

LA JOLLA PHARMACEUTICAL CO

Form 10-Q

August 10, 2012

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 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)

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<b>California</b> (State or other jurisdiction of incorporation or organization)	<b>33-0361285</b> (I.R.S. Employer Identification No.)
<b>4370 La Jolla Village Drive, Suite 400</b>	
<b>San Diego, CA</b> (Address of principal executive offices)	<b>92122</b> (Zip Code)
<b>Registrant's telephone number, including area code: (858) 452-6600</b>	

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

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

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input checked="" type="checkbox"/>

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

The number of shares of the registrant's common stock, \$0.0001 par value per share, outstanding at August 6, 2012 was 13,567,383.

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**LA JOLLA PHARMACEUTICAL COMPANY**

**FORM 10-Q**

**QUARTERLY REPORT**

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**Table of Contents****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)

	June 30, 2012 (Unaudited)	December 31, 2011 (See Note)
<b><u>ASSETS</u></b>		
Current assets:		
Cash and cash equivalents	\$ 3,806	\$ 5,040
Prepays and other current assets	97	60
<b>Total current assets</b>	<b>3,903</b>	<b>5,100</b>
<b>Total assets</b>	<b>\$ 3,903</b>	<b>\$ 5,100</b>
<b><u>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS DEFICIT</u></b>		
Current liabilities:		
Accounts payable	\$ 129	\$ 8
Accrued expenses	89	240
Accrued payroll and related expenses	12	7
Derivative liabilities	13,806	15,270
<b>Total current liabilities</b>	<b>14,036</b>	<b>15,525</b>
Series C-1 <sup>2</sup> redeemable convertible preferred stock, \$0.0001 par value; 11,000 shares authorized, 5,392 and 5,043 shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively (redemption value and liquidation preference in the aggregate of \$5,468 at June 30, 2012 and \$5,116 at December 31, 2011)	5,560	5,133
<b>Commitments and contingencies</b>		
Stockholders' deficit:		
Common stock	5	
Preferred stock	3,595	
Additional paid-in capital	422,747	424,071
Accumulated deficit	(442,040)	(439,629)
<b>Total stockholders' deficit</b>	<b>(15,693)</b>	<b>(15,558)</b>
<b>Total liabilities, redeemable convertible preferred stock and stockholders' deficit</b>	<b>\$ 3,903</b>	<b>\$ 5,100</b>

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.



**Table of Contents****Condensed Statements of Comprehensive Income (Loss)**

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<b>Expenses:</b>				
Research and development	\$ 336	\$ 177	\$ 370	\$ 177
General and administrative	2,877	727	3,514	1,205
 Total expenses	 3,213	 904	 3,884	 1,382
 Loss from operations	 (3,213)	 (904)	 (3,884)	 (1,382)
<b>Other income (expense):</b>				
Adjustments to fair value of derivative liabilities	(4,485)	5,382	1,469	(647)
Other income (expense), net	1	236	2	234
 Net income (loss)	 (7,697)	 4,714	 (2,413)	 (1,795)
Preferred stock dividend forfeited (earned)	(76)	78	(76)	78
 Net income (loss) and comprehensive income (loss) attributable to common stockholders	 \$ (7,773)	 \$ 4,792	 \$ (2,489)	 \$ (1,717)
 Net income (loss) per basic share	 \$ (0.67)	 \$ 0.39	 \$ (0.36)	 \$ (0.26)
Net income (loss) per diluted share	\$ (0.67)	\$ 0.01	\$ (0.36)	\$ (0.26)
 Shares used in computing basic net income (loss) per share	 11,603	 12,389	 6,886	 6,700
Shares used in computing diluted net income (loss) per share	11,603	556,871	6,886	6,700

See accompanying notes.

**Table of Contents****LA JOLLA PHARMACEUTICAL COMPANY****Condensed Statements of Cash Flows**

(Unaudited)

(In thousands)

	Six Months Ended June 30,	
	2012	2011
<b>Operating activities:</b>		
Net loss	\$ (2,413)	\$ (1,795)
Adjustments to reconcile net loss to net cash used for operating activities:		
Share-based compensation expense	2,710	131
(Gain) loss on adjustments to fair value of derivative liabilities	(1,469)	647
Change in operating assets and liabilities:		
Prepays and other current assets	(37)	48
Accounts payable	121	(13)
Accrued expenses	(151)	(79)
Accrued payroll and related expenses	5	(13)
<b>Net cash used for operating activities</b>	<b>(1,234)</b>	<b>(1,074)</b>
Net decrease in cash and cash equivalents	(1,234)	(1,074)
Cash and cash equivalents at beginning of period	5,040	6,866
Cash and cash equivalents at end of period	\$ 3,806	\$ 5,792
<b>Supplemental schedule of noncash investing and financing activities:</b>		
Issuance of preferred stock	\$ 3,611	\$
Conversion of preferred stock into common stock	\$ (25)	\$ (248)
Reclassification of preferred stock currently redeemable	\$	\$ 5,532
Preferred stock dividends earned	\$ (76)	\$
Payment of preferred stock dividends	\$ 374	\$
Forfeiture of preferred stock dividends	\$	\$ (78)

See accompanying notes.

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**LA JOLLA PHARMACEUTICAL COMPANY**

**Notes to Condensed Financial Statements**

(Unaudited)

**June 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 six months ended June 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 June 30, 2012, the Company had no revenue sources, an accumulated deficit of \$442,040,000 and available cash and cash equivalents of \$3,806,000, 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 June 30, 2012. However, these factors raise substantial doubt about the Company's ability to continue as a going concern.

*Significant 2012 Events*

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 to 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<sup>1</sup> 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<sup>2</sup> Convertible Preferred Stock (Series C-1<sup>2</sup> Stock), Series C-2 Convertible Preferred Stock (Series C-2 Stock), Series D-1 Convertible Preferred Stock (Series D-1 Stock) and Series D-2 Convertible Preferred Stock (Series D-2 Stock) (the Series C-1<sup>2</sup> 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<sup>2</sup> Stock, Series C-2<sup>2</sup> Stock, Series D-1<sup>2</sup> Stock, and Series D-2<sup>2</sup> Stock (collectively, the 2012 New Preferred Stock ). It exchanged on a one-for-one basis each share of its existing Series C-1<sup>1</sup> Convertible Preferred Stock that was outstanding for a new share of Series C-1<sup>2</sup> 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<sup>2</sup> Stock held by the stockholder on the Closing multiplied by the Conversion Cap (as defined in the Series C-1<sup>2</sup>/D-1<sup>2</sup> Certificate) for such week. Depending on the Volume-Weighted Closing Price, or VWCP (as defined in the Series C-1<sup>2</sup>/D-1<sup>2</sup> Certificate), for the last three Trading Days (as defined in the Series C-1<sup>2</sup>/D-1<sup>2</sup> 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<sup>2</sup> Stock may redeem a number of shares of Series C-1<sup>2</sup> Stock equal to the lesser of (i) the entire balance of the outstanding Series C-1<sup>2</sup> Stock, and (ii) 2,900 shares of Series C-1<sup>2</sup> 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<sup>2</sup> Stock redeem a number of shares of Series C-1<sup>2</sup> Stock equal to or greater than the lesser of (i) the entire balance of the outstanding Series C-1<sup>2</sup> Stock and (ii) 2,900 shares of Series C-1<sup>2</sup> 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.

*Significant 2011 Events*

In March 2011, the Company and its formerly wholly-owned subsidiary, Jewel Merger Sub, Inc. acquired the rights to compounds known as Regenerative Immunophilin Ligands ( RILs or Compounds ) from privately held GliMed, Inc. ( GliMed ). The Compounds were acquired pursuant to an Asset Purchase Agreement (the Asset Agreement ) for a nominal amount, and if certain development and regulatory milestones were met, the Company would have paid GliMed additional consideration consisting of up to 8,205 shares of newly designated Series E Convertible Preferred Stock ( Series E Preferred ), which would have been convertible into approximately 20% of the Company's fully diluted outstanding common stock on an as-converted basis. GliMed would have also been eligible for a potential cash payment from the Company if a Compound was approved by the Food and Drug Administration, or FDA, or European Medicines Agency, or EMA, in two or more clinical indications (see Note 5).

Also in March 2011, the Company entered into a Consent and Amendment Agreement (the Consent Agreement ), dated as of March 29, 2011, with certain holders of convertible redeemable Series C-1 preferred stock ( Series C-1 Preferred ), in order to amend certain terms of the Company's Securities Purchase Agreement, dated as of May 24, 2010 ( Securities Purchase Agreement ) (see Note 6). The purpose of the Consent Agreement was to revise certain terms of the Company's outstanding preferred

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securities in connection with the Company's acquisition of the Compounds. Additionally, as part of the Consent Agreement, the Company designated five new series of preferred stock: its Series C-1<sup>1</sup> Convertible Preferred Stock ( Series C-1<sup>1</sup>Preferred ), Series C-2<sup>1</sup> Convertible Preferred Stock ( Series C-2<sup>1</sup>Preferred ), Series D-1<sup>1</sup> Convertible Preferred Stock ( Series D-1<sup>1</sup>Preferred ), Series D-2<sup>1</sup> Convertible Preferred Stock ( Series D-2<sup>1</sup>Preferred ) and collectively with the Series C-1<sup>1</sup>Preferred, the Series C-2<sup>1</sup> Preferred and the Series D-1<sup>1</sup> Preferred, the New Preferred Stock ) and Series E Preferred. The Company exchanged on a one-for-one basis each share of its existing Series C-1 Preferred that was outstanding for a new share of Series C-1<sup>1</sup> Preferred (see Note 5).

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

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

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

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

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

As of December 31, 2011, the Preferred Stockholders had the right to require the Company to redeem all outstanding shares of Series C-1<sup>1</sup> Preferred for an aggregate sum of approximately \$5,116,000. The Preferred Stockholders did not exercise this redemption right at December 31, 2011 or prior to the Asset Purchase Agreement in January 2012.

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### **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

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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.

### **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 six months ended June 30, 2012 and 2011 and the three months ended June 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

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

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

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

	<b>Fair Value Measurements at June 30, 2012</b>			
	Balance at June 30, 2012	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Embedded derivative liabilities	\$ 4,062	\$	\$	\$ 4,062
Warrant derivative liabilities	9,744			9,744
<b>Total</b>	<b>\$ 13,806</b>	<b>\$</b>	<b>\$</b>	<b>\$ 13,806</b>

	<b>Fair Value Measurements at December 31, 2011</b>			
	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
<b>Total</b>	<b>\$ 15,270</b>	<b>\$</b>	<b>\$</b>	<b>\$ 15,270</b>

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

	<b>Fair Value Measurements Using Significant Unobservable Inputs (Level 3)</b>		
	<b>Embedded Derivative Liabilities</b>	<b>Derivative Liabilities</b>	<b>Total</b>
Beginning balance at December 31, 2011	\$ 3,680	\$ 11,590	\$ 15,270
Adjustments to estimated fair value	(539)	(5,415)	(5,954)
Accrued dividends payable in Series C-1 <sup>2</sup> Preferred	101		101
Ending balance at March 31, 2012	\$ 3,242	\$ 6,175	\$ 9,417
Adjustments to estimated fair value	916	3,569	4,485
Accrued dividends payable in Series C-1 <sup>2</sup> Preferred	(96)		(96)
<b>Ending balance at June 30, 2012</b>	<b>\$ 4,062</b>	<b>\$ 9,744</b>	<b>\$ 13,806</b>

During the six months ended June 30, 2012, the net decrease in the estimated fair value of derivative liabilities of \$1,469,000 was recorded as non-cash other income in the Statement of Comprehensive Income (Loss).

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	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Warrant		
	Embedded Derivative Liabilities	Derivative Liabilities	Total
Beginning balance at December 31, 2010	\$ 5,170	\$ 932	\$ 6,102
Adjustments to estimated fair value	159	5,870	6,029
Forfeited accrued dividends payable in Series C-1 <sup>2</sup> Preferred	(72)		(72)
Ending balance at March 31, 2011	\$ 5,257	\$ 6,802	\$ 12,059
Adjustments to estimated fair value	(924)	(4,458)	(5,382)
Ending balance at June 30, 2011	\$ 4,333	\$ 2,344	\$ 6,677

During the six months ended June 30, 2011, the estimated fair value of derivative liabilities increased by a net amount of \$647,000, which was recorded as other expense in the Statement 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<sup>2</sup>/D-1<sup>2</sup> Certificate with the State of Delaware on January 20, 2012. The Series C-1<sup>2</sup>/D-1<sup>2</sup> 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<sup>2</sup> Stock and Series C-2<sup>2</sup> 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<sup>2</sup> Stock and Series C-2<sup>2</sup> Stock, respectively. Neither the Series D-1<sup>2</sup> Stock nor the Series D-2<sup>2</sup> 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

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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 June 30, 2012, 613 shares of Series C-1<sup>2</sup> Preferred had been converted into common stock.



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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<sup>2</sup> Preferred shall have the right, upon the delivery of a notice to the Company by the Requisite Holders, to have such shares redeemed by the Company for an amount equal to the greater of \$1,000 per share, plus accrued and unpaid dividends, or the fair market value of the underlying common stock issuable upon conversion of the Series C-1<sup>2</sup> 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<sup>2</sup> Stock are redeemable on, and only on, the twelve-month anniversary of the Closing of the asset purchase.

**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.

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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<sup>1</sup> Stock, Series C-2<sup>1</sup> Stock, Series D-1<sup>1</sup> Stock, Series D-2<sup>1</sup> 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<sup>1</sup> 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.

As discussed in Note 1, 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<sup>1</sup> Preferred and Series C-2<sup>1</sup> Preferred (ii) to provide an additional cash payment of approximately \$236,000 in exchange for the right to receive Series C-2<sup>1</sup> Preferred upon the achievement of certain pre-specified results in the preclinical study of one of the Compounds (the Preclinical Milestone), (iii) to increase the warrants that must be exercised for cash from 10,268 to 10,646 units, (iv) the mandatory exercise of \$7,452,000 of such warrants upon the achievement of the Preclinical Milestone, (v) the mandatory exercise of the remaining \$3,194,000 of warrants upon the achievement of a future clinical milestone and (vi) an automatic one-time downward conversion price adjustment following the 2011 Reverse Stock Split.

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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<sup>2</sup>/D-1<sup>2</sup> Certificate that was filed on January 20, 2012 and the Series C-1<sup>2</sup>/D-1<sup>2</sup> 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<sup>1</sup> Stock and Series C-2<sup>1</sup> Stock (together referred to herein as the Series C 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<sup>1</sup> Stock, Series C-2<sup>1</sup> Stock and Series E Preferred Stock, respectively, but subject to the temporary suspension of dividends with respect to the Series C<sup>1</sup> Preferred, as described above. Neither the Series D-1<sup>1</sup> Stock nor the Series D-2<sup>1</sup> 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<sup>1</sup> 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<sup>1</sup> 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

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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<sup>1</sup> Preferred (ii) to provide additional working capital by July 29, 2011, in an amount to be determined, if the Requisite Holders (as defined in the Amendment Agreement) determined by July 22, 2011 that, as of such date, the Company was continuing to pursue a Strategic Transaction (as defined in the Amendment Agreement) (iii) to purchase up to all of the outstanding Series C-1<sup>1</sup> 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<sup>1</sup> Preferred (ii) to provide additional working capital, in an amount to be determined, if the Requisite Holders (as defined in the Second Amendment Agreement) determine by September 2, 2011, and then again by September 26, 2011, that, as of such date, the Company was continuing to pursue a Strategic Transaction (as defined in the Second Amendment Agreement) (iii) to purchase up to all of the outstanding Series C-1<sup>1</sup> 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<sup>2</sup> Preferred and recorded the par value of \$0.0001 per share with a corresponding reduction to paid-in capital, given that there was no allocated value from the proceeds to the Series C-1<sup>2</sup> 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<sup>2</sup> Preferred that are not solely within the control of the Company, the Series C-1<sup>2</sup> Preferred was classified outside of permanent equity.

The Company may be required to redeem the Series C-1<sup>2</sup> Preferred if a redemption event occurs. Since the Company did not consummate a Strategic Transaction by February 26, 2011, the Series C-1<sup>2</sup> Preferred was currently redeemable and therefore the Company adjusted the carrying value of the Series C-1<sup>2</sup> Preferred to the redemption value of such shares. The carrying value at June 30, 2012, of \$5,560,000, represents the redemption value of the Series C-1<sup>2</sup> Preferred plus accrued and unpaid dividends.

### **Derivative Liabilities**

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

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The Series C-2<sup>2</sup> Warrants and Series D-1<sup>2</sup> Warrants are exercisable starting on the issuance date and expire three years from the date of issuance. The Series C-2<sup>2</sup> Warrants must be exercised in cash and beginning in June 2011, they are no longer subject to mandatory exercise terms. The Series D-1<sup>2</sup> 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<sup>2</sup> Preferred (the Embedded Derivatives) in accordance with accounting guidance covering derivatives. Under this accounting guidance, companies may be required to bifurcate conversion and redemption features embedded in redeemable convertible preferred stock from their host instruments and account for these embedded derivatives as free standing derivative financial instruments. If the underlying security of the embedded derivative requires net cash settlement in the event of circumstances that are not solely within the Company's control, the embedded derivative should be classified as a liability, measured at fair value at issuance and adjusted to their current fair value at each period. As there are redemption triggering events for net cash settlement for Series C-1<sup>2</sup> Preferred that are not solely within the Company's control, and the conversion feature is a derivative, the Embedded Derivatives are classified as liabilities and are accounted for using fair value accounting at each reporting date (also see Note 3).

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

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

	<b>Fair Value Measurements at</b>	
	<b>June 30, 2012</b>	<b>December 31, 2011</b>
Embedded Derivatives of Series C-1 <sup>2</sup> Preferred (including dividends paid in Series C-1 <sup>2</sup> Preferred)	\$ 3,408	\$ 3,628
Embedded Derivatives of accrued dividends payable in Series C-1 <sup>2</sup> Preferred	654	52
Series D-1 <sup>2</sup> Warrants	588	2,539
Series C-2 <sup>2</sup> Warrants for:		
Series C-2 <sup>2</sup> Preferred	3,535	3,785
Series D-2 <sup>2</sup> Warrants	5,621	5,266
	<b>\$ 13,806</b>	<b>\$ 15,270</b>

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

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as well as the uncertainty of the Company's ability to continue as a going concern, the price per share of the Company's common stock used in the binomial option pricing models for the Derivative Liabilities was discounted from the closing market prices of \$0.06 and \$0.27 on June 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<sup>2</sup> Warrants and Series D-1<sup>2</sup> 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 June 30, 2012, the total value of the Embedded Derivatives was \$4,062,000, resulting in non-cash other expense on the increase in the estimated fair value of the Embedded Derivatives for the six months ended June 30, 2012 of \$378,000 (exclusive of the net increase in the liability of \$4,000 due to the accrual of dividends). Such increase in value was primarily due to the changes in the Company's common stock price, 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 June 30, 2012 and December 31, 2011 using a binomial option pricing model, based on the value of the Series C-1<sup>2</sup> Preferred shares with and without embedded derivative features, with the following assumptions:

	June 30, 2012	December 31, 2011
Closing price per share of common stock	\$ 0.06	\$ 0.27
Conversion price per share	\$ 0.05	\$ 0.60
Volatility	87.5%	88.0%
Risk-free interest rate	0.64%	0.83%
Credit spread	20.4%	20.9%
Remaining expected lives of underlying securities (years)	4.5	5.0

On December 31, 2011, the Series D-1<sup>2</sup> Warrants were recorded at estimated fair value of \$2,539,000. On June 30, 2012, the Series D-1<sup>2</sup> Warrants were revalued at \$588,000 resulting in non-cash other income on the decrease in the estimated fair value of the Series D-1<sup>2</sup> Warrants of \$1,951,000. Such decrease in value was primarily due to the exercise of 4,021 Series D-1<sup>2</sup> Warrants and updates to the assumptions used in the option pricing models.

The Series D-1<sup>2</sup> Warrants were valued at June 30, 2012 and December 31, 2011 using a binomial option pricing model with the following assumptions:

	June 30, 2012	December 31, 2011
Closing price per share of common stock	\$ 0.06	\$ 0.27
Conversion price per share	\$ 0.05	\$ 0.60
Volatility	67.1%	67.5%
Risk-free interest rate	0.30%	0.28%
Remaining expected lives of underlying securities (years)	1.7	2.2
Probability of Strategic Transaction	N/A	70%

On December 31, 2011, the Series C-2<sup>2</sup> Warrants (which consist of rights to purchase Series C-2<sup>2</sup> Preferred and Series D-2<sup>2</sup> Warrants) were recorded at an estimated fair value of \$9,051,000. On June 30, 2012, the

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Series C-2<sup>2</sup> Warrants were revalued at \$9,156,000, resulting in non-cash other expense on the increase in the estimated fair value of the Series C-2<sup>2</sup> Warrants of \$105,000. Such increase in value was primarily due to the removal of the mandatory redemption requirement upon successful completion of the Strategic Transaction, the extension of the term to cover the longer clinical trial period, and the updates to the assumptions used in the option pricing models.

The portion of the Series C-2<sup>2</sup> Warrants that represent the rights to purchase Series C-2<sup>2</sup> Preferred were valued at June 30, 2012 and December 31, 2011 using a binomial option pricing model. The pricing model determines the value of the Series C-2<sup>2</sup> 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<sup>2</sup> Preferred with the exercise price. The assumptions are:

	June 30, 2012	December 31, 2011
Closing price per share of common stock	\$ 0.06	\$ 0.27
Conversion price per share	\$ 0.05	\$ 0.60
Volatility	87.5%	88.0%
Risk-free interest rate	0.64%	0.83%
Credit spread	20.4%	20.9%
Remaining expected lives of underlying securities (years)	4.5	5.0
Time to exercise (months)	18	24

The Series D-2<sup>2</sup> Warrants were valued at June 30, 2012 and December 31, 2011 using a binomial option pricing model with the same assumptions used in the valuation of the Series D-1<sup>2</sup> Warrants. The increase in the value of the Series D-2<sup>2</sup> Warrants for the six months ended June 30, 2012 of \$355,000 was primarily due to the updates to the assumptions used in the option pricing models.

## 7. Preferred Stock

### Preferred Stock

As of June 30, 2012, the Company's Board of Directors is authorized to issue 8,000,000 shares of preferred stock, with a par value of \$0.0001 per share, in one or more series, of which 11,000 are designated for Series C-1<sup>2</sup> Preferred, 22,000 are designated Series C-2<sup>2</sup> Preferred, 5,134 are designated Series D-1<sup>2</sup> Preferred, and 10,868 are designated Series D-2<sup>2</sup> Preferred. As of June 30, 2012, 5,392 shares of Series C-1<sup>2</sup> Preferred Stock and 3,595 shares of Series D-1<sup>2</sup> were issued and outstanding. As of December 31, 2011, 5,043 shares of Series C-1<sup>2</sup> Preferred Stock were issued and outstanding.

## 8. Stockholders Equity

### Warrants

In connection with the Company's public offering of shares of Common Stock and warrants to purchase shares of Common Stock in May 2008, the Company issued warrants to purchase 390 shares of the Company's Common Stock. The warrants were immediately exercisable upon grant, have an exercise price of \$21,500 per share and remain exercisable for five years. As of June 30, 2012, all of these warrants were outstanding and 390 shares of common stock are reserved for issuance upon exercise of the warrants.

### Share-Based Compensation

In June 1994, the Company adopted the La Jolla Pharmaceutical Company 1994 Stock Incentive Plan (the 1994 Plan), under which, as amended, 164 shares of common stock were authorized for issuance. The 1994 Plan expired in June 2004 and there were 11 options outstanding under the 1994 Plan as of June 30, 2012.

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In May 2004, the Company adopted the La Jolla Pharmaceutical Company 2004 Equity Incentive Plan (the 2004 Plan), under which, as amended, 640 shares of common stock have been authorized for issuance. The 2004 Plan provides for the grant of incentive and non-qualified stock options, as well as other share-based payment awards, to employees, directors, consultants and advisors of the Company with up to a 10-year contractual life and various vesting periods as determined by the Company's Compensation Committee or the Board of Directors, as well as automatic fixed grants to non-employee directors of the Company. As of June 30, 2012, there were a total of 75 options outstanding under the 2004 Plan and 537 shares remained available for future grant.

In August 2010, the Company adopted the 2010 Plan. The 2010 Plan is similar to the 2004 Plan, other than with regard to the number of shares authorized for issuance. On May 22, 2012, the 2010 Plan was amended so that a total of 1,188,414 shares, representing 10% of the number of shares of common stock issued and outstanding on April 11, 2012 (the record date used in connection with the Company's annual proxy) may be issued. This number of shares is initially reserved for issuance and is subject to periodic upward adjustment so that the total number of shares reserved under the 2010 Plan will, on the first day of each calendar quarter, be equal to 10% of the common stock issued and outstanding as of the last day of the prior calendar quarter. The adjustments continue through the quarter ending June 30, 2015 (resulting in a final adjustment on July 1, 2015). In no event will the number of shares potentially issuable under the 2010 Plan exceed 676,640,705, which represents 10% of the number of shares of common stock potentially outstanding on a fully-diluted and as-converted basis on April 11, 2012, after giving effect to the potential conversion of the convertible preferred stock that was issued and outstanding on April 11, 2012. As of June 30, 2012, there were a total of 16 options outstanding and 1,188,398 shares remained available for future grant under the 2010 Plan. Effective as of July 1, 2012, the Company has authorized 47,805 additional shares for issuance under the 2010 Plan.

On April 10, 2012, the Company awarded options to purchase up to 592,230,471 shares of common stock to the President and Chief Executive Officer, a board member and an employee. The inducement options were granted outside of the 2010 Plan, but they are subject to the terms and conditions of the 2010 Plan. The inducement options were granted at an exercise price of \$0.06 and two of the grants vest with respect to 25% of the underlying shares on a specified one-year anniversary date, with the remainder vesting monthly, in equal monthly installments, over the three years thereafter. The other grant vests on a quarterly basis over a one-year period (see Note 9).

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

	Outstanding Options	
	Number of Shares	Weighted-Average Exercise Price
Balance at December 31, 2011	894	\$ 17,462
Granted	592,230,471	\$ 0.06
Forfeited/Expired	(792)	\$ 10,457
Balance at June 30, 2012	592,230,573	\$ 0.07

As of June 30, 2012, options exercisable have a weighted-average remaining contractual term of 9.78 years. No stock option exercises occurred during the year ended December 31, 2011. As of June 30, 2012 and December 31, 2011, the total intrinsic value, which is the difference between the exercise price and closing price of the Company's common stock for options outstanding and exercisable, was \$0.

	June 30 2012		December 31 2011	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Exercisable at end of period	4,726,976	\$ 1.10	585	\$ 26,243
Weighted average fair value of options granted during the period	\$ 0.06		\$	





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Exercise prices and weighted-average remaining contractual lives for the options outstanding (excluding shares of restricted stock) as of June 30, 2012 were:

Options	Range of Exercise Prices	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Options Exercisable	Weighted-Average Exercise Price of Options Exercisable
Outstanding	\$0.06	9.78	\$ 0.06	4,726,874	\$ 0.06
592,230,471	\$201 - \$39,900	6.83	\$ 10,278	65	\$ 10,278
65	\$42,000	3.28	\$ 42,000	11	\$ 42,000
11	\$52,600	3.71	\$ 52,600	1	\$ 52,600
1	\$59,700	4.90	\$ 59,700	10	\$ 59,700
10	\$148,000	1.89	\$ 148,000	5	\$ 148,000
5	\$148,500	0.87	\$ 148,500	2	\$ 148,500
2	\$235,500	1.22	\$ 235,500	2	\$ 235,500
2	\$254,500	0.05	\$ 254,500	3	\$ 254,500
3	\$295,000	0.39	\$ 295,000	3	\$ 295,000
3					
592,230,573	\$0.06 - \$295,000	9.78	\$ 0.0683	4,726,976	\$ 1.10

At June 30, 2012, the Company has reserved 593,418,987 shares of common stock for future issuance upon exercise of options granted or to be granted under the 1994, 2004 and 2010 Plans, as well as for inducement options granted outside of the Company's equity compensation plans.

The following table summarizes share-based compensation expense related to stock options, restricted stock and restricted stock units by expense category (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Research and development	\$ 248	\$ 63	\$ 248	\$ 131
General and administrative	2,462	63	2,462	131
Share-based compensation expense included in operating expenses	\$ 2,710	\$ 63	\$ 2,710	\$ 131

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

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

Options:	Three and Six Months Ended	
	June 30, 2012	June 30, 2011

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Risk-free interest rate	1.10%	%
Dividend yield	0.0%	%
Volatility	236%	%
Expected life (years)	6.04	

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The remaining unamortized share-based compensation expense related to stock options as of June 30, 2012 is \$33,080,000. The remaining expense of the inducement option issued to the director totaling \$809,000, will be recognized over seven months, ending in January 2013. The remaining expense of the inducement options issued to the President and Chief Executive Officer and an employee totaling \$32,271,000, will be recognized over approximately 42 months, ending in January 2016.

### **Employee Stock Purchase Plan**

Effective August 1, 1995, the Company adopted the 1995 Employee Stock Purchase Plan, or ESPP, under which shares of common stock are reserved for sale to eligible employees, as defined in the ESPP. Employees may purchase common stock under the ESPP every three months (up to but not exceeding 10% of each employee's base salary or hourly compensation, and any cash bonus paid, subject to certain limitations) over the offering period at 85% of the fair market value of the common stock at specified dates. The offering period may not exceed 24 months. At the Annual Meeting of Stockholders held on August 12, 2010, the stockholders approved an amendment to the ESPP to extend the term thereof from 2010 to 2025 and to increase the shares of common stock authorized for issuance hereunder from 85 to 485. As of June 30, 2012, 72 shares of common stock have been purchased under the ESPP and 413 shares of common stock are available for future issuance. No shares were issued under the ESPP during the year ended December 31, 2011 or for the six months ended June 30, 2012.

### **Restricted Stock**

In April 2012, the Company issued restricted common stock to the President and Chief Executive Officer, a board member and an employee. The shares are issued outside of the 2010 Plan but are subject to the terms and conditions of the 2010 Plan. The total restricted shares are 2,987,850 and the stock will vest as of January 19, 2013, so long as the holders of the Series C-1<sup>2</sup> Preferred have not elected to redeem their holdings (see Note 4). If the services of the holder are terminated during the vesting period, the shares are subject to a reacquisition right. No consideration is paid for the redemption of the shares under the reacquisition right, but the holder is required to return to the Company any cash dividends paid or payable with respect to the shares. The grant date fair value is the market value on the grant date multiplied by the number of shares granted and share-based compensation expense is recognized on a straight-line basis over the vesting period. The share-based compensation expense during the three months and six months ended June 30, 2012 by expense category is \$40,000 for general and administrative expenses and \$11,000 for research and development expenses. The remaining unamortized share-based compensation expense to be recognized over the next seven months is \$128,000.

### **Restricted Stock Units**

On April 10, 2012, the Company granted restricted stock units ( RSUs ) of 14,219 units to an employee and 10,360,892 units to a board member, where each RSU represents a contingent right to receive one share of the Company's common stock. The RSUs vest according to a defined schedule in each agreement. Upon the designated vesting dates, the holders will receive common stock of the Company. The RSUs for the board member vest quarterly beginning on April 20, 2012 and ending on January 20, 2013. Twenty-five percent of the RSUs for the employee vest on January 19, 2013 and the remainder vest monthly after that date for 36 months.

Stock-based compensation cost of RSUs is measured by the market value of the Company's common stock on the date of grant. The grant date value of awards granted is amortized on a straight-line basis over the requisite service periods of the awards, which are the vesting periods. The weighted average grant date value was \$0.06 per RSU. The share-based compensation expense during the three months and six months ended June 30, 2012 by expense category is \$280,000 for general and administrative expenses and \$0 for research and development expenses. The remaining unamortized share-based compensation expense to be recognized over the next seven months is \$342,000 for the board member RSUs and \$1,000 to be recognized over the remaining service period for the employee RSUs.

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### **9. Employment Agreements**

As part of the Asset Purchase Agreement described in Note 1, the Company entered into an Employee Agreement with a new President and Chief Executive Officer on January 19, 2012. The annual base salary will be \$240,000 for the first year of employment with the Company and will increase to \$420,000 on the one-year anniversary of the employment start date. In addition, on April 10, 2012, an option to purchase up to 506,300,087 shares of common stock (the First Option) was awarded to the President and Chief Executive Officer, subject to the terms and conditions of any applicable award agreements and other restrictions and limitations generally applicable to common stock or equity awards held by Company executives or otherwise imposed by law. Subject to applicable terms and conditions, the First Option vests with respect to 25% of the underlying shares on the one-year anniversary of the employment start date, with the remainder vesting monthly, in equal monthly installments, over the three years thereafter. The First Option is exercisable at a price equal to the fair market value of a share of common stock on the date of the grant of the First Option. An additional option will be awarded to the President and Chief Executive Officer to purchase the number of shares of common stock equal to 7.5% of the Company's fully diluted, as-converted shares on the second anniversary of the employment start date, less the number of shares subject to the First Option on the First Option grant date (the Second Option), and the Second Option will also be subject to the same terms and conditions as the First Option. Subject to applicable terms and conditions, 50% of the underlying shares of the Second Option will be fully vested on the date of the grant with the remainder vesting monthly, in equal monthly installments, over the two years thereafter. The Second Option will be exercisable at a price equal to the fair market value of a share of common stock on the date of the grant of the Second Option.

On January 19, 2012, effective upon the closing of the Asset Purchase Agreement, the former President and Chief Executive Officer and the former Chief Financial Officer resigned. Both of the Company's aforementioned officers entered into separation agreements with the Company, and the Company agreed to make separation payments of \$78,000 and \$62,000, respectively. Further, both officers relinquished their rights to all Company stock options, whether vested or unvested.

### **10. 401(k) Plan**

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

Following guidance in IRS Notice 98-52 related to the safe harbor, 401(k) plan method, non-highly compensated employees will receive a contribution from the Company equal to 3% of their annual salaries, as defined in the Code. Such contributions vest immediately and are paid annually following each year end. These safe harbor contributions by the Company were less than \$8,000 for the year ended December 31, 2011. The contribution was paid during April 2012. The Company decided to end this plan in March 2012.

**Table of Contents****11. Net Income (Loss) per Share**

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<b>Numerator</b>				
Net income (loss)	\$ (7,697)	\$ 4,714	\$ (2,413)	\$ (1,795)
Preferred stock dividends forfeited (earned)	(76)	78	(76)	78
Numerator for basic EPS net income (loss) attributable to common stockholders	(7,773)	4,792	(2,489)	(1,717)
<b>Effect of dilutive securities:</b>				
Preferred stock dividends				
Numerator for diluted EPS net income (loss) attributable to common stockholders	\$ (7,773)	\$ 4,792	\$ (2,489)	\$ (1,717)
<b>Denominator:</b>				
<b>Weighted-average shares outstanding:</b>				
Basic EPS	11,603	12,389	6,886	6,700
Effect of dilutive convertible preferred stock and warrants		544,482		
Denominator for diluted EPS	11,603	556,871	6,886	6,700
Basic EPS	\$ (0.67)	\$ 0.39	\$ (0.36)	\$ (0.26)
Diluted EPS	\$ (0.67)	\$ 0.01	\$ (0.36)	\$ (0.26)

At June 30, 2012 and 2011, the potentially dilutive securities include 6.1 billion and 4.4 billion shares reserved for the exercise of outstanding stock options and warrants. The Series C-1<sup>2</sup> Preferred was convertible into 1.2 billion and 887 million at June 30, 2012 and 2011, respectively.

**12. Commitments and Contingencies**

As of June 30, 2012, there were no material operating leases, notes payable, purchase commitments or capital leases.

The Company maintains its operations in a temporary space under a short-term arrangement and expects that it will transition to permanent space under a long-term lease during 2012.

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

**Forward-Looking Statements**

The forward-looking statements in this report involve significant risks, assumptions and uncertainties, and a number of factors, both foreseen and unforeseen, could cause actual results to differ materially from our current expectations. Forward-looking statements include those that express a plan, belief, expectation, estimation, anticipation, intent, contingency, future development or similar expression. Accordingly, you should not rely upon forward-looking statements as predictions of future events. The outcome of the events described in these forward-looking statements are subject to the risks, uncertainties and other factors described in Management's Discussion and Analysis of Financial Condition and Results of Operations and in the Risk Factors contained in our Annual Report on Form 10-K for the year ended December 31, 2011, and in other reports and registration statements that we file with the Securities and Exchange Commission from time to time and as updated in Part II, Item 1A. Risk Factors contained in this Quarterly Report on Form 10-Q. We expressly disclaim any intent to update forward-looking statements.

**Overview**

La Jolla Pharmaceutical Company (the Company) is a biopharmaceutical company that 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.

Historically, we focused on the development and testing of Riquent as a treatment for Lupus nephritis. Lupus is an antibody-mediated disease caused by abnormal B cell production of antibodies that attack healthy tissues. From August 2004 to February 2009, Riquent was being studied in a double-blinded multicenter Phase 3 clinical trial, called the ASPEN trial, which was determined to be futile in February 2009. Accordingly, the ASPEN trial and the development of Riquent were discontinued in 2009. We do not currently plan to spend any additional effort on the development of Riquent.

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

Following the acquisition of the Compounds, the Company initiated a confirmatory preclinical animal study in April 2011 studying the lead RIL compound, LJP1485. This study was completed in May 2011, after which the Company received final data from the Company's clinical research organization, which data showed that the predetermined study endpoints were not met and that the LJP1485 compound did not show statistically significant improvement in the study endpoints as compared to vehicle (placebo). Due to the failure of the study, the Company halted the further development of the Compounds and GliaMed reacquired the Compounds through the purchase of the outstanding capital stock of Jewel Merger Sub, Inc. (which held title to the Compounds) for the same nominal consideration that GliaMed received at the closing of the Company's acquisition of the Compounds.

On January 19, 2012, we acquired rights to certain assets, including a lead clinical-stage compound designated GCS-100, from privately held Solana Therapeutics, Inc. (Solana), which was wholly owned by our largest holder of Series E Convertible Preferred Stock. The GCS-100 compound,

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which inhibits the expression of galectin-3 and may represent a novel treatment for certain types of cancers, was acquired pursuant to an asset purchase agreement for nominal consideration. As a result of our acquisition of these assets, we are now focused on the development of treatments that mediate the production of galectins as a means of treating human diseases such as cancer and chronic organ failure.

### **GCS-100 Overview**

We intend to leverage the unique biochemistry of the galectin family of proteins to pursue the development of innovative therapies to a multitude of human diseases. In particular, over-expression of galectin-3 (one member of the galectin family) has been implicated in cancer and chronic organ failure. Thus, modulation of galectin-3 activity is an attractive therapeutic target. GCS-100, our lead product, is a first-in-class inhibitor designed to sequester and eliminate circulating levels of galectin-3.

Galectins are lectins. Lectins are proteins found in the body that specifically interact with carbohydrate sugars located in, on the surface of and in between cells. This interaction causes the cells to change behavior, including cell movement, multiplication, and other cellular functions. The interactions between lectins and their target carbohydrate sugars occur via a carbohydrate recognition domain, or CRD, within the lectin. Galectins are a subfamily of lectins that have a CRD that bind specifically to  $\beta$ -galactoside sugar molecules. Galectins have a broad range of functions, including mediation of cell survival and adhesion, promotion of cell-cell interactions, growth of blood vessels, immune regulation and inflammation.

Over-expression of galectin-3 has been implicated in a number of human diseases including cancer and chronic organ failure. As such, this makes modulation of the activity of galectin-3 an attractive target for therapy in these diseases. Our initial programs will accordingly focus on modulation of galectin-3 in cancer using GCS-100, a complex polysaccharide that binds to and blocks the effects of galectin-3. We plan to develop GCS-100 and other inhibitors of galectin molecules as proprietary new agents subject to FDA approval.

### **Recent Developments**

On January 19, 2012, we entered into a Consent and Amendment Agreement (the *Amendment Agreement*) with certain of our Series C-1 Convertible Preferred Stock holders to amend the terms of our Securities Purchase Agreement, dated as of May 24, 2010 (the *Securities Purchase Agreement*), and the forms of Cash Warrants and Cashless Warrants (as defined in the Securities Purchase Agreement) initially issued under the Securities Purchase Agreement, as well as to adopt a Certificate of Designations, Preferences and Rights of Series C-1<sup>2</sup> Convertible Preferred Stock (the *Series C-1<sup>2</sup> Stock*), Series C-2 Convertible Preferred Stock (the *Series C-2 Stock*), Series D-1 Convertible Preferred Stock (the *Series D-1 Stock*) and Series D-2 Convertible Preferred Stock (the *Series D-2 Stock*) (the *Series C-1<sup>2</sup> Certificate*). Under the Amendment Agreement, the term of the warrants was extended to the third anniversary of the acquisition of the GCS-100 assets from Solana and the warrants were amended so that they would be exercisable for shares of 2012 New Preferred Stock (defined below).

As part of the Amendment Agreement, the Company designated four new series of preferred stock on January 19, 2012: Series C-1<sup>2</sup> Stock, Series C-2<sup>2</sup> Stock, Series D-1<sup>2</sup> Stock, and Series D-2<sup>2</sup> Stock (collectively, the *2012 New Preferred Stock*). The Company exchanged, on a one-for-one basis, each share of its existing Series C-1<sup>1</sup> Convertible Preferred Stock that was outstanding for a new share of Series C-1<sup>2</sup> 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 (the *Common Stock*), subject to a weekly conversion cap set forth in the Series C-1<sup>2</sup> Certificate. Each 2012 New Preferred Stock holder may only convert such preferred shares into Common Stock to the extent that after such conversion such holder beneficially owns less than 9.999% of the Company's issued and outstanding Common Stock.

On the first anniversary of the asset purchase agreement between the Company and Solana dated January 19, 2012 (the *Asset Purchase Agreement*) (i.e., January 19, 2013), the holders of Series C-1<sup>2</sup> Stock will have a one-time right to elect to redeem a number of shares of Series C-1<sup>2</sup> Stock equal to the lesser of (i) the entire balance of the outstanding Series C-1<sup>2</sup> Stock, and (ii) 2,900 shares of Series C-1<sup>2</sup>



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Stock. The 2012 New Preferred Stock also allows for redemption by its holders following the occurrence of certain other events, such as a breach of the terms and conditions of the Series C-1<sup>2</sup>/D-1<sup>2</sup> Certificate. If the holders of Series C-1<sup>2</sup> Stock redeem a number of shares of Series C-1<sup>2</sup> Stock equal to or greater than the lesser of: (i) the entire balance of the outstanding Series C-1<sup>2</sup> Stock and (ii) 2,900 shares of Series C-1<sup>2</sup> 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 GCS-100 assets, upon repaying to the Company the nominal consideration initially paid pursuant to the Asset Purchase Agreement.

As part of the Amendment Agreement, the Company agreed to implement a reverse split of the Company's Common Stock. Pursuant to the authority delegated to the Company's Board of Directors at a meeting of stockholders held in August 2010, the Company implemented a 1-for-100 reverse split of its Common Stock on February 17, 2012 (the 2012 Reverse Stock Split). No fractional shares were issued and, instead, stockholders received the cash value of any fractional shares that would have been issued. Share amounts in this report are shown post-split and therefore have been adjusted to reflect the Reverse Stock Split.

## **Critical Accounting Policies and Estimates**

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

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

There have been no material changes to the critical accounting policies as previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011 filed on March 30, 2012.

## **Recent Accounting Pronouncements**

Effective January 1, 2012, the Company adopted the guidance issued by the Financial Accounting Standards Board, or 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

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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.

**Results of Operations**

There were no revenues for the three and six months ended June 30, 2012 and 2011.

For the three and six months ended June 30, 2012, we incurred \$0.4 million in research and development expense primarily related to costs associated with the preclinical study compared to \$0.2 million for the same periods in 2011.

For the six months ended June 30, 2012, general and administrative expense increased to \$3.5 million, from \$1.2 million for the same period in 2011. The increase is primarily the result of an increase in share-based compensation expense of \$2.6 million. For the three months ended June 30, 2012, general and administrative expense was \$2.9 million, compared to \$0.7 million for the same period in 2011. The increase is primarily the result of an increase in share-based compensation expense of \$2.6 million.

For the three months ended June 30, 2012, non-operating expense as a result of adjustments to the estimated fair value of derivative liabilities was \$4.5 million. The derivative liabilities issued in the May 2010 financing were remeasured at their estimated fair value as of June 30, 2012, resulting in a net increase in value of \$4.5 million for the three months ended June 30, 2012, primarily due to the increase in the price per share of our Common Stock, the conversion of 5 shares of Series C-1<sup>2</sup> Stock into Common Stock, and changes in other inputs to the valuation models used to estimate the liabilities. This increase in value was recorded as non-operating expense.

For the three months ended June 30, 2011, non-operating income as a result of adjustments to the estimated fair value of derivative liabilities was \$5.4 million. The derivative liabilities issued in the May 2010 financing were remeasured at their estimated fair value as of June 30, 2011, resulting in a net decrease in value of \$5.4 million for the three months ended June 30, 2011, primarily due to the decrease in the price per share of our Common Stock, the conversion of 248 shares of Series C-1<sup>2</sup> Stock into Common Stock, and changes in other inputs to the valuation models used to estimate the liabilities. This decrease in value was recorded as non-operating income.

For the six months ended June 30, 2012, non-operating income as a result of adjustments to the estimated fair value of derivative liabilities was \$1.5 million. The derivative liabilities issued in the May 2010 financing were remeasured at their estimated fair value as of June 30, 2012, resulting in a net decrease in value of \$1.5 million for the six months ended June 30, 2012, primarily due to the decrease in the price per share of our Common Stock, the conversion of 25 shares of Series C-1<sup>2</sup> Stock into Common Stock, the exercise of 4,021 Series D-1<sup>2</sup> warrants and changes in other inputs to the valuation models used to estimate the liabilities. This decrease in value was recorded as non-operating income.

For the six months ended June 30, 2011, non-operating expense as a result of adjustments to the estimated fair value of derivative liabilities was \$0.6 million. The derivative liabilities issued in the May 2010 financing were remeasured at their estimated fair value as of June 30, 2011, resulting in a net increase in value of \$0.6 million for the six months ended June 30, 2011, primarily due to the decrease in the price per share of our Common Stock, the conversion of 248 shares of Series C-1<sup>2</sup> Stock into Common Stock, and changes in other inputs to the valuation models used to estimate the liabilities. This increase in value was recorded as non-operating expense.

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

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### **Liquidity and Capital Resources**

From inception through June 30, 2012, we have incurred a cumulative net loss of approximately \$442.0 million and have financed our operations through public and private offerings of securities, revenues from collaborative agreements, equipment financings and interest income on invested cash balances. From inception through June 30, 2012, we have raised approximately \$413 million in net proceeds from sales of equity securities.

At June 30, 2012, we had \$3.8 million in cash as compared to \$5.0 million of cash at December 31, 2011. Of our available cash at June 30, 2012, we could be required to pay up to \$2.9 million upon the redemption of our outstanding Series C-1<sup>2</sup> Stock. Such redemption was not considered probable as of June 30, 2012. Our working capital was (\$10.1) million at June 30, 2012, as compared to (\$10.4) million at December 31, 2011 and is largely driven by our derivative liability obligations which will likely change in value in the future. The decrease in cash resulted from the use of our financial resources to fund our general corporate operations.

In March 2011, we received funding of approximately \$0.2 million from certain of our investors to defray the costs of the confirmatory preclinical study of LJP1485 at that time.

Our history of recurring losses from operations, our cumulative net loss as of June 30, 2012, and the absence of any current revenue sources raise substantial doubt about our ability to continue as a going concern.

We maintain operations in temporary space under a short-term arrangement and expect to transition to permanent space under a long-term lease during 2012. No notes payable, purchase commitments, capital leases or other material contractual obligations existed as of June 30, 2012.

Our current business operations are focused on using our financial resources to fund our current obligations and to develop GCS-100 and other treatments that inhibit the activity of galectins as a means of treating human diseases. We do not have adequate resources to bring our current treatments to market and will need to raise additional cash. In the future, it is possible that we will not have adequate resources to support continued operations and we will need to cease operations.

### **Off-Balance Sheet Arrangements**

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

### **ITEM 4. CONTROLS AND PROCEDURES**

Our management, with the participation of our principal executive officer and principal financial officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2012. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ( "Exchange Act" ), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2012, our principal executive officer and principal financial officer concluded that, as of such date, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the quarter ended June 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



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**PART II. OTHER INFORMATION**

**ITEM 1A. Risk Factors**

**I. RISK FACTORS RELATING TO THE COMPANY AND THE INDUSTRY IN WHICH WE OPERATE.**

*We have only limited assets and we have limits under our charter on our ability to fully spend the cash assets that we currently have.*

As of June 30, 2012, we had no revenue sources, an accumulated deficit of \$442.0 million and available cash and cash equivalents of \$3.8 million, of which, at that time, up to \$2.9 million could be required to be paid upon the triggering of a redemption right under our outstanding Series C-1<sup>2</sup> Stock including accrued dividends. Although we acquired the GCS-100 patent estate in January 2012 for nominal consideration and we retain the rights (to the extent not forfeited) to the Riquent patent estate, the values of these assets are highly uncertain and Riquent has been written down under United States generally accepted accounting principles to nearly zero. As a result, we have only limited assets available to operate and develop our business. We are utilizing a portion of our existing cash balances to conduct future clinical study of GCS-100 and to evaluate whether or not GCS-100 should be developed further. If we determine that GCS-100 does not warrant further development and the investors redeem their C-1<sup>2</sup> Preferred, we would have only limited cash and would likely be forced to liquidate the Company. In that event, the funds resulting from the liquidation of our assets, net of amounts payable, would likely return only a small amount, if anything, to our stockholders.

Additionally, the Articles contain a term that, for a period of one year, purports to render *ultra vires* any transaction in which the Company causes its net cash balance to fall below \$2.9 million. Thus, if the Company authorizes any expenditure or enters into any contract whereby the Company's cash balance falls below this threshold, it is possible that a court could find that the Company did not have the requisite corporate authority to take such action. Accordingly, the Company intends to limit its overall expenditures through February 2013 so that it maintains this minimum balance. As a result, the Company effectively has only \$0.9 million available for the maintenance of operations and development of GCS-100 for the period of June 2012 through February 2013.

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**II. RISK FACTORS RELATED SPECIFICALLY TO OUR STOCK.**

*We currently have 13.6 million shares of Common Stock outstanding and currently may be required to issue up to 7.3 billion shares of Common Stock upon conversion of existing preferred stock and preferred stock warrants. Such an issuance would be significantly dilutive to our existing common stockholders.*

Upon the closing of the May 2010 Financing, the Company issued to investors approximately 5,134 shares of Series C-1<sup>2</sup> Stock. In light of the conversion ratio of our preferred stock (213,083 shares of Common Stock underlying every one share of Series C-1<sup>2</sup> Stock), the issuance of such a large number of preferred shares diluted the ownership of our existing stockholders and provided the new investors with a sizeable interest in the Company. These investors also received warrants to purchase shares of other series of preferred stock that may also be converted into Common Stock at a rate of 213,083 shares of Common Stock for every share of preferred stock held.

Giving effect to the potential exercise of the outstanding preferred warrants, and assuming the conversion of all preferred stock into Common Stock at the current conversion rate, we would have approximately 7.3 billion shares of Common Stock issued and outstanding, although the issuance of the Common Stock upon the conversion of our preferred stock is limited by a 9.999% beneficial ownership cap for each preferred stockholder. With approximately 13.6 million shares of Common Stock issued and outstanding as of the date of this report, the issuance of this number of shares of Common Stock underlying the preferred stock would represent approximately 99% dilution to our existing stockholders. It is possible that our current stock price does not reflect our fully-diluted and as-converted capital structure, which means that the conversion of preferred stock into Common Stock could significantly reduce our stock price.

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**ITEM 6. EXHIBITS**

<b>Exhibit Number</b>	<b>Description</b>
2.1	Agreement and Plan of Merger of La Jolla Pharmaceutical Company, a Delaware corporation and LJPC Merger Sub, Inc., a California corporation (1)
3.1	Articles of Incorporation (1)
3.2	Bylaws (1)
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
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

(1) Previously filed with the Company's Current Report on Form 8-K, filed June 20, 2012 and incorporated by reference herein.

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**SIGNATURES**

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

Date: August 10, 2012

La Jolla Pharmaceutical Company

/s/ George Tidmarsh  
George Tidmarsh, M.D., Ph.D.  
President, Chief Executive Officer and  
Secretary (As Principal Executive, Financial  
and Accounting Officer)