyx's NDA, \$4.3 million was paid in January 2012 under the terms of the agreement, and an additional \$3.5 million was paid upon approval by the FDA of Kyprolis for the potential treatment of patients with relapsed and refractory multiple myeloma. We recorded a cash payment of \$0.1 million for the Topiramate orphan drug designation milestone to former license holders. We may be required to make additional payments upon achievement of certain clinical and regulatory milestones to the CyDex shareholders and former license holders. In addition, we will pay CyDex shareholders, for each respective year from 2014 through 2016, 20% of all CyDex-related revenue, but only to the extent that, and beginning only when, CyDex-related revenue for such year exceed \$15.0 million; plus an additional 10% of all CyDex-related revenue recognized during such year, but only to the extent that, and beginning only when aggregate CyDex-related revenue for such year exceeds \$35.0 million. We have paid \$2.8 million to the CyDex shareholders for revenue sharing payments under the terms of the CVR agreement. The estimated fair value of the contingent liabilities recorded as part of the CyDex acquisition at September 30, 2014 was \$12.9 million.

### Leases and Off-Balance Sheet Arrangements

We lease our office and research facilities under operating lease arrangements with varying terms through November 2021. Some of our agreements provide for increases in annual rents based on changes in the Consumer Price Index or fixed percentage increases ranging from 3.0% to 3.5%. We also sublease a portion of our facilities through August 2016. The sublease agreement provides for a 3% increase in annual rents. We had no off-balance sheet arrangements at September 30, 2014 and December 31, 2013.



Table of Contents

## Contractual Obligations

As of September 30, 2014, future minimum payments due under our contractual obligations were as follows (in thousands):

	Payments Due by Period				
	Total	Less than 1 year	2-3 years	4-5 years	More than 5 years
Obligations for uncertain tax positions (1)	\$—	\$ —	\$—	\$—	\$—
Co-promote termination obligations (2)	\$523	\$ 523	\$—	\$—	\$—
Purchase obligations (3)	\$11,005	\$ 11,005	\$—	\$—	\$—
Contingent liabilities (4)	\$1,526	\$ 1,526	\$—	\$—	\$—
Note and interest payment obligations (5)	\$254,188	\$ 1,838	\$3,675	\$248,675	\$—
Operating lease obligations (6)	\$10,440	\$ 5,220	\$3,914	\$1,306	\$—

(1) Expected payments related to obligations for uncertain tax positions cannot be reasonably estimated.

Co-promote termination obligations represent our legal obligation as primary obligor to Organon due to the fact that Organon did not consent to the legal assignment of the co-promote termination obligation to Pfizer. The liability is offset by an asset which represents a non-interest bearing receivable for future payments to be made by Pfizer.

(3) Purchase obligations represent our commitments under our supply agreement with Hovione, LLC for Captisol purchases.

(4) Contingent liabilities to former shareholders and licenseholders are subjective and affected by changes in inputs to the valuation model including management's assumptions regarding revenue volatility, probability of commercialization of products, estimates of timing and probability of achievement of certain revenue thresholds and developmental and regulatory milestones and affect amounts owed to former license holders and CVR holders. Only payments due as a result of achievement of revenue thresholds or development and regulatory milestones are included in the table above.

(5) Note and interest payment obligations represent principal and interest payments due under the 2019 Convertible Senior Notes.

(6) We lease office and research facilities that we have fully vacated under operating lease arrangements expiring in July 2015 and August 2016. We sublet portions of these facilities through the end of our lease. As of September 30, 2014, we expect to receive aggregate future minimum lease payments totaling \$1.7 million (nondiscounted) over the duration of the sublease agreement (not included in the table above) as follows: less than one year: \$1.3 million, and two to three years: \$0.4 million.

We are also required under our CyDex CVR Agreement to invest at least \$1.5 million per year, inclusive of employee expenses, in the acquired business through the year ended 2015. As of September 30, 2014, we have exceeded that amount for the year ended December 31, 2014.

## Critical Accounting Policies

Certain of our policies require the application of management judgment in making estimates and assumptions that affect the amounts reported in our consolidated financial statements and the disclosures made in the accompanying notes. Those estimates and assumptions are based on historical experience and various other factors deemed applicable and reasonable under the circumstances. The use of judgment in determining such estimates and

assumptions is by nature, subject to a degree of uncertainty. Accordingly, actual results could differ materially from the estimates made. There have been no material changes in our accounting policies as disclosed in our annual report on Form 10-K for the year ended December 31, 2013, with the exception of policies put in place with regards to the 2019 Convertible Senior Notes and the Viking Therapeutics, Inc. consolidated variable interest entity.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk from interest rates and equity prices which could affect our results of operations, financial condition and cash flows. We manage our exposure to these market risks through our regular operating and financing activities.

Investment Portfolio Risk

At September 30, 2014, our investment portfolio included investments in available-for-sale equity securities of \$5.9 million. These securities are subject to market risk and may decline in value based on market conditions.

Equity Price Risk

Our 2019 Convertible Senior Notes include conversion and settlement provisions that are based on the price of our common stock at conversion or maturity of the notes, as applicable. The minimum amount of cash we may be required to pay is \$245.0 million, but will ultimately be determined by the price of our common stock. The fair values of our 2019 Convertible Senior Notes are dependent on the price and volatility of our common stock and will generally increase or decrease as the market price of our common stock changes. In connection with the issuance with the 2019 Convertible Senior Notes, to minimize the impact of potential dilution to our common stock upon the conversion of such notes, we entered into convertible bond hedges covering 3,264,643 shares of our common stock. Concurrently with entering into the convertible bond hedge transactions, we entered into warrant transactions whereby we sold warrants with an exercise price of approximately \$125.08 per share, subject to adjustment. Throughout the term of the 2019 Convertible Senior Notes, the notes may have a dilutive effect on our earnings per share to the extent the stock price exceeds the conversion price of the notes. Additionally, the warrants may have a dilutive effect on our earnings per share to the extent the stock price exceeds the strike price of the warrants.

Foreign currency risk

We purchase Captisol from Hovione, located in Lisbon, Portugal. Payments to Hovione are denominated and paid in U.S. dollars, however the unit price of Captisol contains an adjustment factor which is based on the sharing of foreign currency risk between the two parties. The effect of an immediate 10% change in foreign exchange rates would not have a material impact on our financial condition, results of operations or cash flows.

Interest rate risk

We are exposed to market risk involving rising interest rates. To the extent interest rates rise, our interest costs could increase. An increase in interest costs of 10% would not have a material impact on our financial condition, results of operations or cash flows.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

As of September 30, 2014, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based upon and as of the date of that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in reports we file or submit pursuant to the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (2) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Our disclosure controls were designed to provide reasonable assurance that the controls and procedures would meet their objectives. Our management, including the Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable assurance of achieving the designed control objectives and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusions of two or more people, or by management override of the control. Because of the inherent limitations in a cost-effective, maturing control system, misstatements due to error or fraud may occur and not be detected.

We have implemented standards and procedures related to the consolidation of a VIE, Viking Therapeutics, Inc., and related to the issuance of the 2019 Convertible Senior Notes. Other than these changes, there have not been any changes in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter of the fiscal year to which this report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Securities Litigation

On June 8, 2012, a federal securities class action and shareholder derivative lawsuit was filed in the Eastern District of Pennsylvania against Genaera Corporation and its officers, directors, major shareholders and trustee ("Genaera Defendants") for allegedly breaching their fiduciary duties to Genaera shareholders. The lawsuit also names us and our CEO, as additional defendants for allegedly aiding and abetting the Genaera Defendants' various breaches of fiduciary duties based on our purchase of a licensing interest in a development-stage pharmaceutical drug program from the Genaera Liquidating Trust in May 2010 and our subsequent sale of half of its interest in the transaction to Biotechnology Value Fund, Inc.

Following an amendment to the complaint and a round of motions to dismiss, the court dismissed the amended complaint with prejudice on August 12, 2013. Plaintiff appealed that dismissal on September 10, 2013, and the Third Circuit reversed on October 17, 2014. We intend to continue to vigorously defend the claims against us and our CEO. Due to the complex nature of the legal and factual issues involved, however, the outcome of this matter is not presently determinable.

Other Litigation

On June 19, 2014, a complaint was filed in California Superior Court seeking attorneys' fees in connection with claims related to executive compensation matters described in our June 6, 2013 supplemental proxy materials. On August 1, 2014 we filed an answer denying all allegations in the complaint and asserting several affirmative defenses. Management believes the fees demanded by plaintiffs' counsel are excessive and we intend to defend ourselves vigorously in the litigation. Due to the complex nature of the legal and factual issues involved, however, the outcome of this matter is not presently determinable.

Table of Contents

ITEM 1A. RISK FACTORS

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

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

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

Revenue from sales of Captisol material to our collaborative partners represents a significant portion of our current revenue and our continued development and supply of Captisol is subject to a number of risks.

In January 2011, we completed our merger with CyDex. All of CyDex's products and product candidates, as well as the technology that it outlicenses, are based on Captisol. As a result, any setback that may occur with respect to Captisol could significantly impair our operating results and/or reduce the market price of our stock. Setbacks for Captisol could include problems with shipping, distribution, manufacturing, product safety, marketing, government regulation or reimbursement, licenses and approvals, intellectual property rights, competition with existing or new products and physician or patient acceptance of the products using Captisol, as well as higher than expected total rebates, returns or discounts for such products.

If products or product candidates incorporating Captisol technology were to cause any unexpected adverse events, the perception of Captisol safety could be seriously harmed. If this were to occur, we may not be able to market Captisol products unless and until we are able to demonstrate that the adverse event was unrelated to Captisol, which we may not be able to do. Further, whether or not the adverse event was a result of Captisol, we could be required by the FDA to submit to additional regulatory reviews or approvals, including extensive safety testing or clinical testing of products using Captisol, which would be expensive and, even if we were to demonstrate that the adverse event was unrelated to Captisol, would delay our marketing of Captisol-enabled products and receipt of revenue related to those products, which could significantly impair our operating results and/or reduce the market price of our stock.

We obtain Captisol from a sole source supplier, and if this supplier were to cease to be able, for any reason, to supply Captisol to us in the amounts we require, or decline to supply Captisol to us, we would be required to seek an alternative source, which could potentially take a considerable length of time and impact our revenue and customer relationships.

We currently depend on our arrangements with our outlicensees to sell products using our Captisol technology. These agreements generally provide that outlicensees may terminate the agreements at will. If our outlicensees discontinue sales of products using our Captisol technology, fail to obtain regulatory approval for products using our Captisol technology, fail to satisfy their obligations under their agreements with us, or choose to utilize a generic form of Captisol should it become available, or if we are unable to establish new licensing and marketing relationships, our

financial results and growth prospects would be materially affected. We maintain inventory of Captisol, which has a five year shelf life, at three geographically spread storage locations in the United States and Europe. If we were to encounter problems maintaining our inventory, such as natural disasters, at one or all three of these locations, it could lead to supply interruptions. Further, under most of our Captisol outlicenses, the amount of royalties we receive will be reduced or will cease when the relevant patent expires. Our high purity patents, U.S. Patent Nos. 7,635,773 and 8,410,077 and foreign equivalents, are not expected to expire until 2029 and our morphology patents, U.S. Patent Nos. 7,629,331 and 8,049,003 and foreign equivalents, are not expected to expire until 2025, but the initially filed patents relating to Captisol expired starting in 2010 in the United States and will expire by 2016 in most countries outside the United States. If our other intellectual property rights are not sufficient to prevent a generic form of Captisol from coming to market and if in such case our outlicensees choose to terminate their agreements with us, our Captisol revenue may decrease significantly.

## Table of Contents

The product candidates of our partners and us face significant development and regulatory hurdles prior to partnering and/or marketing which could delay or prevent licensing, sales and/or milestone revenue.

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

The rates at which we complete our scientific studies and clinical trials depends on many factors, including, but are not limited to, our ability to obtain adequate supplies of the products to be tested and patient enrollment. Patient enrollment is a function of many factors, including the size of the patient population, the proximity of patients to clinical sites, the eligibility criteria for the trial and other potential drug candidates being studied. Delays in patient enrollment for our trials may result in increased costs and longer development times. In addition, our collaborative partners have rights to control product development and clinical programs for products developed under our collaborations. As a result, these collaborative partners may conduct these programs more slowly or in a different manner than expected. Moreover, even if clinical trials are completed, we or our collaborative partners still may not apply for FDA approval in a timely manner or the FDA still may not grant approval.

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

Our strategy for developing and commercializing many of our potential products, including products aimed at larger markets, includes entering into collaboration agreements with corporate partners and others. These agreements give our collaborative partners significant discretion when deciding whether or not to pursue any development program. Our existing collaborations may not continue or be successful, and we may be unable to enter into future collaborative arrangements to develop and commercialize our unpartnered assets.

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

or could result in litigation or arbitration. The occurrence of any of these problems could be time-consuming and expensive and could adversely affect our business.

Table of Contents

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

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

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

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

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

We have obtained patent protection in the United States through 2025 on one or more Agglomerated forms of Captisol and through 2029 on one or more High Purity forms of Captisol. We also have filed patent applications covering the Captisol product that if issued, would not be set to expire until 2033 (for example, our patent WO 2013/130666, filed Feb. 27, 2013, contains composition of matter and use claims). There is no guarantee that our patents will be sufficient to prevent competitors from creating a generic form of Captisol and competing against us, or from developing combination patents for products that will prevent us from developing products using those APIs. In addition, most of the agreements in our Captisol outlicensing business, provide that once the relevant patent expires, the amount of royalties we receive will be reduced or eliminated.

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

If our collaborative partners terminate their collaborations with us or do not commit sufficient resources to the development, manufacture, marketing or distribution of our partnered programs, we could be required to devote

additional resources to our partnered programs, seek new collaborative partners or abandon such partnered programs, all of which could have an adverse effect on our business.

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

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

Table of Contents

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

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

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

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

If we are unable to maintain the effectiveness of our internal controls, our financial results may not be accurately reported.

The Sarbanes-Oxley Act of 2002 requires, among other things, that we maintain effective internal controls for financial reporting and disclosure controls and procedures. While we anticipate maintaining the integrity of our internal controls over financial reporting and all other aspects of Sarbanes-Oxley Act of 2002, we cannot be certain that a material weakness will not be identified when we test the effectiveness of our control systems in the future. The existence of one or more material weaknesses or significant deficiencies in our internal control over financial reporting could result in errors in our consolidated financial statements. Substantial costs and resources may be required to rectify any internal control deficiencies. If we fail to maintain the adequacy of our internal controls in accordance with applicable standards, we may be unable to conclude on an ongoing basis that we have effective internal controls over financial reporting. If we cannot produce reliable financial reports, our business and financial condition could be harmed, investors could lose confidence in our reported financial information, or the market price of our stock could decline significantly. In addition, our ability to obtain additional financing to operate and expand our business, or obtain additional financing on favorable terms, could be materially and adversely affected, which, in turn, could materially and adversely affect our business, our financial condition and the market value of our securities. Moreover, our reputation with customers, lenders, investors, securities analysts and others may be adversely affected.

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



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

As part of our efforts to acquire companies, business or product candidates or to enter into other significant transactions, we conduct business, legal and financial due diligence with the goal of identifying and evaluating material risks involved in the

Table of Contents

transaction. Despite our efforts, we ultimately may be unsuccessful in ascertaining or evaluating all such risks and, as a result, might not realize the intended advantages of the transaction. If we fail to realize the expected benefits from acquisitions we may consummate in the future or have consummated in the past, whether as a result of unidentified risks, integration difficulties, regulatory setbacks, litigation with current or former employees and other events, our business, results of operations and financial condition could be adversely affected. If we acquire product candidates, we will also need to make certain assumptions about, among other things, development costs, the likelihood of receiving regulatory approval and the market for such product candidates. Our assumptions may prove to be incorrect, which could cause us to fail to realize the anticipated benefits of these transactions.

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

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

If we are unable to hire and/or retain key employees, we may not have sufficient resources to successfully manage our assets or our business, and we may not be able to perform our obligations under various contracts and commitments. Furthermore, there can be no assurance that we will be able to retain all of our key management and scientific personnel. If we fail to retain such key employees, it could materially and adversely affect our business, financial condition, results of operations or the market price of our stock.

Aggregate revenues based on sales of our other products may not meet expectations.

Revenues based on sales of Avinza, Duavee, Conbriza and Nexterone may not meet expectations. Any setback that may occur with respect to these products could impair our operating results and/or reduce the market price of our stock. Setbacks for these products could include problems with shipping, distribution, manufacturing, product safety, marketing, government regulation or reimbursement, licenses and approvals, intellectual property rights, competition with existing or new products and physician or patient acceptance of the product, as well as higher than expected total rebates, returns or discounts. These products also are or may become subject to generic competition. Any such setback could reduce our revenue.

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

As is common in our industry, our partners and we face an inherent risk of product liability as a result of the clinical testing of our product candidates in clinical trials and face an even greater risk for commercialized products. Although we are not currently a party to product liability litigation, if we are sued, we may be held liable if any product or product candidate we develop causes injury or is found otherwise unsuitable during product testing, manufacturing, marketing or sale. Regardless of merit or eventual outcome, liability claims may result in decreased demand for any product candidates or products that we may develop, injury to our reputation, discontinuation of clinical trials, costs to defend litigation, substantial monetary awards to clinical trial participants or patients, loss of revenue and the inability to commercialize any products that we develop. We have product liability insurance that covers our clinical trials up to a \$5.0 million annual limit. If we are sued for any injury caused by our product candidates or any future products, our liability could exceed our total assets.

In addition, we have agreed to indemnify Eisai and King Pharmaceuticals (now a subsidiary of Pfizer), under certain circumstances pursuant to the asset purchase agreements we entered into in connection with the sale of our prior commercial product lines. Some of our indemnification obligations still remain and our potential liability in certain circumstances is not limited to specific dollar amounts. We cannot predict the liabilities that may arise as a result of these matters. Any claims related to our indemnification obligations to Pfizer or Eisai could materially and adversely affect our financial condition. In addition, Pfizer assumed our obligation to make payments to Organon based on net sales of Avinza (the fair value of which was \$0.5 million as of September 30, 2014). We remain liable to Organon in the event Pfizer defaults on this obligation. Any requirement to pay a material amount to Organon could adversely affect our business and the price of our securities. The sale of our prior commercial product lines does not relieve us of exposure to product liability risks on products we sold prior to divesting these product lines. A successful product liability claim or series of claims brought against us may not be insured against and could result in payment of significant amounts of money and divert management's attention from our business.

Table of Contents

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

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

If our business does not perform according to our expectations, we may not have sufficient resources to operate our business as currently contemplated.

We believe that our capital resources, including our currently available cash, cash equivalents, and short-term investments as well as our current and future royalty revenues, will be adequate to fund our operations at their current levels at least for the next 12 months. However, changes may occur that would cause us to consume available capital resources before that time and we may need to complete additional equity or debt financings to fund our operations. Our inability to obtain additional financing could adversely affect our business. Financings may not be available at all or on terms favorable to us. In addition, these financings, if completed, may not meet our capital needs and could result in substantial dilution to our stockholders. If adequate funds are not available, we may be required to delay, reduce the scope of or eliminate one or more of our research or drug development programs. We may also be required to liquidate our business or file for bankruptcy protection. Alternatively, we may be forced to attempt to continue development by entering into arrangements with collaborative partners or others that require us to relinquish some or all of our rights to technologies or drug candidates that we would not otherwise relinquish.

We recently sold \$245.0 million aggregate principal amount of 0.75% Convertible Senior Notes, which may impact our financial results, result in the dilution of existing stockholders, and restrict our ability to take advantage of future opportunities.

In August of 2014, we sold \$245.0 million aggregate principal amount of 0.75% Convertible Senior Notes due 2019, or the 2019 Convertible Senior Notes. We will be required to pay interest on the 2019 Convertible Senior Notes until they come due or are converted, and the payment of that interest will reduce our net income. The sale of the 2019 Convertible Senior Notes may also affect our earnings per share figures, as accounting procedures require that we include in our calculation of earnings per share the number of shares of our common stock into which the 2019 Convertible Senior Notes are convertible. The 2019 Convertible Senior Notes may be converted, under the conditions and at the premium specified in the 2019 Convertible Senior Notes, into cash and shares of our common stock, if any (subject to our right to pay cash in lieu of all or a portion of such shares). If shares of our common stock are issued to the holders of the 2019 Convertible Senior Notes upon conversion, there will be dilution to our shareholders equity. Upon the occurrence of certain circumstances, holders of the 2019 Convertible Senior Notes may require us to purchase all or a portion of their notes for cash, which may require the use of a substantial amount of cash. If such cash is not available, we may be required to sell other assets or enter into alternate financing arrangements at terms that may or may not be desirable. The existence of the 2019 Convertible Senior Notes and the obligations that we incurred by issuing them may restrict our ability to take advantage of certain future opportunities, such as engaging in future debt or equity financing activities. As of September 30, 2014, no events have occurred which would trigger settlement of the notes in cash.

Our ability to use our net operating losses, or NOLs, to offset taxes that would otherwise be due could be limited or lost entirely.

Our ability to use our NOLs to offset taxes that would otherwise be due is dependent upon our generation of future taxable income before the expiration dates of the NOLs, and we cannot predict with certainty whether we will be able to generate future taxable income. In addition, even if we generate taxable income, realization of our NOLs to offset taxes that would otherwise be due could be restricted by annual limitations on use of NOLs triggered by a past or future “ownership change” under Section 382 of the Internal Revenue Code and similar state provisions. An “ownership change” may occur when there is a 50% or greater change in total ownership of our company by one or more 5% shareholders within a three-year period. The loss of some or all of our NOLs could materially and adversely affect our business, financial condition and results of operations. In addition, California and certain states have suspended use of NOLs for certain taxable years, and other states may consider similar measures. As a result, we may incur higher state income tax expense in the future. Depending on our future tax position, continued suspension of our ability to use NOLs in states in which we are subject to income tax could have an adverse impact on our operating results and financial condition. The calculation of the amount of our net operating loss carryforwards

Table of Contents

may be changed as a result of a challenge by the IRS or other governmental authority or our learning of new information about the ownership of, and transactions in, our securities.

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

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

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

Our shareholder rights plan and provisions contained in our certificate of incorporation and bylaws may discourage transactions involving an actual or potential change in our ownership. In addition, our Board of Directors may issue shares of common or preferred stock without any further action by the stockholders. Our directors and Biotechnology Value Fund, L.P. and its affiliates, or BVF, collectively beneficially own a significant portion of our outstanding common stock. BVF can increase its ownership level up to 19.99% under the terms of an agreement we have with BVF, and BVF has agreed to vote the shares it owns above 15% of our outstanding common stock in accordance with our Board of Director's recommendations in the event that BVF exceeds a 15% ownership level. Such restrictions, circumstances and issuances may have the effect of delaying or preventing a change in our ownership. If changes in our ownership are discouraged, delayed or prevented, it would be more difficult for our current Board of Directors to be removed and replaced, even if you or our other stockholders believe that such actions are in the best interests of us and our stockholders.

Funding of our drug development programs may not result in future revenues.

Our drug development programs may require substantial additional capital to successfully complete, arising from costs to: conduct research, preclinical testing and human studies; establish pilot scale and commercial scale manufacturing processes and facilities; and establish and develop quality control, regulatory, marketing, sales and administrative capabilities to support these programs. While we expect to fund our research and development activities from cash generated from royalties and milestones from our partners in various past and future collaborations to the extent possible, if we are unable to do so, we may need to complete additional equity or debt financings or seek other external means of financing. These financings could depress our stock price. If additional funds are required to support our operations and we are unable to obtain them on terms favorable to us, we may be required to cease or reduce further development or commercialization of our products, to sell some or all of our technology or assets or to merge with another entity.

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

Our results of operations could be materially negatively affected by economic conditions generally, both in the United States and elsewhere around the world. Continuing concerns over inflation, energy costs, geopolitical issues, the availability and cost of credit, and the U.S. financial markets have contributed to increased volatility and diminished expectations for the economy and the markets going forward. Domestic and international equity markets periodically experience heightened volatility and turmoil. These events may have an adverse effect on us. In the event of a market downturn, our results of operations could be adversely affected by those factors in many ways, including making it

more difficult for us to raise funds if necessary, and our stock price may further decline. We cannot provide assurance that our investments are not subject to adverse changes in market value. If our investments experience adverse changes in market value, we may have less capital to fund our operations.

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

The market prices for securities of biotechnology and pharmaceutical companies have historically been highly volatile, and the market has recently experienced significant price and volume fluctuations that are unrelated to the operating performance of particular companies. Continued volatility in the overall capital markets could reduce the market price of our common stock in spite of our operating performance. Further, high stock price volatility could result in higher stock-based compensation expense.

Table of Contents

Our common stock has experienced significant price and volume fluctuations and may continue to experience volatility in the future. Many factors may have a significant impact on the market price of our common stock, including, but not limited to, the following factors: results of or delays in our preclinical studies and clinical trials; the success of our collaboration agreements; publicity regarding actual or potential medical results relating to products under development by us or others; announcements of technological innovations or new commercial products by us or others; developments in patent or other proprietary rights by us or others; comments or opinions by securities analysts or major stockholders; future sales of our common stock by existing stockholders; regulatory developments or changes in regulatory guidance; litigation or threats of litigation; economic and other external factors or other disaster or crises; the departure of any of our officers, directors or key employees; period-to-period fluctuations in financial results; and price and volume fluctuations in the overall stock market.

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

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

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

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



Table of Contents

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

## Purchases of Equity Securities By the Issuer and Affiliated Purchasers

The following table presents information regarding repurchases by us of our common stock during the quarter ended September 30, 2014 under the stock repurchase program approved by our board of directors on August 11, 2014, under which we may acquire up to \$200.0 million of our common stock in open market and negotiated purchases for a period of one year.

## ISSUER PURCHASES OF EQUITY SECURITIES

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Dollar Value of Shares that May Yet Be Purchased Under the Program
July 1 -July 31, 2014	—	\$ —	—	\$ —
August 1 - August 31, 2014	692,800	55.60	692,800	161,477
September 1 - September 30, 2014	—	—	—	—
Total	692,800	\$ 55.60	692,800	\$ 161,477

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

## ITEM 5. OTHER INFORMATION

None.

## ITEM 6. EXHIBITS

The Exhibit Index to this Quarterly Report on Form 10-Q is incorporated herein by reference.

Table of Contents

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.

Date: October 31, 2014

By: /s/ Nishan de Silva  
Nishan de Silva  
Vice President, Finance and Strategy and Chief Financial Officer  
Duly Authorized Officer and Principal Financial Officer

51

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Table of Contents

EXHIBIT INDEX

Exhibit Number Description

4.1	Indenture, dated as of August 18, 2014, between the Company and Wilmington Trust, National Association, as trustee, including the form of 0.75% Convertible Senior Notes due 2019 (incorporated by reference to the Company's Current Report on Form 8-K filed on August 18, 2014).
10.1	Letter Agreement, dated as of August 12, 2014, between Bank of America, N.A. and the Company regarding the Base Convertible Note Hedge Transactions (incorporated by reference to the Company's Current Report on Form 8-K filed on August 18, 2014).
10.2	Letter Agreement, dated as of August 12, 2014, between Bank of America, N.A. and the Company regarding the Base Warrant Transactions (incorporated by reference to the Company's Current Report on Form 8-K filed on August 18, 2014).
10.3	Letter Agreement, dated as of August 12, 2014, between Deutsche Bank AG, London Branch and the Company regarding the Base Convertible Note Hedge Transactions (incorporated by reference to the Company's Current Report on Form 8-K filed on August 18, 2014).
10.4	Letter Agreement, dated as of August 12, 2014, between Deutsche Bank AG, London Branch and the Company regarding the Base Warrant Transactions (incorporated by reference to the Company's Current Report on Form 8-K filed on August 18, 2014).
10.5	Letter Agreement, dated as of August 14, 2014, between Bank of America, N.A. and the Company regarding the Additional Convertible Note Hedge Transactions (incorporated by reference to the Company's Current Report on Form 8-K filed on August 18, 2014).
10.6	Letter Agreement, dated as of August 14, 2014, between Bank of America, N.A. and the Company regarding the Additional Warrant Transactions (incorporated by reference to the Company's Current Report on Form 8-K filed on August 18, 2014).
10.7	Letter Agreement, dated as of August 14, 2014, between Deutsche Bank AG, London Branch and the Company regarding the Additional Convertible Note Hedge Transactions (incorporated by reference to the Company's Current Report on Form 8-K filed on August 18, 2014).
10.8	Letter Agreement, dated as of August 14, 2014, between Deutsche Bank AG, London Branch and the Company regarding the Additional Warrant Transactions (incorporated by reference to the Company's Current Report on Form 8-K filed on August 18, 2014).
10.9†	First Amendment to Master License Agreement, dated as of September 6, 2014, among Metabasis Therapeutics, Inc., the Company and Viking Therapeutics, Inc.
31.1	Certification by Principal Executive Officer, Pursuant to Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by Principal Financial Officer, Pursuant to Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification by Principal Executive Officer, Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification by Principal Financial Officer, Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document

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101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

† Confidential treatment has been requested for portions of this exhibit. These portions have been omitted and submitted separately to the Securities and Exchange Commission.