LIGAND PHARMACEUTICALS INC
Form 10-Q
August 09, 2006

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

Mark One

þ **Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 2006

or

o **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: 0-20720
LIGAND PHARMACEUTICALS INCORPORATED
(Exact Name of Registrant as Specified in its Charter)

Delaware	**77-0160744**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
10275 Science Center Drive San Diego, CA	**92121-1117**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s Telephone Number, Including Area Code: (858) 550-7500

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large Accelerated Filer o Accelerated Filer þ Non-Accelerated Filer o

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

As of July 31, 2006, the registrant had 78,740,945 shares of common stock outstanding.

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* No information provided due to inapplicability

of item.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LIGAND PHARMACEUTICALS INCORPORATED
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(in thousands, except share data)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 41,615	$ 66,756
Short-term investments	19,168	20,174
Accounts receivable, net	18,667	20,954
Current portion of inventories, net	8,467	9,333
Other current assets	25,986	15,750
Total current assets	113,903	132,967
Restricted investments	1,826	1,826
Long-term portion of inventories, net	5,211	5,869
Property and equipment, net	21,561	22,483
Acquired technology, product rights and royalty buy-down, net	139,766	146,770
Other assets	3,665	4,704
Total assets	$ 285,932	$ 314,619
LIABILITIES AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	$ 19,460	$ 15,360
Accrued liabilities	58,302	59,587
Current portion of deferred revenue, net	143,102	157,519
Current portion of co-promote termination liability	45,046	
Current portion of equipment financing obligations	2,146	2,401
Current portion of long-term debt	356	344
Total current liabilities	268,412	235,211
Long-term debt	139,463	166,745
Long-term portion of co-promote termination liability	94,261	
Long-term portion of equipment financing obligations	2,851	3,430
Long-term portion of deferred revenue, net	4,100	4,202
Other long-term liabilities	3,002	3,105
Total liabilities	512,089	412,693
Commitments and contingencies		
Common stock subject to conditional redemption; 997,568 shares issued and outstanding at June 30, 2006 and December 31, 2005	12,345	12,345
Stockholders deficit:		

Convertible preferred stock, $0.001 par value; 5,000,000 shares authorized; none issued		
Common stock, $0.001 par value; 200,000,000 shares authorized; 77,730,044 and 73,136,340 shares issued at June 30, 2006 and December 31, 2005, respectively	78	73
Additional paid-in capital	751,547	720,988
Accumulated other comprehensive income	30	490
Accumulated deficit	(989,246)	(831,059)
	(237,591)	(109,508)
Treasury stock, at cost; 73,842 shares	(911)	(911)
Total stockholders deficit	(238,502)	(110,419)
	$ 285,932	$ 314,619

See accompanying notes.

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LIGAND PHARMACEUTICALS INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(in thousands, except share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues:				
Product sales	$ 47,327	$ 41,735	$ 95,311	$ 76,780
Collaborative research and development and other revenues	1,120	4,064	4,092	6,004
Total revenues	48,447	45,799	99,403	82,784
Operating costs and expenses:				
Cost of products sold	10,266	10,667	20,006	21,732
Research and development	13,895	14,524	26,113	29,259
Selling, general and administrative	24,637	20,149	46,988	39,364
Co-promotion	11,073	6,966	21,880	14,706
Co-promote termination charges	(434)		132,507	
Total operating costs and expenses	59,437	52,306	247,494	105,061
Loss from operations	(10,990)	(6,507)	(148,091)	(22,277)
Other income (expense):				
Interest income	587	398	1,160	842
Interest expense	(6,156)	(3,030)	(12,223)	(6,157)
Other, net	619	232	1,002	233
Total other expense, net	(4,950)	(2,400)	(10,061)	(5,082)
Loss before income taxes	(15,940)	(8,907)	(158,152)	(27,359)
Income tax expense	(18)	(17)	(35)	(37)
Net loss	$ (15,958)	$ (8,924)	$ (158,187)	$ (27,396)
Basic and diluted per share amounts:				
Net loss	$ (0.20)	$ (0.12)	$ (2.03)	$ (0.37)
Weighted average number of common shares	78,539,820	74,036,753	78,021,236	73,976,939

See accompanying notes.

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

	Six Months Ended June 30,	
	2006	**2005**
Operating activities		
Net loss	$ (158,187)	$ (27,396)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of acquired technology and license rights	7,140	6,806
Depreciation and amortization of property and equipment	1,747	1,865
Amortization of debt issue costs	473	512
Gain on sale of Exelixis stock	(908)	(233)
Stock-based compensation	2,043	
Non-cash interest expense converted into additional paid-in capital	60	
Other	(17)	52
Changes in operating assets and liabilities:		
Accounts receivable, net	2,287	9,831
Inventories, net	1,524	(3,283)
Other current assets	(10,236)	4,789
Accounts payable and accrued liabilities	2,874	(4,120)
Other liabilities	(19)	(14)
Deferred revenue, net	(14,519)	689
Co-promote termination liability	139,307	
Net cash used in operating activities	(26,431)	(10,502)
Investing activities		
Purchases of short-term investments	(12,694)	(24,849)
Proceeds from sale of short-term investments	14,185	9,683
Increase in restricted investments		(170)
Purchases of property and equipment	(674)	(1,145)
Payment to buy-down ONTAK royalty obligation		(33,000)
Capitalized portion of payment of lasofoxifene royalty rights		(558)
Other, net	46	146
Net cash provided by (used in) investing activities	863	(49,893)
Financing activities		
Principal payments on equipment financing obligations	(1,379)	(1,449)
Proceeds from equipment financing arrangements	545	1,390
Repayment of long-term debt	(170)	(159)
Proceeds from issuance of common stock	1,519	920
Decrease in other long-term liabilities	(88)	(37)
Net cash provided by financing activities	427	665

Net decrease in cash and cash equivalents	(25,141)	(59,730)
Cash and cash equivalents at beginning of period	66,756	92,310
Cash and cash equivalents at end of period	$ 41,615	$ 32,580
Supplemental disclosure of cash flow information		
Interest paid	$ 4,944	$ 5,208
Non-cash impact of the conversion of 6% convertible subordinated notes into common stock:		
Conversion of principal amount of convertible notes	$ 27,100	$
Conversion of unamortized debt issue costs	(362)	
Conversion of unpaid accrued interest	264	
	$ 27,002	$

See accompanying notes.

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

1. Basis of Presentation

The accompanying condensed consolidated financial statements of Ligand Pharmaceuticals Incorporated (the Company or Ligand) were prepared in accordance with instructions for Form 10-Q and, therefore, do not include all information necessary for a complete presentation of financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America. However, all adjustments, consisting of normal recurring adjustments, which, in the opinion of management, are necessary for a fair presentation of the condensed consolidated financial statements, have been included. The results of operations for the three and six-month periods ended June 30, 2006 and 2005 are not necessarily indicative of the results that may be expected for the entire fiscal year or any other future period. These statements should be read in conjunction with the consolidated financial statements and related notes, which are included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

Principles of Consolidation

The condensed consolidated financial statements include the Company s wholly owned subsidiaries, Ligand Pharmaceuticals International, Inc., Ligand Pharmaceuticals (Canada) Incorporated, Seragen, Inc. (Seragen) and Nexus Equity VI LLC (Nexus). Intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, including disclosure of contingent assets and contingent liabilities, at the date of the consolidated financial statements, and the reported amounts of revenue and expenses during the reporting period. The Company s critical accounting policies are those that are most important to both the Company s financial condition and results of operations and require the most difficult, subjective or complex judgments on the part of management in their application, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Because of the uncertainty of factors surrounding the estimates or judgments used in the preparation of the consolidated financial statements, actual results may materially vary from these estimates.

Loss Per Share

Net loss per share is computed using the weighted average number of common shares outstanding. Basic and diluted net loss per share amounts are equivalent for the periods presented as the inclusion of potential common shares in the number of shares used for the diluted computation would be anti-dilutive. Potential common shares, the shares that would be issued upon the conversion of convertible notes and the exercise of outstanding warrants and stock options were 28.4 million and 32.7 million at June 30, 2006 and December 31, 2005, respectively.

Guarantees and Indemnifications

The Company accounts for and discloses guarantees in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 45 (FIN 45), *Guarantor s Accounting and Disclosure Requirements for Guarantees Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and rescission of FIN 34*. The following is a summary of the Company s agreements that the Company has determined are within the scope of FIN 45:

Under its bylaws, the Company has agreed to indemnify its officers and directors for certain events or occurrences arising as a result of the officer s or director s serving in such capacity. The term of the indemnification period is for the officer s or director s lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. However, the Company has a directors and officers liability insurance policy that limits its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of

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these indemnification agreements is minimal and has no liabilities recorded for these agreements as of June 30, 2006 and December 31, 2005.

The Company enters into indemnification provisions under its agreements with other companies in its ordinary course of business, typically with business partners, contractors, customers and landlords. Under these provisions the Company generally indemnifies and holds harmless the indemnified party for direct losses suffered or incurred by the indemnified party as a result of the Company s activities or, in some cases, as a result of the indemnified party s activities under the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification provisions is unlimited. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of June 30, 2006 and December 31, 2005.

Accounting for Stock-Based Compensation

Prior to January 1, 2006, the Company accounted for stock-based compensation in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations. The pro forma effects of employee stock options were disclosed as required by *Financial Accounting Standard Board Statement* (SFAS) No. 123, *Accounting for Stock-Based Compensation* (SFAS 123).

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)), using the modified prospective transition method. No stock-based employee compensation cost was recognized prior to January 1, 2006, as all options granted prior to 2006 had an exercise price equal to the market value of the underlying common stock on the date of the grant. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). Under the transition method, compensation cost recognized in 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted in the first quarter 2006, based on grant-date fair value estimated in accordance with the provisions of SFAS 123(R).

Additionally, the Company accounts for the fair value of options granted to non-employee consultants under Emerging Issues Task Force (EITF) 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction With Selling, Goods or Services*.

Total compensation expense for stock-based compensation for the three and six months ended June 30, 2006 was approximately $1.2 million and $2.0 million, respectively. There was no deferred tax benefit recognized in connection with this cost.

Results for the three and six months ended June 30, 2005 have not been retrospectively adjusted. The fair value of the options was estimated using a Black-Scholes option-pricing formula and amortized to expense over the options vesting periods.

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The following table illustrates the pro forma effect of share-based compensation on net loss and loss per share for the three and six months ended June 30, 2005 (in thousands, except per share data):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss, as reported	$ (8,924)	$ (27,396)
Stock-based employee compensation expense included in reported net loss		
Less: total stock-based compensation expense determined under fair value based method for all awards continuing to vest	(781)	(1,538)
Less: total stock-based compensation expense determined under fair value based method for options accelerated in January 2005 (1)		(12,455)
Net loss, pro forma	$ (9,705)	$ (41,389)
Basic and diluted per share amounts:		
Net loss per share as reported	$ (0.12)	$ (0.37)
Net loss per share pro forma	$ (0.13)	$ (0.56)

(1) Represents pro forma unrecognized expense for accelerated options as of the date of acceleration.

On January 31, 2005, Ligand accelerated the vesting of certain unvested and out-of-the-money stock options previously awarded to the executive officers and other employees under the Company s 1992 and 2002 stock option plans which had an exercise price greater than $10.41, the closing price of the Company s stock on that date. The vesting for options to purchase approximately 1.3 million shares of common stock (of which approximately 450,000 shares were subject to options held by the executive officers) were accelerated. Options held by non-employee directors were not accelerated.

Holders of incentive stock options (ISOs) within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended, were given the election to decline the acceleration of their options if such acceleration would have the effect of changing the status of such option for federal income tax purposes from an ISO to a non-qualified stock option. In addition, the executive officers plus other members of senior management agreed that they will not sell any shares acquired through the exercise of an accelerated option prior to the date on which the exercise would have been permitted under the option s original vesting terms. This agreement does not apply to a) shares sold in order to pay applicable taxes resulting from the exercise of an accelerated option or b) upon the officers retirement or other termination of employment.

The purpose of the acceleration was to eliminate any future compensation expense the Company would have otherwise recognized in its statement of operations with respect to these options upon the implementation of SFAS 123(R).

Other Stock-Related Information

The 2002 Stock Incentive Plan contains four separate equity programs Discretionary Option Grant Program, Automatic Option Grant Program, Stock Issuance Program and Director Fee Option Grant Program (the 2002 Plan). On January 31, 2006, shareholders of the Company approved an amendment to the 2002 Plan to increase the number of shares of the Company s common stock authorized for issuance by 750,000 shares, from 8.3 million shares to 9.1 million shares. As of June 30, 2006, options for 7,058,550 shares of common stock were outstanding under the 2002 plan and 545,101 shares remained available for future option grant or direct issuance.

The Company grants options to employees, non-employee consultants, and non-employee directors. Additionally, the Company granted restricted stock to non-employee directors in the first quarter of 2006.

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Non-employee directors are accounted for as employees under SFAS 123(R). Options and restricted stock granted to certain directors vest in equal monthly installments over one year. Options granted to employees vests 1/8 on the six month anniversary and 1/48 each month thereafter for forty-two months. Options granted to non-employee consultants generally vest between 24 and 36 months. All option awards generally expire ten years from the date of the grant.

Stock-based compensation cost for awards to employees and non-employee directors is recognized on a straight-line basis over the vesting period until the last tranche vests. Compensation cost for consultant awards is recognized over each separate tranche s vesting period. The Company recognized compensation expense of approximately $1.2 million and $2.0 million for the three and six months ended June 30, 2006, respectively, associated with option awards and restricted stock. Of the total compensation expense associated with option awards, approximately $0.01 million and $0.2 million related to options granted to non-employee consultants for the three and six months ended June 30, 2006, respectively.

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

	Three Months Ended June 30		Six Months Ended June 30	
	2006	**2005**	**2006**	**2005**
Risk-free interest rate	4.9%	3.7%	4.7%	3.7%
Dividend yield				
Expected volatility	70%	73%	70%	73%
Expected term	6.2 years	5 years	6.0 years	5 years

The expected term of the employee and non-employee director options is the estimated weighted-average period until exercise or cancellation of vested options (forfeited unvested options are not considered). SAB 107 guidance permits companies to use a safe harbor expected term assumption for grants up to December 31, 2007 based on the mid-point of the period between vesting date and contractual term, averaged on a tranche-by-tranche basis. The Company used the safe harbor in selecting the expected term assumption in 2006. The expected term for consultant awards is the remaining period to contractual expiration.

Volatility is a measure of the expected amount of variability in the stock price over the expected life of an option expressed as a standard deviation. SFAS 123(R) requires an estimate of future volatility. In selecting this assumption, the Company used the historical volatility of the Company s stock price over a period equal to the expected term.

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Stock Option Activity

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term in Years	Aggregate Intrinsic Value (in thousands)
Balance at December 31, 2005	7,001,657	$ 11.76		
Granted	771,556	11.51		
Exercised	(188,204)	8.12		
Forfeited	(139,335)	9.39		
Cancelled	(387,124)	13.84		
Balance at June 30, 2006	7,058,550	$ 11.76	5.98	$ 1,941
Exercisable at June 30, 2006	5,412,185	$ 12.32	5.07	$ 1,164
Options expected to vest as of June 30, 2006	6,840,692	$ 11.81	5.87	$ 1,856

The weighted-average grant-date fair value of all stock options granted during the six months ended June 30, 2006 was $7.65 per share. The total intrinsic value of all options exercised during the six months ended June 30, 2006 was $0.75 million. As of June 30, 2006, there was approximately $7.9 million of total unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a weighted average period of 2.95 years.

Cash received from options exercised for the six months ended June 30, 2006 and 2005 was approximately $1.5 million and $0.9 million, respectively. There is no current tax benefit related to options exercised because of net operating losses (NOLs) for which a full valuation allowance has been established.

Restricted Stock Activity

	Shares	Weighted-Average Stock Price
Balance at December 31, 2005		$
Granted	15,566	11.56
Vested	6,486	11.56
Forfeited		
Nonvested at June 30, 2006	9,080	$ 11.56

The weighted-average grant-date fair value of restricted stock granted during the six months ended June 30, 2006 was $11.56 per share. As of June 30, 2006, there was $92,683 of total unrecognized compensation cost related to nonvested restricted stock. That cost is expected to be recognized over the remainder of 2006.

Employee Stock Purchase Plan

The Company also has an employee stock purchase plan (the ESPP). Since its adoption in 2002, a total of 510,248 shares of common stock have been reserved for issuance under the ESPP. As of June 30, 2006, 362,738 shares of common stock had been issued under the ESPP, and 147,510 shares are available for future issuance. For the six months ended June 30, 2006, there were no issuances of common shares under the ESPP.

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Accounts Receivable

Accounts receivable consist of the following (in thousands):

	June 30, 2006	December 31, 2005
Trade accounts receivable	$ 8,629	$ 1,344
Due from finance company (Note 2)	10,746	20,464
Less: discounts and allowances	(708)	(854)
	$ 18,667	$ 20,954

Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method. Inventories consist of the following (in thousands):

	June 30, 2006	December 31, 2005
Raw materials	$ 1,852	$ 1,508
Work-in-process	9,337	9,115
Finished goods	4,963	6,324
Less: inventory reserves	(2,474)	(1,745)
	13,678	15,202
Less: current portion	(8,467)	(9,333)
Long-term portion of inventories, net	$ 5,211	$ 5,869

In 2005, the Company completed a multi-year process of transferring its filling and finishing of ONTAK from Eli Lilly and Company (Lilly) to Hollister-Stier. In anticipation of this transfer, the Company used Lilly to fill and finish, in 2003, a higher than normal number of ONTAK lots each of which required a forward dating determination. ONTAK otherwise has a shelf life projection of up to 36 months. If commercial and clinical usage of these lots does not approximate the estimated pattern of usage as determined for purposes of dating, the Company could be required to write-off the value of one or more of these lots. In this regard, as of June 30, 2006 and December 31, 2005, inventory reserves relating to ONTAK finished goods inventory totaled approximately $1.1 million and $0.7 million, respectively. As of June 30, 2006 and December 31, 2005, total ONTAK inventory amounted to approximately $7.4 million and $7.8 million, respectively, of which $3.2 million and $2.7 million is classified as long-term, respectively.

During 2005, the Company manufactured a higher than normal amount of drug substance (bexarotene) for Targretin capsules in the event the Company s non-small cell lung cancer (NSCLC) clinical trials were successful. In March 2005, the Company disclosed that the trials did not meet their endpoints of improved overall survival and projected two year survival. The Company believes, however, that the additional manufactured bexarotene, which has a shelf life projection of approximately 10 years, will be fully used for ongoing production of the Company s marketed products, Targretin capsules and Targretin gel. As of June 30, 2006 and December 31, 2005, total Targretin capsules inventory amounted to $3.2 million and $4.2 million, respectively, of which $2.0 million and $3.2 million is classified as long-term, respectively.

Property and Equipment

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

	June 30, 2006	December 31, 2005
Land	$ 5,176	$ 5,176
Equipment, building, and leasehold improvements	62,254	61,732
Less accumulated depreciation and amortization	(45,869)	(44,425)
	$ 21,561	$ 22,483

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

Other Current Assets

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

	June 30, 2006	December 31, 2005
Deferred royalty cost	$ 4,753	$ 5,203
Deferred cost of products sold	5,332	5,103
Prepaid insurance	535	1,071
Prepaid other	2,324	2,807
Due from insurance company (Note 5)	12,000	
Other	1,042	1,566
	$ 25,986	$ 15,750

Other Assets

Other assets consist of the following (in thousands):

	June 30, 2006	December 31, 2005
Prepaid royalty buyout, net	$ 2,176	$ 2,312
Debt issue costs, net	1,358	2,193
Other	131	199
	$ 3,665	$ 4,704

Amortization of debt issue costs was $0.2 million and $0.3 million for the three months ended June 30, 2006 and 2005, respectively, and $0.5 million for both six month periods ended June 30, 2006 and 2005. Estimated annual amortization of this asset in each of the years in the period from 2006 through 2007 is approximately $1.0 million. As further discussed under Long-term Debt , during the three and six months ended June 30, 2006, convertible notes with a face value of $1.0 million and $27.1 million, respectively, were converted into approximately 0.2 million and 4.4 million shares of common stock. In connection with the conversions, unamortized debt issue costs of $0.01 million and $0.4 million for the three and six months ended June 30, 2006, respectively, were recorded as additional paid-in capital.

Acquired Technology, Product Rights and Royalty Buy-Down, Net

In accordance with SFAS No. 142, *Goodwill and Other Intangibles,* the Company amortizes intangible assets with finite lives in a manner that reflects the pattern in which the economic benefits of the assets are consumed or otherwise used up. If that pattern cannot be reliably determined, the assets are amortized using the straight-line method.

Acquired technology, product rights and royalty buy-down, net as of June 30, 2006 include payments made in 2005 totaling $33.0 million to Lilly in exchange for the elimination of the Company s ONTAK royalty obligations in 2005 and 2006 and a reduced reverse-tiered royalty scale on ONTAK sales in the U.S. thereafter. See Note 3 Royalty Agreements . Amounts paid to Lilly in connection with the royalty restructuring were capitalized and are being amortized over the remaining patent life, which is approximately 10 years and represents the period estimated to be benefited, using the greater of the straight-line method or the expense determined on the tiered royalty schedule as set

forth in Note 3. Other acquired technology and product rights represent payments related to the Company s acquisition of ONTAK and license rights for AVINZA. Because the Company cannot reliably determine the pattern in which the economic benefits of the acquired technology and products rights are realized, acquired technology and product rights are amortized on a straight-line basis over 15 years, which approximated the remaining patent life at the time the assets were acquired and otherwise represents the period estimated to be benefited. Specifically, the Company is amortizing its ONTAK asset through June 2014 which is approximate to

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the expiration date of its U.S. patent of December 2014. The AVINZA asset is being amortized through November 2017, the expiration of its U.S. patent.

Acquired technology, product rights, and royalty buy-down, net consist of the following (in thousands):

	June 30, 2006	December 31, 2005
AVINZA	$ 114,437	$ 114,437
Less accumulated amortization	(27,540)	(23,725)
	86,897	90,712
ONTAK	78,312	78,312
Less accumulated amortization	(25,443)	(22,254)
	52,869	56,058
	$ 139,766	$ 146,770

Amortization of acquired technology, product rights and royalty buy-down, net was $3.5 million and $7.0 million for the three and six months ended June 30, 2006 and $3.5 million and $6.7 million, respectively, for the same 2005 period. Estimated annual amortization for these assets in each of the years in the period from 2006 through 2010 is approximately $14.0 million and a total of $76.7 million, thereafter.

Deferred Revenue, Net

Under the sell-through revenue recognition method, the Company does not recognize revenue upon shipment of product to the wholesaler. For these shipments, the Company invoices the wholesaler, records deferred revenue at gross invoice sales price, and classifies the inventory held by the wholesaler (and subsequently held by retail pharmacies as in the case of AVINZA) as deferred cost of goods sold within other current assets. Deferred revenue is presented net of deferred cash and other discounts. Other deferred revenue reflects certain collaborative research and development payments and the sale of certain royalty rights.

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The composition of deferred revenue, net is as follows (in thousands):

	June 30, 2006	December 31, 2005
Deferred product revenue	$ 144,526	$ 158,030
Other deferred revenue	4,398	5,296
Deferred discounts	(1,722)	(1,605)
Deferred revenue, net	$ 147,202	$ 161,721
Deferred revenue, net:		
Current, net	$ 143,102	$ 157,519
Long term, net	4,100	4,202
	$ 147,202	$ 161,721
Deferred product revenue, net (1):		
Current	$ 142,804	$ 156,425
Long term		
	$ 142,804	$ 156,425
Other deferred revenue:		
Current	$ 298	$ 1,094
Long term	4,100	4,202
	$ 4,398	$ 5,296

(1) Deferred product revenue, net does not include other gross to net revenue adjustments made when the Company reports net product sales. Such adjustments include Medicaid rebates,

managed health care rebates, and government chargebacks, which are included in accrued liabilities in the accompanying condensed consolidated financial statements.

Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	June 30, 2006	December 31, 2005
Allowances for loss on returns, rebates, chargebacks, other discounts, ONTAK end-customer and Panretin product returns	$ 15,679	$ 15,729
Co-promotion	14,406	24,778
Distribution services	3,324	4,044
Compensation	6,084	5,746
Securities class action and derivative lawsuit liability (1)	12,150	
Royalties	2,430	1,994
Seragen purchase liability (1)		2,925
Interest	961	1,164
Other	3,268	3,207
	$ 58,302	$ 59,587

(1) Refer to Note 5. Litigation .

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The following summarizes the activity in the accrued liability accounts related to allowances for loss on returns, rebates, chargebacks, other discounts, and ONTAK end-customer and Panretin returns (in thousands):

	Losses on Returns Due to Changes In Price	Medicaid Rebates	Managed Care Rebates and Other Rebates	Chargebacks	ONTAK End-customer and Panretin Returns	Total
Six Months Ended June 30, 2006:						
Balance at December 31, 2005	$ 4,038	$ 5,348	$ 3,467	$ 200	$ 2,676	$ 15,729
Provision	2,292	2,999	6,469	3,099	1,192	16,051
Payments	¾	(6,560)	(3,053)	(2,873)	¾	(12,486)
Charges	(2,421)	¾	¾	¾	(1,194)	(3,615)
Balance at June 30, 2006	$ 3,909	$ 1,787	$ 6,883	$ 426	$ 2,674	$ 15,679

Long-term Debt

Long-term debt consists of the following (in thousands):

	June 30, 2006	December 31, 2005
6% Convertible Subordinated Notes	$ 128,150	$ 155,250
Note payable to bank	11,669	11,839
	139,819	167,089
Less current portion	(356)	(344)
Long-term debt	$ 139,463	$ 166,745

During the three and six months ended June 30, 2006, certain holders of the Company s outstanding 6% convertible subordinated notes converted notes with face values of $1.0 million and $27.1 million into approximately 0.2 million and 4.4 million shares, respectively, of common stock. In connection with the note conversions, accrued interest related to the converted notes for the three and six months ended June 30, 2006, of $0.01 million and $0.3 million, respectively, was also converted into common stock and recorded to additional paid-in capital. In addition, in connection with the note conversions, unamortized debt issue costs for the three and six months ended June 30, 2006, of $0.01 million and $0.4 million, respectively, were recorded to additional paid-in capital.

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Condensed Changes in Stockholders Deficit

Condensed changes in stockholders deficit for the six months ended June 30, 2006 are as follows (in thousands, except share data):

	Common Stock		Additional paid-in capital	Accumulated other comprehensive income	Accumulated deficit	Treasury Stock		Total stockholders deficit
	Shares	Amount				Shares	Amount	
Balance at December 31, 2005	73,136,340	$ 73	$ 720,988	$ 490	$ (831,059)	(73,842)	$ (911)	$ (110,419)
Issuance of common stock	203,770	1	1,518	¾	¾	¾	¾	1,519
Issuance of common stock on conversion of debt	4,389,934	4	26,998	¾	¾	¾	¾	27,002
Unrealized gains/(losses) on available-for-sale securities	¾	¾	¾	(445)	¾	¾	¾	(445)
Foreign currency translation adjustments	¾	¾	¾	(15)	¾	¾	¾	(15)
Equity- based compensation	¾	¾	2,043	¾	¾	¾	¾	2,043
Net loss	¾	¾	¾	¾	(158,187)	¾	¾	(158,187)
Balance at June 30, 2006	77,730,044	$ 78	$ 751,547	$ 30	$ (989,246)	(73,842)	$ (911)	$ (238,502)

Comprehensive Loss

Comprehensive loss represents net loss adjusted for the change during the periods presented in unrealized gains and losses on available-for-sale securities less reclassification adjustments for realized gains or losses included in net loss, as well as foreign currency translation adjustments. The accumulated unrealized gains or losses and cumulative foreign currency translation adjustments are reported as accumulated other comprehensive income as a separate component of stockholders deficit. Comprehensive loss is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net loss as reported	$ (15,958)	$ (8,924)	$ (158,187)	$ (27,396)
Unrealized gains (losses) on available-for-sale securities	(979)	340	(445)	(620)
Foreign currency translation adjustments	(12)	(22)	(15)	(29)
Comprehensive loss	$ (16,949)	$ (8,606)	$ (158,647)	$ (28,045)

The components of accumulated other comprehensive income are as follows (in thousands):

	June 30, 2006	December 31, 2005
Net unrealized holding gain on available-for-sale securities	$ 298	$ 743
Net unrealized loss on foreign currency translation	(268)	(253)
	$ 30	$ 490

Net Product Sales

The Company s domestic net product sales for AVINZA, ONTAK, Targretin capsules and Targretin gel are determined on a sell-through basis less allowances for rebates, chargebacks, discounts, and losses to be incurred on returns from wholesalers resulting from increases in the selling price of the Company s products. The Company recognizes revenue for Panretin upon shipment to wholesalers as the Company s wholesaler customers only stock minimal amounts of Panretin, if any. As such, wholesaler orders are considered to approximate end-customer

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demand for the product. Revenues from sales of Panretin are net of allowances for rebates, chargebacks, returns and discounts. For international shipments of the Company s product, revenue is recognized upon shipment to the Company s third-party international distributors. In addition, the Company incurs certain distributor service agreement fees related to the management of its product by wholesalers. These fees have been recorded within net product sales. For ONTAK, the Company also has established reserves for returns from end customers (i.e. other than wholesalers) after sell-through revenue recognition has occurred.

A summary of the revenue recognition policy used for each of the Company s products and the expiration of the underlying patents for each product is as follows:

	Method	Revenue Recognition Event	Patent Expiration
AVINZA	Sell-through	Prescriptions	November 2017
ONTAK	Sell-through	Wholesaler out-movement	December 2014
Targretin capsules	Sell-through	Wholesaler out-movement	October 2016
Targretin gel	Sell-through	Wholesaler out-movement	October 2016
Panretin	Sell-in	Shipment to wholesaler	August 2016
International	Sell-in	Shipment to international distributor	February 2011 through April 2013

For the three and six months ended June 30, 2006 and 2005, net product sales recognized under the sell-through method represented approximately 96% of total net product sales in both periods.

The Company s total net product sales for the three months ended June 30, 2006 were $47.3 million compared to $41.7 million for the same 2005 period. Total product sales for the six months ended June 30, 2006 were $95.3 million compared to $76.8 million for the same 2005 period. A comparison of sales by product is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
AVINZA	$ 33,651	$ 27,461	$ 66,146	$ 49,458
ONTAK	8,204	8,779	17,386	16,803
Targretin capsules	4,996	4,671	9,998	8,686
Targretin gel and Panretin gel	476	824	1,781	1,833
Total product sales	$ 47,327	$ 41,735	$ 95,311	$ 76,780

Collaborative Research and Development and Other Revenues

Collaborative research and development and other revenues are recognized as services are performed consistent with the performance requirements of the contract. Non-refundable contract fees for which no further performance obligation exists and where the Company has no continuing involvement are recognized upon the earlier of when payment is received or collection is assured. Revenue from non-refundable contract fees where the Company has continuing involvement through research and development collaborations or other contractual obligations is recognized ratably over the development period or the period for which the Company continues to have a performance obligation. Revenue from performance milestones is recognized upon the achievement of the milestones as specified in the respective agreement. Payments received in advance of performance or delivery are recorded as deferred revenue and subsequently recognized over the period of performance or upon delivery.

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The composition of collaborative research and development and other revenues is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Collaborative research and development	$ 784	$ 862	$ 1,678	$ 1,724
Development milestones and other	336	3,202	2,414	4,280
	$ 1,120	$ 4,064	$ 4,092	$ 6,004

Income Taxes

The Company recognizes liabilities or assets for the deferred tax consequences of temporary differences between the tax bases of assets or liabilities and their reported amounts in the financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes (SFAS 109)*. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets or liabilities are recovered or settled. SFAS 109 requires that a valuation allowance be established when management determines that it is more likely than not that all or a portion of a deferred tax asset will not be realized. The Company evaluates the realizability of its net deferred tax assets on a quarterly basis and valuation allowances are provided, as necessary. During this evaluation, the Company reviews its forecasts of income in conjunction with other positive and negative evidence surrounding the realizability of its deferred tax assets to determine if a valuation allowance is required. Adjustments to the valuation allowance will increase or decrease the Company s income tax provision or benefit. At June 30, 2006 and December 31, 2005, the Company has established a full valuation allowance against net deferred tax assets.

2. Accounts Receivable Factoring Arrangement

During 2003, the Company entered into a one-year accounts receivable factoring arrangement under which eligible accounts receivable are sold without recourse to a finance company. The agreement was renewed for a one-year period in the second quarter of 2004 and for two years in the second quarter of 2005 through December 2007. Commissions on factored receivables are paid to the finance company based on the gross receivables sold, subject to a minimum annual commission. Additionally, the Company pays interest on the net outstanding balance of the uncollected factored accounts receivable at an interest rate equal to the JPMorgan Chase Bank prime rate. The Company continues to service the factored receivables. The servicing expenses for the three and six months ended June 30, 2006 and 2005 were not material. There were no material gains or losses on the sale of such receivables. The Company accounts for the sale of receivables under this arrangement in accordance with SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*.

As of June 30, 2006 and December 31, 2005, the Company had received cash of $18.7 million and $23.3 million, respectively, under the factoring arrangement for the sale of trade receivables that were outstanding as of such dates. The gross amount due from the finance company at June 30, 2006 and December 31, 2005 was $10.7 million and $20.5 million, respectively.

3. Royalty Agreements

Restructuring of ONTAK Royalty

In November 2004, Ligand and Eli Lilly and Company (Lilly) agreed to amend their ONTAK royalty agreement to add options in 2005 that if exercised would restructure Ligand s royalty obligations on net sales of ONTAK. Under the revised agreement, Ligand and Lilly each obtained two options. Ligand s options, which were exercised, provided for the buy-down of a portion of the Company s ONTAK royalty obligation on net sales in the United States for total consideration of $33.0 million. Lilly also had two options exercisable in July 2005 and October 2005 to trigger the same royalty buy-downs for total consideration of up to $37.0 million, dependent on whether Ligand had exercised one or both of its options.

Ligand s first option, providing for a one-time payment of $20.0 million to Lilly in exchange for the elimination of Ligand s ONTAK royalty obligations in 2005 and a reduced reverse-tiered royalty scale on ONTAK sales in the

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U.S. thereafter, was exercised in January 2005. The second option which provided for a one-time payment of $13.0 million to Lilly in exchange for the elimination of royalties on ONTAK net sales in the U.S. in 2006 and a reduced reverse-tiered royalty thereafter was exercised in April 2005. Additionally, beginning in 2007 and throughout the remaining ONTAK patent life (2014), Ligand will pay no royalties to Lilly on U.S. sales up to $38.0 million. Thereafter, Ligand will pay royalties to Lilly at a rate of 20% on net U.S. sales between $38.0 million and $50.0 million; at a rate of 15% on net U.S. sales between $50.0 million and $72.0 million; and at a rate of 10% on net U.S. sales in excess of $72.0 million. The option payments totaling $33.0 million were capitalized and are being amortized over the remaining ONTAK patent life of approximately 10 years, which represents the period estimated to be benefited, using the greater of the straight-line method or the expense determined based on the tiered royalty schedule set forth above. In accordance with SFAS No. 142, *Goodwill and Other Intangibles,* the Company amortizes intangible assets with finite lives in a manner that reflects the pattern in which the economic benefits of the assets are consumed or otherwise used up. If that pattern cannot be reliably determined, the assets are amortized using the straight-line method.

Buyout of Salk Royalty Obligations

In January 2005, Ligand paid Salk $1.1 million to exercise an option to buy out milestone payments, other payment-sharing obligations and royalty payments due on future sales of lasofoxifene for vaginal atrophy. This payment resulted from a supplemental lasofoxifene new drug application (NDA) filing by Pfizer. As the Company had previously sold rights to Royalty Pharma AG of approximately 50% of any royalties to be received from Pfizer for sales of lasofoxifene, it recorded approximately 50% of the payment made to Salk, approximately $0.6 million, as development expense in the first quarter of 2005. The balance of approximately $0.5 million was capitalized to be amortized over the period any such royalties were to be received from Pfizer for the vaginal atrophy indication. In connection with Pfizer s receipt of a non-approvable letter from the FDA for the vaginal atrophy indication in February 2006, however, the Company wrote-off the remaining capitalized balance of $0.5 million in the fourth quarter of 2005.

In August 2006, Ligand paid Salk $0.8 million to exercise an option to buy out milestone payments, other payment sharing obligations and royalty payments due on future sales of bazedoxifene, a product being developed by Wyeth. This payment resulted from a bazedoxifene NDA filed by Wyeth for postmenopausal osteoporosis therapy. The Company will recognize the $0.8 million payment as development expense in its third quarter 2006 consolidated financial statements.

Settlement of Patent Interference

In March 2005, Ligand announced that it reached a settlement agreement in a patent interference action initiated by Ligand against two patents owned by The Burnham Institute and SRI International, but exclusively licensed to Ligand. The Company believes the settlement strengthens its intellectual property position for bexarotene, the active ingredient in the Targretin products. The settlement also reduces the royalty rate on those products while extending the royalty payment term to SRI/Burnham.

Under the agreement, Burnham has a research-only sublicense to conduct basic research under the assigned patents and Ligand will have an option on the resulting products and technology. In addition, Burnham and SRI agreed to accept a reduction in the royalty rate paid to them on U.S. sales of Targretin under an earlier agreement. The aggregate royalty rate owed to SRI and Burnham by Ligand was reduced from 4% to 3% of net sales and the term of the royalty payments extended from 2012 to 2016. If the patent issued on the pending Ligand patent application is extended beyond 2016, the royalty rate would be reduced to 2% and paid for the term of the longest Ligand patent covering bexarotene.

4. AVINZA Co-Promotion

In February 2003, Ligand and Organon Pharmaceuticals USA Inc. (Organon) announced that they had entered into an agreement for the co-promotion of AVINZA. Under the terms of the agreement, Organon committed to a specified minimum number of primary and secondary product calls delivered to certain high prescribing physicians and hospitals beginning in March 2003. Organon s compensation was structured as a percentage of net sales based on generally accepted accounting principles (GAAP), which paid Organon for their efforts and also provided

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Organon an economic incentive for performance and results. In exchange, Ligand paid Organon a percentage of AVINZA net sales based on the following schedule:

Annual Net Sales of AVINZA	% of Incremental Net Sales Paid to Organon by Ligand
$0-150 million	30% (0% for 2003)
$150-300 million	40%
$300-425 million	50%
> $425 million	45%

In January 2006, Ligand signed an agreement with Organon that terminated the AVINZA co-promotion agreement between the two companies and returns AVINZA co-promotion rights to Ligand. The effective date of the termination agreement is January 1, 2006; however, the parties have agreed to continue to cooperate during a transition period ending September 30, 2006 (the Transition Period) to promote the product. The Transition Period co-operation includes a minimum number of product sales calls per quarter (100,000 for Organon and 30,000 for Ligand with an aggregate of 375,000 and 90,000, respectively, for the Transition Period) as well as the transition of ongoing promotions, managed care contracts, clinical trials and key opinion leader relationships to Ligand. During the Transition Period, Ligand will pay Organon an amount equal to 23% of AVINZA net sales as reported by Ligand. Ligand will also pay and be responsible for the design and execution of all clinical, advertising and promotion expenses and activities.

Additionally, in consideration of the early termination and return of rights under the terms of the agreement, Ligand will unconditionally pay Organon $37.75 million on or before October 15, 2006. Ligand will further pay Organon $10.0 million on or before January 15, 2007, provided that Organon has made its minimum required level of sales calls. Under certain conditions, including change of control, the cash payments will accelerate. In addition, after the termination, Ligand will make quarterly payments to Organon equal to 6.5% of AVINZA net sales through December 31, 2012 and thereafter 6.0% through patent expiration, currently anticipated to be November of 2017.

The unconditional payment of $37.75 million to Organon and the estimated fair value of the amounts to be paid to Organon after the termination ($95.2 million as of January 1, 2006), based on the net sales of the product (currently anticipated to be paid quarterly through November 2017) were recognized as liabilities and expensed as costs of the termination as of the effective date of the agreement, January 2006. Additionally, the conditional payment of $10.0 million, which represents an approximation of the fair value of the service element of the agreement during the Transition Period (when the provision to pay 23% of AVINZA net sales is also considered), is being recognized ratably as additional co-promotion expense over the Transition Period. For the three and six months ended June 30, 2006, the pro-rata recognition of this element of co-promotion expense amounted to $3.3 million and $6.6 million, respectively.

Although the quarterly payments to Organon will be based on net reported AVINZA product sales, such payments will not result in current period expense in the period upon which the payment is based, but instead will be charged against the co-promote termination liability. The accretion to the current net present value for each reporting period will, however, be recognized as other non-operating expense (interest expense) for that period at a rate of 15%, the discount rate used to initially value this component of the termination liability. Additionally, any changes to the Company s estimates of future net AVINZA product sales will result in a change to the liability which will be recognized as an increase or decrease to earnings in the period such changes are identified. Accreted interest expense for the three and six months ended June 30, 2006 was $3.5 million and $6.8 million, respectively.

On a quarterly basis, management reviews the carrying value of the co-promote termination liability. Due to assumptions and judgments inherent in determining the estimates of future net AVINZA sales through November 2017, the actual amount of net AVINZA sales used to determine the current fair value of the Company s co-promote termination liability may be materially different from its current estimates. In addition, because of the inherent difficulties of predicting possible changes to the estimates and assumptions used to determine the estimate of

future AVINZA product sales, the Company is unable to quantify an estimate of the reasonably likely effect of

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any such changes on its results of operations or financial position. For the three months ended June 30, 2006, the Company recorded a reduction in the co-promote termination liability and a corresponding increase to earnings of $0.4 million based on the Company s updated estimate of future AVINZA net sales.

The components of the co-promote termination liability as of June 30, 2006 are as follows (in thousands):

Payment due October 15, 2006	$ 37,750
Net present value of payments based on estimated future net AVINZA product sales as of January 1, 2006	95,191
Reduction in net present value of liability resulting from updated estimate of net AVINZA product sales as of June 30, 2006	(434)
Accretion of interest expense to net present value of payments based on net AVINZA product sales as of June 30, 2006	6,800
	139,307
Less: current portion of co-promote termination liability	(45,046)
Long-term portion of co-promote termination liability	$ 94,261