LA JOLLA PHARMACEUTICAL CO
Form 10-Q
November 09, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

OR

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

For the transition period from to

Commission file number: 0-24274

LA JOLLA PHARMACEUTICAL COMPANY

(Exact name of registrant as specified in its charter)

California	**33-0361285**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

4370 La Jolla Village Drive, Suite 400 San Diego, CA	**92122**
(Address of principal executive offices)	**(Zip Code)**

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

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

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

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

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

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

The number of shares of the registrant s common stock, $0.0001 par value per share, outstanding at November 2, 2012 was 13,567,383.

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LA JOLLA PHARMACEUTICAL COMPANY

FORM 10-Q

QUARTERLY REPORT

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED FINANCIAL STATEMENTS - UNAUDITED

LA JOLLA PHARMACEUTICAL COMPANY

Condensed Balance Sheets

(in thousands, except share and par value amounts)

	September 30, 2012 (Unaudited)	December 31, 2011 (See Note)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,363	$ 5,040
Prepaids and other current assets	40	60
Total current assets	3,403	5,100
Total assets	$ 3,403	$ 5,100
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	$ 68	$ 8
Accrued expenses	128	240
Accrued payroll and related expenses	18	7
Derivative liabilities	12,717	15,270
Total current liabilities	12,931	15,525
Series C-1[2] redeemable convertible preferred stock, $0.0001 par value; 11,000 shares authorized, 5,386 and 5,043 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively (redemption value and liquidation preference in the aggregate of $5,667 at September 30, 2012 and $5,116 at December 31, 2011)	5,800	5,133
Commitments and contingencies		
Stockholders deficit:		
Common stock	5	
Preferred stock	3,595	
Additional paid-in capital	425,333	424,071
Accumulated deficit	(444,261)	(439,629)
Total stockholders deficit	(15,328)	(15,558)
Total liabilities, redeemable convertible preferred stock and stockholders deficit	$ 3,403	$ 5,100

Note: The condensed balance sheet at December 31, 2011 has been derived from the audited financial statements as of that date but does not include all of the information and disclosures required by U.S. generally accepted accounting principles (see Note 1).

See accompanying notes.

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Condensed Statements of Comprehensive Income (Loss)

(Unaudited)

(in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	**2011**	**2012**	**2011**
Expenses:				
Research and development	$ 474	$	$ 844	$ 177
General and administrative	2,974	423	6,485	1,628
Total expenses	3,448	423	7,329	1,805
Loss from operations	(3,448)	(423)	(7,329)	(1,805)
Other income (expense):				
Adjustments to fair value of derivative liabilities	1,227	3,993	2,696	3,346
Other income (expense), net	(1)		1	234
Net income (loss)	(2,222)	3,570	(4,632)	1,775
Preferred stock dividend forfeited (earned)	(205)	(3)	(281)	75
Net income (loss) and comprehensive income (loss) attributable to common stockholders	$ (2,427)	$ 3,567	$ (4,913)	$ 1,850
Net income (loss) per basic share	$ (0.18)	$ 6.69	$ (0.55)	$ 8.25
Net income (loss) per diluted share	$ (0.18)	$ 0.28	$ (0.55)	$ 0.04
Shares used in computing basic net income (loss) per share	13,253	533	8,995	224
Shares used in computing diluted net income (loss) per share	13,253	12,880	8,995	48,696

See accompanying notes.

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LA JOLLA PHARMACEUTICAL COMPANY

Condensed Statements of Cash Flows

(Unaudited)

(in thousands)

	Nine Months Ended September 30,	
	2012	**2011**
Operating activities:		
Net loss	$ (4,632)	$ 1,775
Adjustments to reconcile net loss to net cash used for operating activities:		
Share-based compensation expense	5,672	194
Gain on adjustments to fair value of derivative liabilities	(2,696)	(3,346)
Change in operating assets and liabilities:		
Prepaids and other current assets	20	58
Accounts payable	60	(16)
Accrued expenses	(112)	(27)
Accrued payroll and related expenses	11	(2)
Net cash used for operating activities	(1,677)	(1,364)
Net decrease in cash and cash equivalents	(1,677)	(1,364)
Cash and cash equivalents at beginning of period	5,040	6,866
Cash and cash equivalents at end of period	$ 3,363	$ 5,502
Supplemental schedule of noncash investing and financing activities:		
Issuance of preferred stock	3,611	
Conversion of preferred stock into common stock	46	748
Reclassification of preferred stock currently redeemable		5,532
Preferred stock dividends (earned)	(281)	
Payment of preferred stock dividends	(374)	
Forfeiture of preferred stock dividends		75

See accompanying notes.

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LA JOLLA PHARMACEUTICAL COMPANY

Notes to Condensed Financial Statements

(Unaudited)

September 30, 2012

1. Basis of Presentation

The accompanying unaudited condensed financial statements of La Jolla Pharmaceutical Company (the Company) have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they do not include all of the information and disclosures required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals and valuation adjustments) considered necessary for a fair presentation have been included. Operating results for the three months ended September 30, 2012 are not necessarily indicative of the results that may be expected for other quarters or the year ending December 31, 2012. For more complete financial information, these unaudited condensed financial statements, and the notes thereto, should be read in conjunction with the audited financial statements for the year ended December 31, 2011 included in the Company s Form 10-K filed with the Securities and Exchange Commission on March 30, 2012.

The accompanying unaudited condensed financial statements have been prepared assuming that the Company will continue as a going concern. This basis of accounting contemplates the recovery of the Company s assets and the satisfaction of its liabilities in the normal course of business and this does not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. While the basis of presentation remains that of a going concern, the Company has a history of recurring losses from operations and, as of September 30, 2012, the Company had no revenue sources, an accumulated deficit of $444,261,000 and available cash and cash equivalents of $3,363,000, of which $2,900,000 could be required to be paid upon the exercise of redemption rights under the Company s outstanding preferred securities (see Note 4). Such redemption was not considered probable as of September 30, 2012. However, these factors raise substantial doubt about the Company s ability to continue as a going concern.

On January 19, 2012, the Company entered into an Asset Purchase Agreement (the Asset Purchase Agreement), dated as of January 19, 2012, with Solana Therapeutics, Inc., a Delaware corporation (Solana). Pursuant to the Asset Purchase Agreement, the Company agreed to acquire from Solana the global development and commercialization rights and certain assets related to an investigational new drug referred to as GCS-100 (GCS-100), which include patents and patent rights, regulatory registrations and study drug supplies (collectively, the Purchased Assets). The acquisition of the Purchased Assets was completed on January 19, 2012 and the Company agreed to pay a nominal amount for the Purchased Assets at that time.

On January 19, 2012, the Company entered into a Consent and Amendment Agreement (the Amendment Agreement) with certain of its Series C-1[1] Convertible Preferred Stock holders to amend the terms of the Securities Purchase Agreement, dated as of May 24, 2010 (Securities Purchase Agreement), and the forms of Cash Warrants (as defined in the Securities Purchase Agreement) and Cashless Warrants (as defined in the Securities Purchase Agreement), as well as to adopt the Certificate of Designations, Preferences and Rights of Series C-1[2] Convertible Preferred Stock (Series C-1[2] Stock), Series C-2[2] Convertible Preferred Stock (Series C-2[2] Stock), Series D-1[2] Convertible Preferred Stock (Series D-1[2] Stock) and Series D-2[2] Convertible Preferred Stock (Series D-2[2] Stock) (the Series C-2/D-1[2] Certificate). Under the Amendment Agreement, the Termination Date (as defined in the Cash Warrants and Cashless Warrants) was amended to extend the Termination Date to the date that is three years following the closing of the asset purchase. Additionally, the mandatory redemption provision of the Cash Warrants was removed.

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As part of the Amendment Agreement, the Company designated four new series of preferred stock on January 19, 2012: its Series C-1^2 Stock, Series C-2^2 Stock, Series D-1^2 Stock, and Series D-2^2 Stock (collectively, the 2012 New Preferred Stock). It exchanged on a one-for-one basis each share of its existing Series C-1^1 Convertible Preferred Stock that was outstanding for a new share of Series C-1^2 Stock. Each holder of 2012 New Preferred Stock may convert its 2012 New Preferred Stock shares into the Company s common stock, par value $0.0001 per share (Common Stock), subject to a weekly conversion cap equal to the product of the face amount of the outstanding Series C-1^2 Stock held by the stockholder on the Closing multiplied by the Conversion Cap (as defined in the Series C-1^2/D-1^2 Certificate) for such week. Depending on the Volume-Weighted Closing Price, or VWCP (as defined in the Series C-1^2/D-1^2 Certificate), for the last three Trading Days (as defined in the Series C-1^2/D-1^2 Certificate) during the previous calendar week, the Conversion Cap can range from 0% to 3.76%. Each 2012 New Preferred Stock holder may only convert such preferred shares into common stock to the extent that after such conversion such holder owns less than 9.999% of the Company s issued and outstanding common stock.

On the first anniversary of the Asset Purchase Agreement (i.e. January 19, 2013), the holders of Series C-1^2 Stock may redeem a number of shares of Series C-1^2 Stock equal to the lesser of (i) the entire balance of the outstanding Series C-1^2 Stock, or (ii) 2,900 shares of Series C-1^2 Stock. The 2012 New Preferred Stock also allows for redemption by its holders following the occurrence of certain other events. If the holders of Series C-1^2 Stock redeem a number of shares of Series C-1^2 Stock equal to or greater than the lesser of (i) the entire balance of the outstanding Series C-1^2 Stock or (ii) 2,900 shares of Series C-1^2 Stock, then Solana shall have the right for a period of 10 business days following the earlier of (i) or (ii) above, to elect to purchase from the Company all right, title and interest in and to the Purchased Assets, including any assets and patent rights arising from the Purchased Assets after the Closing of the asset purchase, upon repaying to the Company the nominal consideration paid pursuant to the Agreement.

2. Accounting Policies

Corporate Structure

The Company was originally incorporated in Delaware in 1989. At the annual meeting of stockholders of the Delaware company on May 22, 2012, the stockholders, upon the recommendation of the Delaware company s board of directors, approved a proposal to merge the Delaware company with and into its wholly-owned subsidiary, LJPC Merger Sub, Inc., for the purpose of changing the domicile of the Company from Delaware to California (the Merger). Following stockholder approval, the Merger was effected on June 7, 2012. As a result, the Company is now a California corporation and LJPC Merger Sub, Inc. changed its name to La Jolla Pharmaceutical Company. The authorized capital stock of the Company increased from 6,008,000,000 to 12,008,000,000 shares. All common and preferred shares of the Delaware company were exchanged for common and preferred shares of the Company.

Use of Estimates

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

Recent Accounting Pronouncements

Effective January 1, 2012, the Company adopted the guidance issued by the FASB in May 2011, regarding common fair value measurements and disclosure requirements in U.S. GAAP and IFRS. This accounting standard clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurements that are estimated using significant unobservable inputs. The adoption of this standard did not have a material impact on the financial position or results of operations of the Company.

Effective January 1, 2012, the Company adopted the guidance issued by the FASB in June 2011 and amended in December 2011, regarding comprehensive income. This accounting standard (1) eliminates the option

to present the components of other comprehensive income as part of the statement of changes in stockholders equity; and (2) requires the consecutive presentation of the statement of net income and other comprehensive income. The amendments do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income nor do the amendments affect how earnings per share is calculated or presented. As this accounting standard only requires enhanced disclosure, the adoption of this standard did not impact the Company s financial position or results of operations.

Impairment of Long-Lived Assets

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

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

Reverse Stock Split

The Board of Directors approved the reverse stock split (the 2012 Reverse Stock Split) of the Company s common stock, which became effective on February 17, 2012, with an exchange ratio of 1-for-100. As a result of the 2012 Reverse Stock Split, each 100 shares of the Company s issued and outstanding common stock were automatically reclassified as and changed into one share of the Company s common stock. No fractional shares were issued in connection with the 2012 Reverse Stock Split. Stockholders who were entitled to fractional shares instead became entitled to receive a cash payment in lieu of receiving fractional shares (after taking into account and aggregating all shares of the Company s common stock then held by such stockholder) equal to the fractional share interest. The 2012 Reverse Stock Split affected all of the holders of the Company s common stock uniformly. Effective on March 3, 2012, each share of 2012 New Preferred Stock was convertible into approximately 213,083 shares of common stock.

The Board of Directors approved the reverse stock split (the 2011 Reverse Stock Split) of the Company s common stock, which became effective on April 14, 2011, with an exchange ratio of 1-for-100. As a result of the 2011 Reverse Stock Split, each 100 shares of the Company s issued and outstanding common stock were automatically reclassified as and changed into one share of the Company s common stock. No fractional shares were issued in connection with the 2011 Reverse Stock Split. Stockholders who were entitled to fractional shares instead became entitled to receive a cash payment in lieu of receiving fractional shares (after taking into account and aggregating all shares of the Company s common stock then held by such stockholder) equal to the fractional share interest. The 2011 Reverse Stock Split affected all of the holders of the Company s common stock uniformly. Effective on May 7, 2011, each share of New Preferred Stock was convertible into approximately 166,667 shares of common stock.

All common stock share and per share information in the accompanying unaudited condensed financial statements have been restated to reflect retrospective application of the 2012 and 2011 Reverse Stock Split for all periods presented, except for par value per share and the number of authorized shares, which were not affected. Shares of the Company s common stock underlying outstanding options and warrants were proportionately reduced and the exercise prices of outstanding options and warrants were proportionately increased in accordance with the terms of the agreements governing such securities. Shares of the Company s common stock underlying outstanding convertible preferred stock and warrants were proportionately reduced and the conversion rates were proportionately decreased in accordance with the terms of the agreements governing such securities.

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Net Income (Loss) Per Share

Basic and diluted net income (loss) per share is computed using the weighted-average number of common shares outstanding during the periods. Basic earnings per share (EPS) is calculated by dividing the net income or loss by the weighted-average number of common shares outstanding for the period, without consideration for common stock equivalents. Diluted EPS is computed by dividing the net income or loss by the weighted-average number of common shares and common stock equivalents outstanding for the period issuable upon the conversion of preferred stock and exercise of stock options and warrants. These common stock equivalents are included in the calculation of diluted EPS only if their effect is dilutive (see Note 11). There is no difference between basic and diluted net loss per share for the three and nine months ended September 30, 2012, as potentially dilutive securities have been excluded from the calculation of diluted net loss per common share because the inclusion of such securities would be antidilutive.

Derivative Liabilities

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

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

3. Fair Value of Financial Instruments

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

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

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

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

As of September 30, 2012 and 2011, cash and cash equivalents were comprised of cash in checking accounts.

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In conjunction with the May 2010 Financing, the Company issued redeemable convertible preferred stock with certain embedded derivative features, as well as warrants to purchase various types of convertible preferred stock and units. These instruments are accounted for as derivative liabilities (see Note 6).

The Company used Level 3 inputs for its valuation methodology for the embedded derivative liabilities and warrant derivative liabilities. The estimated fair values were determined using a binomial option pricing model based on various assumptions (see Note 6). The Company s derivative liabilities are adjusted to reflect their estimated fair value at each period end, with any decrease or increase in the estimated fair value being recorded in other income or expense accordingly, as adjustments to fair value of derivative liabilities.

At September 30, 2012 and December 31, 2011, the estimated fair values of the liabilities measured on a recurring basis are as follows (in thousands):

		Fair Value Measurements at September 30, 2012		
	Balance at September 30, 2012	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Embedded derivative liabilities	$ 3,900	$	$	$ 3,900
Warrant derivative liabilities	8,817			8,817
Total	$ 12,717	$	$	$ 12,717

		Fair Value Measurements at December 31, 2011		
	Balance at December 31, 2011	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Embedded derivative liabilities	$ 3,680	$	$	$ 3,680
Warrant derivative liabilities	11,590			11,590
Total	$ 15,270	$	$	$ 15,270

The following tables present the activity for liabilities measured at estimated fair value using unobservable inputs for the nine months ended September 30, 2012 and 2011 (in thousands):

	Fair Value Measurements Using Significant Unobservable Inputs (Levels 3)		
	Embedded Derivative Liabilities	Warrant Derivative Liabilities	Total
Beginning balance at December 31, 2011	$ 3,680	$ 11,590	$ 15,270
Adjustment to estimated fair value	77	(2,773)	(2,696)
Accrued dividends payable in Series C-1[2] Preferred	143		143

Ending balance at September 30, 2012	$ 3,900	$ 8,817	$ 12,717

During the three and nine months ended September 30, 2012, the net decrease in the estimated fair value of derivative liabilities of $1,227,000 and $2,696,000 was recorded as non-cash other income in the Condensed Statements of Comprehensive Income (Loss).

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

During the three and nine months ended September 30, 2011, the net decrease in the estimated fair value of derivative liabilities of $3,993,000 and $3,346,000, was recorded as non-cash other income in the Condensed Statements of Comprehensive Income (Loss).

4. Asset Purchase Agreement

As described in Note 1, the Company acquired certain assets and rights to the GCS-100 compound on January 19, 2012 from Solana in an asset purchase transaction for nominal consideration.

This asset acquisition has been accounted for in accordance with the authoritative guidance for intangible assets. The consideration paid to acquire the Purchased Assets is required to be measured at fair value and, initially, the consideration to be measured consists only of the nominal amount paid at the Closing.

The Company filed its Series C-1[2]/D-1[2] Certificate with the State of Delaware on January 20, 2012. The Series C-1[2]/D-1[2] Certificate was superseded by the Articles of Incorporation of LJPC California (the Articles) in connection with the Company s reincorporation from Delaware to California. The Articles provide the holders with the following rights:

The holders of 2012 New Preferred Stock do not have voting rights, unless required by the California General Corporation Law or as set forth below.

Cumulative dividends are payable on the Series C-1[2] Stock and Series C-2[2] Stock (together referred to herein as the Series C Preferred) at a rate of 15% per annum, each accruing from the date of issuance through the date of conversion or redemption, payable semi-annually in shares of Series C-1[2] Stock and Series C-2[2] Stock, respectively. Neither the Series D-1[2] Stock nor the Series D-2[2] Stock is entitled to dividends.

The 2012 New Preferred Stock was initially convertible into Common Stock, at a rate of 166,667 shares of Common Stock for each share of 2012 New Preferred Stock, subject to certain limitations discussed below, at the election of the holders of New Preferred Stock. The conversion rate will be adjusted for certain events, such as stock splits, stock dividends, reclassifications and recapitalizations, and the 2012 New Preferred Stock is subject to full-ratchet anti-dilution protection such that any subsequent issuance of Common Stock below the effective conversion price of the 2012 New Preferred Stock at the time of such issuance automatically adjusts the conversion price of the 2012 New Preferred Stock to such lower price. There are also limits on the amount of 2012 New Preferred Stock that can be converted and the timing of such conversions. In accordance with the Consent Agreement, after the 2012 Reverse Stock Split, the conversion ratio for the 2012 New Preferred Stock was adjusted based on the trading price of the Company s common stock over a period of time. Accordingly, effective March 3, 2012, each share of 2012 New Preferred Stock was convertible into approximately 213,083 shares of common stock.

Effective with the Consent Agreement, in any week, each holder of 2012 New Preferred Stock may convert its amount of the outstanding 2012 New Preferred Stock held by the stockholder multiplied by the Conversion Cap (as defined in the Articles) for such week. Depending on the Closing Sales Prices (as defined in the Articles), the Conversion Cap can range from 0% to 3.76%. Moreover, holders of 2012 New Preferred Stock may not convert if such conversion would result in the holder or any of its affiliates beneficially owning more than 9.999% of the Company s then issued and outstanding shares of common stock. As of September 30, 2012, 613 shares of Series C-1^{2} Preferred had been converted into common stock.

Upon a Liquidation Event (as defined in the Articles), no other class or series of capital stock can receive any payment unless the 2012 New Preferred Stock has first received a payment in an amount equal to $1,000 per share, plus all accrued and unpaid dividends, if applicable.

In the event that certain actions occur without the prior written consent of the holders of 80% of the shares of 2012 New Preferred Stock and Warrants (as defined in the Securities Purchase Agreement) on an as-converted basis (the Requisite Holders), such as the Company s material breach of any material representation or warranty under the Asset Purchase Agreement, a suspension of the trading of the common stock, the failure to timely deliver shares on conversion of the 2012 New Preferred Stock, the Company commences a bankruptcy proceeding, winding up, dissolution and the like, or the consummation of a Change of Control (as defined in the Articles), then the holders of the Series C-1^{2} Preferred shall have the right, upon the delivery of a notice to the Company by the Requisite Holders, to have such shares redeemed by the Company for an amount equal to the greater of $1,000 per share, plus accrued and unpaid dividends, or the fair market value of the underlying common stock issuable upon conversion of the Series C-1^{2} Preferred.

In the event that the Company fails to timely deliver shares on conversion of the 2012 New Preferred Stock, under certain circumstances, the Company must pay the 2012 New Preferred Stock holder s costs and expenses of acquiring Cover Shares (as defined in the Articles).

Upon certain redemption events, such as the Company s breach of covenants or material representations or warranties under the Asset Purchase Agreement, the conversion price of the 2012 New Preferred Stock decreases to 10% of the conversion price in effect immediately before such redemption event.

So long as at least 1,000 shares of 2012 New Preferred Stock remain outstanding (or at least 3,000 shares of 2012 New Preferred Stock remain outstanding, if the Cash Warrants have been fully exercised), the Company may not take a variety of actions (such as altering the rights, powers, preferences or privileges of the 2012 New Preferred Stock so as to effect the 2012 New Preferred Stock adversely, amending any provision of the Company s articles of incorporation, setting aside any monies for the redemption, purchase or other acquisition of, or declare or pay any dividend or make any Distribution (as defined in the Articles) or other distribution other than pursuant to the Articles or equity compensation plans, increasing the value of the Common Stock, entering into an agreement for a Strategic Transaction or Change of Control (as defined in the Articles), consummating any financing or filing a registration statement with the Securities and Exchange Commission, incurring liabilities for no consideration or for cash consideration, property, services or other exchange, or taking any action or entering into any agreement causing the Company s Net Cash (as defined in the Articles) to fall below $2,900,000 until the date that is thirteen months from the Closing of the asset purchase) without the prior approval of the Requisite Holders.

Subject to the approval of the Requisite Holders, 2,900 shares of the Series C-1^{2} Stock are redeemable on, and only on, the twelve-month anniversary of the Closing of the asset purchase.

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5. GliaMed Asset Purchase

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

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

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

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

As part of this asset purchase, the Company designated five new series of preferred stock on March 30, 2011: its Series C-1[1] Stock, Series C-2[1] Stock, Series D-1[1] Stock, Series D-2[1] Stock (collectively, the New Preferred Stock) and Series E Preferred Stock. It exchanged on a one-for-one exchange ratio each share of its existing Series C-1 Preferred Stock that was outstanding for a new share of Series C-1[1] Stock. Each holder of New Preferred Stock and Series E Preferred Stock may convert its shares into common stock subject to a weekly conversion cap and certain common stock ownership limits.

6. Securities Purchase Agreement

On May 24, 2010, the Company entered into a Securities Purchase Agreement by and among the Company and the purchasers named therein (the Purchasers). The Purchasers included institutional investors as well as the Company s then Chief Executive Officer and Chief Financial Officer as well as an additional Company employee at that time. The total investment by these Company employees represented less than 3% of the proceeds received by the Company in the May 2010 Financing. Pursuant to the Securities Purchase Agreement, on May 26, 2010 (the Closing Date or Closing), for total consideration of $6,003,000, the Purchasers purchased (i) an aggregate of 2,897 shares of the Company s Common Stock, par value $0.0001 per share, at a contractually stated price of $300 per share, and (ii) 5,134 shares of the Company s Series C-1 Preferred, par value $0.0001 per share, at a contractually stated price of $1,000 per share. The Purchasers also received (i) Series D-1 Warrants to purchase 5,134 shares of the Company s Series D-1 Preferred, par value $0.0001 per share, at an exercise price of $1,000 per share, which warrants may be exercised on a cashless basis, and (ii) Series C-2 Warrants to purchase 10,268 units, at an exercise price of $1,000 per unit, which warrants are exercisable only in cash, with each unit consisting of one share of the Company s Series C-2 Preferred, par value $0.0001 per share, and an additional Series D-2 Warrant to purchase one share of the Company s Series D-2 Preferred, par value $0.0001 per share, at an exercise price of $1,000 per share.

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

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

The Company filed its Series C/D Certificate and Series E Certificate (collectively, the Certificates) with the State of Delaware on March 30, 2011. Each Certificate provided the holders with the following rights (the Series C/D Certificate was superseded by the Series C-1^{2}/D-1^{2} Certificate that was filed on January 20, 2012 and the Series C-1^{2}/D-1^{2} Certificate was superseded by the Articles of Incorporation of LJPC California filed in connection with the Company s reincorporation from Delaware to California):

The holders of New Preferred Stock and Series E Preferred Stock (collectively, the C/D/E Preferred Stock) did not have voting rights unless required by the Delaware General Corporation Law or as set forth below.

Cumulative dividends were payable on the Series C-1^{1} Stock and Series C-2^{1} Stock (together referred to herein as the Series C^{1} Preferred) at a rate of 15% per annum and on the Series E Preferred Stock at a rate of 5% per annum, each accruing from the date of issuance through the date of conversion or redemption, payable semi-annually in shares of Series C-1^{1} Stock, Series C-2^{1} Stock and Series E Preferred Stock, respectively, but subject to the temporary suspension of dividends with respect to the Series C^{1} Preferred, as described above. Neither the Series D-1^{1} Stock nor the Series D-2^{1} Stock was entitled to dividends.

The C/D/E Preferred Stock was convertible into common stock, initially at a rate of 66,667 shares of common stock for each share of C/D/E Preferred Stock, subject to certain limitations discussed below, at the election of the holders of C/D/E Preferred Stock. The conversion rate was adjusted for certain events, such as stock splits, stock dividends, reclassifications and recapitalizations, and the New Preferred Stock was subject to full-ratchet anti-dilution protection such that any subsequent issuance of common stock below the effective conversion price of the C/D/E Preferred Stock at the time of such issuance automatically adjusts the conversion price of the C/D/E Preferred Stock to such lower price. There were also limits on the amount of C/D/E Preferred Stock that could be converted and the timing of such conversions. The New Preferred Stock could be converted starting the first Monday following the Closing of the asset purchase. The Series E Preferred Stock could not be converted until the first Monday following the achievement of the Preclinical Milestone under the Agreement.

Upon a Liquidation Event (as defined in each Certificate), no other class or series of capital stock could receive any payment unless the New Preferred Stock has first received a payment in an amount equal to $1,000 per share, plus all accrued and unpaid dividends, if applicable. Once the New Preferred Stock received its liquidation payment, the Series E Preferred Stock was entitled to receive a payment in an amount equal to $1,000 per share, plus all accrued and unpaid dividends, if applicable.

In the event that certain actions occurred without the prior written consent of the holders of two-thirds of the then outstanding shares of New Preferred Stock (the Requisite Holders), such as the Company s material breach of any material representation or warranty under the Securities Agreement, a suspension of the trading of the Company s common stock, the failure to timely deliver shares on conversion of the C/D/E Preferred Stock, or the consummation of a Change of Control (as defined in the Certificate of Designations), then the holders of the Series C^{1} Preferred had the right, upon the delivery of a notice to the Company by the Requisite Holders, to have such shares redeemed by the Company for an amount equal to

the greater of $1,000 per share, plus accrued and unpaid dividends, or the fair market value of the underlying common stock issuable upon conversion of the Series C^{1} Preferred. The Series E Preferred Stock did not have similar redemption rights.

Upon certain redemption events, such as the Company s breach of covenants or material representations or warranties under the Purchase Agreement, the conversion price of the C/D/E Preferred Stock would decrease to 10% of the conversion price in effect immediately before such redemption event.

So long as at least 1,000 shares of New Preferred Stock remained outstanding (or at least 3,000 shares of New Preferred Stock remained outstanding if the Cash Warrants had been fully exercised), the Company may not take a variety of actions (such as altering the rights, powers, preferences or privileges of the New Preferred Stock so as to effect the New Preferred Stock adversely, amending any provision of the Company s certificate of incorporation, entering into an agreement for a Strategic Transaction or Change of Control (as each is defined in the Series C/D Certificate, and may not consummate any financing or file a registration statement with the Securities and Exchange Commission without the prior approval of the Requisite Holders. The Series E Preferred Stock did not have similar protective provisions.

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

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

Accounting Treatment

On May 26, 2010, the Company issued 5,134 shares of Series C-1^{2} Preferred and recorded the par value of $0.0001 per share with a corresponding reduction to paid-in capital, given that there was no allocated value from the proceeds to the Series C-1^{2} Preferred.

Under accounting guidance covering accounting for redeemable equity instruments, preferred securities that are redeemable for cash or other assets are to be classified outside of permanent equity (within the mezzanine section between liabilities and equity on the balance sheets) if they are redeemable at the option of the holder or upon the occurrence of an event that is not solely within the control of the issuer. As there are redemption-triggering events related to the Series C-1^{2} Preferred that are not solely within the control of the Company, the Series C-1^{2} Preferred was classified outside of permanent equity.

The Company may be required to redeem the Series C-1^{2} Preferred if a redemption event occurs. Since the Company did not consummate a Strategic Transaction by February 26, 2011, the Series C-1^{2} Preferred is currently redeemable and therefore the Company adjusted the carrying value of the Series C-1^{2} Preferred to the redemption value of such shares. The carrying value at September 30, 2012, of $5,800,000 represents the redemption value of the Series C-1^{2} Preferred plus accrued and unpaid dividends.

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Derivative Liabilities

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

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

Accounting Treatment

The Company accounts for the conversion and redemption features embedded in the Series C-1^2 Preferred (the Embedded Derivatives) in accordance with accounting guidance covering derivatives. Under this accounting guidance, companies may be required to bifurcate conversion and redemption features embedded in redeemable convertible preferred stock from their host instruments and account for these embedded derivatives as free standing derivative financial instruments. If the underlying security of the embedded derivative requires net cash settlement in the event of circumstances that are not solely within the Company s control, the embedded derivative should be classified as a liability, measured at fair value at issuance and adjusted to their current fair value at each period. As there are redemption triggering events for net cash settlement for Series C-1^2 Preferred that are not solely within the Company s control, and the conversion feature is a derivative, the Embedded Derivatives are classified as liabilities and are accounted for using fair value accounting at each reporting date (also see Note 3).

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

The estimated fair values of the Derivative Liabilities as of September 30, 2012 and December 31, 2011 are summarized as follows (in thousands):

	Fair Value Measurement at	
	September 30, 2012	December 31, 2011
Embedded Derivatives of Series C-1^2 Preferred (including dividends paid in Series C-1^2 Preferred)	$ 3,707	$ 3,628
Embedded Derivatives of accrued dividends payable in Series C-1^2 Preferred	193	52
Series D-1^2 Warrants	571	2,539
Series C-2^2 Warrants for:		
Series C-2^2 Preferred	2,782	3,785
Series D-2^2 Warrants	5,464	5,266
	$ 12,717	$ 15,270

The Derivative Liabilities were valued using binomial option pricing models with various assumptions detailed below. Due to the six month trading restriction on the unregistered shares of common stock issued or issuable from the conversion of Preferred Stock and the weekly conversion limitation on Preferred Stock as well as

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the uncertainty of the Company s ability to continue as a going concern, the price per share of the Company s common stock used in the binomial option pricing models for the Derivative Liabilities was discounted from the closing market prices of $0.06 and $0.27 on September 30, 2012 and December 31, 2011, respectively. The expected lives that were used to value each of the Derivative Liabilities were based on the individual characteristics of the underlying Preferred Stock, which impact the expected timing of conversion into common stock. In addition, the probabilities associated with the successful clinical development of a drug candidate based on industry data were used in each of the binomial option pricing models. The models used to value the Series C-2[2] Warrants and Series D-1[2] Warrants are particularly sensitive to such probabilities, as well as to the closing price per share of the Company s common stock. To better estimate the fair value of the Derivative Liabilities at each reporting period, the binomial option pricing models and their inputs were refined based on information available to the Company. Such changes did not have a significant impact on amounts recorded in previous interim reporting periods.

At December 31, 2011, the total value of the Embedded Derivatives was $3,680,000. At September 30, 2012, the total value of the Embedded Derivatives was $3,900,000, resulting in non-cash other expense on the increase in the estimated fair value of the Embedded Derivatives for the nine months ended September 30, 2012 of $77,000 (exclusive of the net increase in the liability of $143,000 due to the accrual of dividends). Such increase in value was primarily due to the changes in the Company s common stock price and adjustment to the conversion price of the preferred stock, after consideration of the 2012 Reverse Stock Split and the updates to the assumptions used in the option pricing models.

The Embedded Derivatives were valued at September 30, 2012 and December 31, 2011 using a binomial option pricing model, based on the value of the Series C-1[2] Preferred shares with and without embedded derivative features, with the following assumptions:

	September 30, 2012	December 31, 2011
Closing price per share of common stock	$ 0.044	$ 0.27
Conversion price per share	$ 0.005	$ 0.60
Volatility	98.2%	88.0%
Risk-free interest rate	0.58%	0.83%
Credit spread	19.8%	20.9%
Remaining expected lives of underlying securities (years)	4.8	5.0

On December 31, 2011, the Series D-1[2] Warrants were recorded at estimated fair value of $2,539,000. On September 30, 2012, the Series D-1[2] Warrants were revalued at $571,000 resulting in non-cash other income on the decrease in the estimated fair value of the Series D-1[2] Warrants of $1,968,000. Such decrease in value was primarily due to the exercise of 3,611 Series D-1[2] Warrants and updates to the assumptions used in the option pricing models.

The Series D-1[2] Warrants were valued at September 30, 2012 and December 31, 2011 using a binomial option pricing model with the following assumptions:

	September 30, 2012	December 31, 2011
Closing price per share of common stock	$ 0.044	$ 0.27
Conversion price per share	$ 0.005	$ 0.60
Volatility	74.8%	67.5%
Risk-free interest rate	0.23%	0.28%
Remaining expected lives of underlying securities (years)	2.5	2.2
Probability of Strategic Transaction	41%	70%

On December 31, 2011, the Series C-2[2] Warrants (which consist of rights to purchase Series C-2[2] Preferred and Series D-2[2] Warrants) were recorded at an estimated fair value of $9,051,000. On September 30, 2012, the Series C-2[2] Warrants were revalued at $8,246,000, resulting in non-cash other income on the decrease in the estimated fair value of the Series C-2[2] Warrants of $805,000. Such decrease in value was primarily due to the extension of the term to cover the longer clinical trial period, and the updates to the assumptions used in the option pricing models.

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The portion of the Series C-2[2] Warrants that represent the rights to purchase Series C-2[2] Preferred were valued at September 30, 2012 and December 31, 2011 using a binomial option pricing model. The pricing model determines the value of the Series C-2[2] Preferred at the warrant exercise date, which is assumed to be at the end of the successful Phase 2 clinical trial and subtracts the value of the Series C-2[2] Preferred with the exercise price. The assumptions are:

	September 30, 2012	December 31, 2011
Closing price per share of common stock	$ 0.044	$ 0.27
Conversion price per share	$ 0.005	$ 0.60