

ARENA PHARMACEUTICALS INC

Form 10-Q

May 10, 2011

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

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended March 31, 2011

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-31161

**ARENA PHARMACEUTICALS, INC.**

(Exact name of registrant as specified in its charter)

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|  |  |
|--|--|
| <b>Delaware</b><br>(State or other jurisdiction of<br>incorporation or organization)     | <b>23-2908305</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>6166 Nancy Ridge Drive, San Diego, CA</b><br>(Address of principal executive offices) | <b>92121</b><br>(Zip Code)                                   |
| <b>858.453.7200</b><br>(Registrant's telephone number, including area code)              |  |

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

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

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

|  |   |
|--|---|
| Large accelerated filer <input type="checkbox"/>   | Accelerated filer <input checked="" type="checkbox"/> |
| Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting company <input 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 common stock outstanding as of the close of business on May 2, 2011:

| Class                            | Number of Shares Outstanding |
|----------------------------------|------------------------------|
| Common Stock, \$0.0001 par value | 145,894,281                  |

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In this report, Arena Pharmaceuticals, Arena, we, us and our refer to Arena Pharmaceuticals, Inc., and our wholly owned subsidiaries, unless context otherwise provides.

Arena Pharmaceuticals®, Arena® and our corporate logo are registered service marks of Arena. CART and BRL Screening are unregistered service marks of Arena. Any other brand names or trademarks appearing in this Quarterly Report on Form 10-Q are the property of their respective holders.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.****Arena Pharmaceuticals, Inc.****Condensed Consolidated Balance Sheets****(In thousands)**

|  | <b>March 31,<br/>2011<br/>(Unaudited)</b> | <b>December 31,<br/>2010 <sup>1</sup></b> |
|--|---|---|
| <b>Assets</b>  |   |   |
| Current assets:  |   |   |
| Cash and cash equivalents                                    | \$ 119,862                                | \$ 150,669                                |
| Accounts receivable  | 2,959                                     | 3,499                                     |
| Prepaid expenses and other current assets                    | 2,629                                     | 2,638                                     |
| Total current assets   | 125,450                                   | 156,806                                   |
| Land, property and equipment, net                            | 89,619                                    | 91,533                                    |
| Acquired technology and other intangibles, net               | 11,852                                    | 12,031                                    |
| Other non-current assets                                     | 5,810                                     | 5,992                                     |
| Total assets   | \$ 232,731                                | \$ 266,362                                |
| <b>Liabilities and Stockholders' Equity</b>                  |   |   |
| Current liabilities:   |   |   |
| Accounts payable and other accrued liabilities               | \$ 4,683                                  | \$ 5,017                                  |
| Accrued compensation   | 3,246                                     | 4,427                                     |
| Accrued clinical and preclinical study fees                  | 525                                       | 1,236                                     |
| Accrued restructuring  | 1,782                                     | 0   |
| Current portion of deferred revenues                         | 3,880                                     | 3,846                                     |
| Current portion of derivative liabilities                    | 0   | 607                                       |
| Current portion of note payable to Siegfried                 | 7,079                                     | 3,560                                     |
| Current portion of note payable to Deerfield <sup>2</sup>    | 0   | 17,175                                    |
| Current portion of lease financing obligations               | 1,073                                     | 998                                       |
| Total current liabilities                                    | 22,268                                    | 36,866                                    |
| Deferred rent  | 370                                       | 412                                       |
| Deferred revenues, less current portion                      | 43,269                                    | 44,231                                    |
| Derivative liabilities, less current portion                 | 1,225                                     | 1,664                                     |
| Note payable to Siegfried, less current portion              | 0   | 6,801                                     |
| Note payable to Deerfield, less current portion <sup>2</sup> | 12,151                                    | 20,602                                    |
| Lease financing obligations, less current portion            | 75,483                                    | 75,771                                    |
| Other accrued liabilities, less current portion              | 116                                       | 0   |
| Commitments and contingencies and subsequent events          |   |   |
| Stockholders' equity:  |   |   |
| Common stock   | 14  | 12  |

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|  |             |            |
|--|-------------|------------|
| Series C convertible preferred stock       | 0           | 0          |
| Additional paid-in capital                 | 1,105,981   | 1,068,634  |
| Treasury stock, at cost                    | (23,070)    | (23,070)   |
| Accumulated other comprehensive income     | 5,349       | 4,966      |
| Accumulated deficit                        | (1,010,425) | (970,527)  |
| Total stockholders' equity                 | 77,849      | 80,015     |
| Total liabilities and stockholders' equity | \$ 232,731  | \$ 266,362 |

<sup>1</sup> The balance sheet data at December 31, 2010 has been derived from audited financial statements at that date. It does not include, however, all of the information and notes required by US generally accepted accounting principles for complete financial statements.

<sup>2</sup> The outstanding principal balance of the note payable to Deerfield was \$22.3 million and \$60.0 million at March 31, 2011 and December 31, 2010, respectively. See Note 5.

See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****Arena Pharmaceuticals, Inc.****Condensed Consolidated Statements of Operations****(In thousands, except per share data)****(Unaudited)**

|   | <b>Three months ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2011</b>               | <b>2010</b> |
| <b>Revenues:</b>  |                           |             |
| Manufacturing services  | \$ 1,408                  | \$ 1,975    |
| Collaborative agreements  | 2,517                     | 538         |
| Total revenues  | 3,925                     | 2,513       |
| <b>Operating Expenses:</b>  |                           |             |
| Cost of manufacturing services  | 2,381                     | 1,865       |
| Research and development  | 15,935                    | 18,314      |
| General and administrative  | 6,890                     | 7,014       |
| Restructuring charges   | 3,467                     | 0           |
| Amortization of acquired technology and other intangibles                               | 436                       | 537         |
| Total operating expenses  | 29,109                    | 27,730      |
| Loss from operations  | (25,184)                  | (25,217)    |
| <b>Interest and Other Income (Expense):</b>   |                           |             |
| Interest income   | 49                        | 139         |
| Interest expense  | (4,694)                   | (7,650)     |
| Gain from valuation of derivative liabilities   | 439                       | 1,419       |
| Loss on extinguishment of debt  | (10,514)                  | 0           |
| Other   | 6                         | 39          |
| Total interest and other expense, net   | (14,714)                  | (6,053)     |
| Net loss  | (39,898)                  | (31,270)    |
| Deemed dividend related to beneficial conversion feature of convertible preferred stock | (2,260)                   | 0           |
| Net loss allocable to common stockholders   | \$ (42,158)               | \$ (31,270) |
| Net loss per share allocable to common stockholders, basic                              | \$ (0.35)                 | \$ (0.33)   |
| Net loss per share allocable to common stockholders, diluted                            | \$ (0.35)                 | \$ (0.33)   |
| Shares used in calculating net loss per share allocable to common stockholders, basic   | 121,654                   | 94,955      |
| Shares used in calculating net loss per share allocable to common stockholders, diluted | 121,654                   | 94,955      |

See accompanying notes to unaudited condensed consolidated financial statements.



**Table of Contents****Arena Pharmaceuticals, Inc.****Condensed Consolidated Cash Flow Statements****(In thousands)****(Unaudited)**

|   | <b>Three months ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2011</b>                             | <b>2010</b> |
| <b>Operating Activities</b>   |   |             |
| Net loss  | \$ (39,898)                             | \$ (31,270) |
| Adjustments to reconcile net loss to net cash used in operating activities: |   |             |
| Depreciation and amortization   | 2,560                                   | 2,645       |
| Amortization of acquired technology and other intangibles                   | 436                                     | 537         |
| Share-based compensation  | 1,330                                   | 1,811       |
| Gain from valuation of derivative liabilities                               | (439)                                   | (1,419)     |
| Amortization of prepaid financing costs                                     | 283                                     | 115         |
| Accretion of note payable to Deerfield                                      | 1,599                                   | 3,922       |
| Loss on extinguishment of debt  | 10,514                                  | 0           |
| Accretion of note payable to Siegfried                                      | 126                                     | 66          |
| Gain on disposal of equipment   | 0                                       | (1)         |
| Changes in assets and liabilities:  |   |             |
| Accounts receivable   | 524                                     | (557)       |
| Prepaid expenses and other assets   | (85)                                    | (135)       |
| Accounts payable and accrued liabilities                                    | (384)                                   | (5,640)     |
| Deferred revenues   | (928)                                   | (37)        |
| Deferred rent   | (42)                                    | (34)        |
| Net cash used in operating activities                                       | (24,404)                                | (29,997)    |
| <b>Investing Activities</b>   |   |             |
| Purchases of short-term investments, available-for-sale                     | 0                                       | (145)       |
| Purchases of land, property and equipment                                   | (90)                                    | (1,855)     |
| Proceeds from sale of equipment   | 0                                       | 2           |
| Other non-current assets  | 3                                       | (152)       |
| Net cash used in investing activities                                       | (87)                                    | (2,150)     |
| <b>Financing Activities</b>   |   |             |
| Principal payments on lease financing obligations                           | (213)                                   | (147)       |
| Principal payments on note payable to Deerfield                             | (37,739)                                | 0           |
| Repayment on note payable to Siegfried                                      | (3,430)                                 | 0           |
| Proceeds from issuance of common stock                                      | 17,662                                  | 24,469      |
| Proceeds from issuance of preferred stock                                   | 17,750                                  | 0           |
| Net cash provided by (used in) financing activities                         | (5,970)                                 | 24,322      |
| Effect of exchange rate changes on cash                                     | (346)                                   | (162)       |
| Net decrease in cash and cash equivalents                                   | (30,807)                                | (7,987)     |
| Cash and cash equivalents at beginning of period                            | 150,669                                 | 94,733      |
| Cash and cash equivalents at end of period                                  | \$ 119,862                              | \$ 86,746   |

See accompanying notes to unaudited condensed consolidated financial statements.





**Table of Contents****Notes to Unaudited Condensed Consolidated Financial Statements****1. Basis of Presentation and Recent Events**

The accompanying unaudited condensed consolidated financial statements of Arena Pharmaceuticals, Inc., which include our wholly owned subsidiaries, should be read in conjunction with the audited consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2010, as filed with the Securities and Exchange Commission, or SEC, from which we derived our balance sheet as of December 31, 2010. The accompanying financial statements have been prepared in accordance with US generally accepted accounting principles, or GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, since they are interim statements, the accompanying financial statements do not include all of the information and notes required by GAAP for complete financial statements. The accompanying financial statements reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of our management, necessary to a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year.

During the first quarter of 2011, we identified an error in our consolidated financial statements for the years ended December 31, 2003 through December 31, 2008 related to the dividends and accretion of discount on our Series B Convertible Preferred Stock, which is no longer outstanding. The error relates to dividends that were recorded to our accumulated deficit rather than to additional paid-in capital. To correct the error, we recorded a non-cash cumulative adjustment as of December 31, 2008 to reduce both our accumulated deficit and additional paid-in capital by \$18.6 million. This adjustment is reflected on the accompanying condensed consolidated balance sheets as of December 31, 2010. We determined that this adjustment was not material to our financial position for any previously reported period, and it had no impact on our results of operations and cash flows.

The preparation of financial statements in accordance with GAAP requires our management to make estimates and assumptions that affect amounts reported in the financial statements and notes thereto. The amounts reported could differ under different estimates and assumptions.

**2. Fair Value Disclosures**

We measure our financial assets and liabilities at fair value, which is defined as the exit price, or the amount that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

We use the following three-level valuation hierarchy that maximizes the use of observable inputs and minimizes the use of unobservable inputs to value our financial assets and liabilities:

Level 1 - Observable inputs such as unadjusted quoted prices in active markets for identical instruments.

Level 2 - Quoted prices for similar instruments in active markets or inputs that are observable for the asset or liability, either directly or indirectly.

Level 3 - Unobservable inputs based on our assumptions.

The following table presents our valuation hierarchy for our financial assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2011, in thousands:

|  | Fair Value Measurements at March 31, 2011 |   |   |  |
|--|---|---|---|--|
|  | Balance at<br>March 31,<br>2011           | Quoted<br>Prices in<br>Active<br>Markets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <i>Assets:</i>                                       |   |   |   |  |
| Money market funds and cash equivalents <sup>1</sup> | \$ 78,241                                 | \$ 78,241   | \$ 0  | \$ 0   |
| <i>Liabilities:</i>                                  |   |   |   |  |
| Warrants and other derivative instruments            | \$ 1,225                                  | \$ 0  | \$ 0  | \$ 1,225   |

<sup>1</sup> Included in cash and cash equivalents on our condensed consolidated balance sheet.

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The following table presents our valuation hierarchy for our financial assets and liabilities that are measured at fair value on a recurring basis as of December 31, 2010, in thousands:

|  | Fair Value Measurements at December 31, 2010 |   |   |   |
|--|--|---|---|---|
|  | Balance at December 31, 2010                 | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <i>Assets:</i>                                       |  |   |   |   |
| Money market funds and cash equivalents <sup>1</sup> | \$ 138,195                                   | \$ 138,195                                | \$ 0  | \$ 0                                      |
| <i>Liabilities:</i>                                  |  |   |   |   |
| Warrants and other derivative instruments            | \$ 2,271                                     | \$ 0                                      | \$ 0  | \$ 2,271                                  |

<sup>1</sup> Included in cash and cash equivalents on our consolidated balance sheet.

The following table presents the activity for our derivative liabilities during the three months ended March 31, 2011, in thousands:

|  | Significant Unobservable Inputs (Level 3) |
|--|---|
| Balance at December 31, 2010                                   | \$ 2,271                                  |
| Termination of Deerfield Additional Loan Election (see Note 5) | (607)                                     |
| Gain from valuation of derivative liabilities                  | (439)                                     |
| Balance at March 31, 2011                                      | \$ 1,225                                  |

**3. Acquired Technology and Other Intangibles**

In February 2001, we acquired Bunsen Rush Laboratories, Inc. for \$15.0 million in cash and assumed \$0.4 million in liabilities. We allocated \$15.4 million to the patented Melanophore screening technology acquired in such transaction. We amortized this technology over its estimated useful life of 10 years, which we determined based on an analysis as of the acquisition date.

In January 2008, we acquired from Siegfried Ltd, or Siegfried, certain drug product facility assets, including manufacturing facility production licenses originally valued at \$12.1 million. We are amortizing the manufacturing facility production licenses, which are necessary for us to produce and package tablets and other dosage forms in such facility, over their estimated useful life of 20 years as of the acquisition date.

Acquired technology and other intangibles, net, consisted of the following at March 31, 2011, in thousands:

|  | Gross Carrying Amount | Accumulated Amortization | Net       |
|--|-----------------------|--------------------------|-----------|
| Acquired Melanophore screening technology            | \$ 15,378             | \$ (15,378)              | \$ 0      |
| Acquired manufacturing facility production licenses  | 14,152                | (2,300)                  | 11,852    |
| Total acquired technology and other intangibles, net | \$ 29,530             | \$ (17,678)              | \$ 11,852 |

**4. Note Payable to Siegfried Ltd and Related Agreements**

In January 2008, we acquired from Siegfried certain drug product facility assets, including manufacturing facility production licenses, fixtures, equipment, other personal property and real estate assets in Zofingen, Switzerland, under an Asset Purchase Agreement between Siegfried and Arena Pharmaceuticals GmbH, or Arena GmbH, our wholly owned subsidiary. These assets are being used to manufacture lorcaserin and certain drug products for Siegfried. In connection with this transaction, we and Siegfried also entered into a long-term supply agreement for the active pharmaceutical ingredient of lorcaserin, a manufacturing services agreement and a technical services agreement.

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The purchase price under the Asset Purchase Agreement, in Swiss francs, was CHF 31.8 million in cash and 1,488,482 shares of our common stock valued at \$8.0 million, which we issued to Siegfried in January 2008. We paid CHF 21.8 million, or \$19.6 million, of the cash purchase price in January 2008 and CHF 3.3 million, or \$3.4 million, in January 2011. We were required to pay the remaining CHF 6.7 million cash portion of the purchase price in two equal installments, with the first due in January 2012 and the second due in January 2013.

In March 2011, Arena GmbH amended its agreements with Siegfried, effective January 1, 2011, whereby, among other changes, Arena GmbH agreed to accelerate its payments to Siegfried for the remaining CHF 6.7 million of the cash purchase price under the Asset Purchase Agreement to June 2011 and October 2011, respectively. Also under the amended agreements, Siegfried agreed (i) to order from Arena GmbH 400 million units of drug product for manufacture by Arena GmbH in 2011, (ii) to use its reasonable commercial effort to order from Arena GmbH 200 million units of drug product for manufacture by Arena GmbH from January 1, 2012 to June 30, 2012, and (iii) to reduce its fees for providing Arena GmbH with certain technical and business services. The prices under the amended manufacturing services agreement between Arena GmbH and Siegfried are lower than cost and the prices Siegfried paid in 2010.

In accordance with relevant guidance, we recognized a provision for loss related to services to be rendered through June 30, 2012 whereby the costs will exceed the related revenues under the amended manufacturing services agreement. This loss provision, estimated at \$0.8 million, was recorded as part of our cost of manufacturing services on our condensed consolidated statements of operations during the three months ended March 31, 2011. Of this amount, \$0.7 million is included in the accounts payable and other accrued liabilities line item on our condensed consolidated balance sheet and \$0.1 million is reported in the other accrued liabilities line item.

**5. Note Payable to Deerfield**

In July 2009, pursuant to a Facility Agreement we entered into in June 2009, or the Facility Agreement, with Deerfield Private Design Fund, L.P., Deerfield Private Design International, L.P., Deerfield Partners, L.P., Deerfield International Limited, Deerfield Special Situations Fund, L.P., and Deerfield Special Situations Fund International Limited, or collectively Deerfield, Deerfield provided us with a \$100.0 million secured loan. We received net proceeds of \$95.6 million from this loan. In connection with the loan, we issued Deerfield warrants to purchase an aggregate of 28,000,000 shares of our common stock, exercisable until June 17, 2013, at an exercise price of \$5.42 per share. We refer to these warrants as the 2009 Warrants. Deerfield has the right to require us to accelerate principal payments under the loan under certain circumstances, and at any time we may prepay any or all of the outstanding principal at par.

Deerfield previously had the right to make a one-time election, which we refer to as the Deerfield Additional Loan Election, to loan us up to an additional \$20.0 million under the Facility Agreement, with the additional loan maturing on the same date as the original loan, June 17, 2013. For each additional \$1.0 million that Deerfield loaned us under the Facility Agreement, we would have been required to issue Deerfield warrants for 280,000 shares of our common stock at an exercise price of \$5.42 per share. In addition, Deerfield previously had the right to require us to accelerate payments under the loan in connection with certain equity issuances. Each of these rights was terminated in March 2011 as described below.

In accordance with relevant guidance, we separately valued four components under the Facility Agreement as of the date of the initial loan. Since that date, as discussed below in this note, we have amended the terms of the Facility Agreement, repaid certain of the debt, and exchanged certain of the warrants, which affects how we value and account for the Facility Agreement. The four components under the Facility Agreement were previously valued as of July 6, 2009 as follows:

- (1) The \$100.0 million loan was valued at \$47.9 million on a relative fair value basis, and was recorded as a long-term liability on our condensed consolidated balance sheet.
- (2) The 2009 Warrants to purchase an aggregate of 28,000,000 shares of our common stock, net of issuance costs, were valued at \$39.1 million on a relative fair value basis. The relative fair value of the warrants was recorded as additional paid-in capital on our condensed consolidated balance sheet, and the resulting debt discount is being accreted to interest expense over the term of the loan or until paid using the effective interest rate method. These warrants were valued at their date of issuance using an option pricing model and the following assumptions: expected life of 3.95 years, risk-free interest rate of 2.0%, expected volatility of 66% and no dividend yield. Because these warrants are eligible for equity classification, no adjustments to the recorded value will be made on an ongoing basis.

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- (3) The Deerfield Additional Loan Election was valued at \$9.5 million. The Deerfield Additional Loan Election was classified as a liability on our condensed consolidated balance sheet and, accordingly, was revalued on each subsequent balance sheet date until it was terminated, with any changes in the fair value between reporting periods recorded in the interest and other income (expense) section of our condensed consolidated statements of operations (see Note 6). Until the Deerfield Additional Loan Election was terminated, we accreted the additional debt discount that resulted from the allocation of proceeds under the Facility Agreement to interest expense using the effective interest rate method.

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- (4) Deerfield's ability to accelerate principal payments under the loan under certain circumstances, including upon certain changes of control, was valued at \$0.5 million. The acceleration right was classified as a liability on our condensed consolidated balance sheet and, accordingly, will be revalued on each subsequent balance sheet date until it is exercised or expires, with any changes in the fair value between reporting periods recorded in the interest and other income (expense) section of our condensed consolidated statements of operations (see Note 6). This allocation of proceeds under the Facility Agreement resulted in additional debt discount that we will accrete to interest expense over the term of the loan or until paid using the effective interest rate method.

As a result of the closing of our public offering of common stock in July 2009, which occurred after we entered into the Facility Agreement, we were required to repay Deerfield \$10.0 million that was originally scheduled to be repaid in July 2010. In connection with this \$10.0 million repayment, we retired a proportional share of the debt discount and issuance costs directly related to the repaid debt and recognized a non-cash loss on extinguishment of debt of \$2.5 million in 2009.

In June 2010, we entered into a Purchase and Exchange Agreement, or the 2010 Purchase Agreement, with Deerfield, pursuant to which we sold Deerfield 11,000,000 shares of our common stock at a price of \$3.23 per share, resulting in net proceeds to us of \$35.5 million. Also pursuant to the 2010 Purchase Agreement, we exchanged a portion of the 2009 Warrants to purchase an aggregate of 16,200,000 shares of our common stock at an exercise price of \$5.42 per share for new warrants, which we refer to as the 2010 Warrants, to purchase a like number of shares of our common stock at an exercise price of \$3.45 per share. The outstanding 2010 Warrants are exercisable until June 17, 2013. Other than the exercise price and certain provisions related to cashless exercise and early termination of the warrants, the 2010 Warrants contain substantially the same terms as the 2009 Warrants.

We valued the 2010 Warrants at their June 2010 issuance date using an option pricing model and the following assumptions: expected life of 3.03 years, risk-free interest rate of 1.2%, expected volatility of 72% and no dividend yield. We determined that the incremental value of the 2010 Warrants was \$5.5 million, which was recorded as a component of the stock issuance and warrant exchange under the 2010 Purchase Agreement in the stockholders' equity section of our condensed consolidated balance sheet. Because the 2010 Warrants are eligible for equity classification, no adjustments to the recorded value will be made on an ongoing basis.

In August 2010, we sold 8,955,224 shares of our common stock at a price of \$6.70 per share in a registered direct public offering to Deerfield. As part of this transaction, we entered into the first of two amendments to the Facility Agreement, pursuant to which \$30.0 million of the proceeds from this transaction was used to prepay the portion of the principal amount that we otherwise would have been required to repay in July 2012. Net proceeds to us from this transaction, after prepayment of the \$30.0 million, were approximately \$30.0 million. In connection with this \$30.0 million prepayment, we retired a proportional share of the debt discount and issuance costs directly related to the repaid debt and recognized a non-cash loss on extinguishment of debt of \$12.4 million in 2010. In accordance with relevant guidance, we also evaluated whether this amendment constituted an extinguishment of debt resulting in extinguishment accounting or modification accounting. Based on our analysis, we determined that this amendment was not a substantial modification and, accordingly, we accounted for this amendment under modification accounting. Had extinguishment accounting been required, we would have recognized a gain or loss based on the difference between the carrying value of our note payable to Deerfield and its fair value.

To reduce our interest payments, in January 2011, we prepaid \$20.0 million of the principal amount that was originally scheduled to be repaid to Deerfield in July 2011. In connection with this \$20.0 million prepayment, we retired a proportional share of the debt discount and issuance costs directly related to the repaid debt and recognized a non-cash loss on extinguishment of debt of \$2.5 million in the three months ended March 31, 2011.

In March 2011, we and Deerfield entered into (i) an Exchange Agreement, (ii) a Securities Purchase Agreement, and (iii) a Second Amendment to the Facility Agreement, or the Second Amendment.

Under the Exchange Agreement, we agreed to exchange 14,368,590 of the 2010 Warrants for new warrants, which we refer to as the 2011 Warrants, to purchase a like number of shares of our common stock at an exercise price of \$1.68 per share. The 2011 Warrants will be exercisable beginning on October 1, 2011 and will remain exercisable until June 17, 2015. Other than the exercise period, the exercise price and certain provisions related to cashless exercise and early termination of the warrants, the 2009 Warrants, the 2010 Warrants and the 2011 Warrants each contain substantially the same terms.

Under the Securities Purchase Agreement, Deerfield purchased 12,150,000 shares of our common stock for a purchase price of \$1.46 per share and 12,150 shares of our Series C Convertible Preferred Stock, or Series C Preferred, for a purchase price of \$1,460.00 per share. Each share of Series C Preferred was convertible into 1,000 shares of our common stock at any time at the option of the holder, subject to certain limitations. See Note 14. The fair value of the common stock into which the Series C Preferred was convertible on the date of issuance exceeded the proceeds, allocated on a relative fair value basis, by \$2.3 million, resulting in a beneficial conversion feature that we recognized as a decrease to additional paid-in capital and a deemed dividend to the Series C Preferred stockholders for the three months ended March 31, 2011.





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Under the Second Amendment, we prepaid \$17.7 million of the principal amount that we otherwise would have been required to repay to Deerfield in June 2013. Taking into account such prepayment, net proceeds to us under the Securities Purchase Agreement were approximately \$17.6 million. In connection with this \$17.7 million prepayment, we retired a proportional share of the debt discount and issuance costs directly related to the repaid debt and recognized a non-cash loss on extinguishment of debt of \$8.0 million in the three months ended March 31, 2011. In accordance with relevant guidance, we also evaluated whether this amendment constituted an extinguishment of debt resulting in extinguishment accounting or modification accounting. Based on our analysis, we determined that this amendment was not a substantial modification and, accordingly, we accounted for this amendment under modification accounting. Had extinguishment accounting been required, we would have recognized a gain or loss based on the difference between the carrying value of our note payable to Deerfield and its fair value.

The Second Amendment also eliminated the Deerfield Additional Loan Election and our obligation to accelerate payments under the loan in connection with certain equity issuances.

We valued the 2011 Warrants at their March 2011 issuance date using an option pricing model and the following assumptions: expected life of 4.21 years, risk-free interest rate of 1.9%, expected volatility of 82% and no dividend yield. We determined that the incremental value of the 2011 Warrants was \$6.0 million, which was recorded as a component of the stock issuance and warrant exchange in the stockholders' equity section of our condensed consolidated balance sheet. Because the 2011 Warrants are eligible for equity classification, no adjustments to the recorded value will be made on an ongoing basis.

At March 31, 2011, the outstanding principal balance on the Deerfield loan was \$22.3 million, which is due on June 17, 2013. The difference between the \$12.2 million recorded value and the \$22.3 million outstanding principal balance of the loan as of March 31, 2011 represents the remaining debt discount, which we will accrete over the term of the loan or until paid. The outstanding principal accrues interest at the contractual rate of 7.75% per annum on the stated principal balance, payable quarterly in arrears. Total interest expense of \$2.7 million and \$5.7 million, including accretion of the debt discount attributable to the warrants and the other derivative financial instruments and amortization of capitalized issuance costs, was recognized in connection with this loan in the three months ended March 31, 2011 and 2010, respectively. The current effective annual interest rate on the loan is 38.4%.

**6. Derivative Liabilities**

In June 2006 and August 2008, we issued seven-year warrants, which we refer to as the Series B Warrants, to purchase 829,856 and 1,106,344 shares of our common stock, respectively, at an exercise price of \$15.49 and \$7.71 per share, respectively. The Series B Warrants are related to our Series B Convertible Preferred Stock, which we redeemed in 2008 and is no longer outstanding. The warrants contain an anti-dilution provision and, as a result of subsequent equity issuances at prices below the adjustment price of \$6.72 defined in the warrants, as of March 31, 2011, the number of shares issuable upon exercise of the outstanding June 2006 and August 2008 Series B Warrants was increased to 1,227,743 and 1,640,368 respectively, and the exercise price was reduced to \$10.47 and \$5.20 per share, respectively. The Series B Warrants are classified as a liability on our condensed consolidated balance sheets.

In accordance with relevant guidance, we have revalued these warrants on each subsequent balance sheet date, and will continue to do so until they are exercised or expire, with any changes in the fair value between reporting periods recorded as other income or expense. The June 2006 and August 2008 Series B Warrants were valued at March 31, 2011 and 2010 using an option pricing model and the following assumptions:

|                         | March 31, 2011                       |                                     | March 31, 2010                       |                                     |
|-------------------------|--------------------------------------|-------------------------------------|--------------------------------------|-------------------------------------|
|                         | June 2006<br>Series<br>B<br>Warrants | August 2008<br>Series B<br>Warrants | June 2006<br>Series<br>B<br>Warrants | August 2008<br>Series B<br>Warrants |
| Risk-free interest rate | 1.0%                                 | 2.0%                                | 1.7%                                 | 2.7%                                |
| Dividend yield          | 0%                                   | 0%                                  | 0%                                   | 0%                                  |
| Expected volatility     | 90%                                  | 82%                                 | 73%                                  | 66%                                 |
| Expected life (years)   | 2.25                                 | 4.37                                | 3.25                                 | 5.38                                |

As of the July 2009 issuance date of the Deerfield loan, we separately valued the Deerfield Additional Loan Election, including the 5,600,000 contingently issuable warrants to purchase up to 5,600,000 shares of our common stock. Because the Deerfield Additional Loan Election was classified as a liability on our condensed consolidated balance sheet until this right was terminated in March 2011 (see Note 5), it was revalued on each subsequent balance sheet date, with any changes in the fair value between reporting periods recorded as other income or expense. Upon its termination in March 2011, the \$0.6 million value recorded for the Deerfield Additional Loan Election was recorded as a component of the

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stock issuance and warrant exchange in the stockholders' equity section of our condensed consolidated balance sheet.

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We also separately valued Deerfield's right to require us to accelerate payments under the loan under certain circumstances, including upon certain changes of control, at \$0.5 million as of the July 2009 issuance date of the Deerfield loan (see Note 5). The value of this acceleration right is classified as a liability on our condensed consolidated balance sheet and, accordingly, will be revalued on each subsequent balance sheet date until it is exercised or expires, with any changes in the fair value between reporting periods recorded as other income or expense. At each reporting date, this acceleration right was valued using a discounted cash flow model.

Our derivative liabilities consisted of the following at March 31, 2011 and December 31, 2010, in thousands:

|  | <b>March 31,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|--|---------------------------|------------------------------|
| Deerfield Additional Loan Election     | \$ 0                      | \$ 607                       |
| Total current derivative liabilities   | 0                         | 607                          |
| Series B Warrants                      | 975                       | 1,234                        |
| Deerfield acceleration right           | 250                       | 430                          |
| Total long-term derivative liabilities | 1,225                     | 1,664                        |
| Total derivative liabilities           | \$ 1,225                  | \$ 2,271                     |

The change in the fair value of our derivative liabilities is recorded in the interest and other income (expense) section of our condensed consolidated statements of operations. The following table presents the gain we recognized in the three months ended March 31, 2011 and 2010, in thousands:

|   | <b>Three months ended March 31,</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2011</b>                         | <b>2010</b> |
| Series B Warrants                                       | \$ 259                              | \$ 212      |
| Deerfield Additional Loan Election                      | 0                                   | 1,169       |
| Deerfield acceleration right                            | 180                                 | 38          |
| Total gain due to revaluation of derivative liabilities | \$ 439                              | \$ 1,419    |

**7. Warrants**

As part of our June 2010 sale of common stock to Deerfield (see Note 5), we exchanged 16,200,000 of the 2009 Warrants to purchase shares of our common stock at an exercise price of \$5.42 per share for 2010 Warrants to purchase a like number of shares of our common stock at an exercise price of \$3.45 per share. We valued the incremental value of the 2010 Warrants at \$5.5 million as of their issuance date. As part of our March 2011 sale of common and preferred stock to Deerfield (see Note 5), we exchanged 14,368,590 of the 2010 Warrants to purchase shares of our common stock at an exercise price of \$3.45 per share for 2011 Warrants to purchase a like number of shares of our common stock at an exercise price of \$1.68 per share, and extended the expiration date of these warrants to June 17, 2015. We valued the incremental value of the 2011 Warrants at \$6.0 million as of their issuance date.

The following table summarizes our outstanding warrants as of March 31, 2011:

|                         | <b>Balance Sheet<br/>Classification</b> | <b>Number of<br/>Warrants</b> | <b>Exercise<br/>Price</b> | <b>Expiration<br/>Date</b> |
|-------------------------|---|-------------------------------|---------------------------|----------------------------|
| Deerfield 2011 Warrants | Equity                                  | 14,368,590                    | \$ 1.68                   | June 17, 2015              |

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|                                      |           |            |          |                 |
|--------------------------------------|-----------|------------|----------|-----------------|
| Deerfield 2010 Warrants              | Equity    | 1,831,410  | \$ 3.45  | June 17, 2013   |
| Deerfield 2009 Warrants              | Equity    | 11,800,000 | \$ 5.42  | June 17, 2013   |
| August 2008 Series B Warrants        | Liability | 1,640,368  | \$ 5.20  | August 14, 2015 |
| June 2006 Series B Warrants          | Liability | 1,227,743  | \$ 10.47 | June 30, 2013   |
| Total number of warrants outstanding |           | 30,868,111 |          |                 |

**Table of Contents****8. Share-based Activity***Share-based Compensation*

We recognized share-based compensation expense as follows, in thousands, except per share data:

|  | <b>Three months ended<br/>March 31,</b> |              |
|--|---|--------------|
|  | <b>2011</b>                             | <b>2010</b>  |
| Research and development   | \$ 525                                  | \$ 861       |
| General and administrative   | 711                                     | 950          |
| Restructuring charges  | 94                                      | 0            |
| <br>Total share-based compensation expense and impact on net loss allocable to common stockholders | <br>\$ 1,330                            | <br>\$ 1,811 |
| <br>Impact on net loss per share allocable to common stockholders, basic and diluted               | <br>\$ 0.01                             | <br>\$ 0.02  |

*Share-based Award Activity*

The following table summarizes our stock option activity during the three months ended March 31, 2011:

|                                   | <b>Options</b> | <b>Weighted-<br/>Average<br/>Exercise Price</b> |
|-----------------------------------|----------------|---|
| Outstanding at January 1, 2011    | 8,358,594      | \$ 7.63   |
| Granted                           | 2,792,382      | 1.49  |
| Exercised                         | 0              | 0   |
| Forfeited/cancelled/expired       | (547,097)      | 7.77  |
| <br>Outstanding at March 31, 2011 | <br>10,603,879 | <br>\$ 6.01                                     |

The following table summarizes activity with respect to our performance-based restricted stock unit awards during the three months ended March 31, 2011:

|                                   | <b>Performance<br/>Units</b> | <b>Weighted-<br/>Average<br/>Grant-Date<br/>Fair Value</b> |
|-----------------------------------|------------------------------|--|
| Outstanding at January 1, 2011    | 1,666,650                    | \$ 12.50   |
| Granted                           |                              |  |
| Vested                            |                              |  |
| Forfeited/cancelled               | (333,950)                    | 11.98  |
| <br>Outstanding at March 31, 2011 | <br>1,332,700                | <br>\$ 12.63   |

**9. Concentration of Credit Risk and Major Customers**

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Financial instruments, which potentially subject us to concentrations of credit risk, consist primarily of cash, cash equivalents and short-term investments. We limit our exposure to credit loss by placing our cash and investments in US government, agency and government-sponsored enterprise obligations and in corporate debt instruments that are rated investment grade, in accordance with our board-approved investment policy.

We manufacture drug products for Siegfried under a manufacturing services agreement, and all of our manufacturing services revenues are attributable to Siegfried.

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Percentages of our total revenues derived from our manufacturing services agreement and from our most significant collaborators for the periods presented are as follows:

| Source of Revenue  | Three months ended<br>March 31, |       |
|--|---------------------------------|-------|
|  | 2011                            | 2010  |
| Manufacturing services agreement with Siegfried                      | 35.9%                           | 78.6% |
| Collaboration with Eisai Inc.  | 50.9%                           | 0     |
| Former collaboration with Ortho-McNeil-Janssen Pharmaceuticals, Inc. | 12.9%                           | 21.2% |

**10. Restructuring Charges**

Around the end of March 2011, we completed a reduction of our US workforce of approximately 25%, or a total of 65 employees, that was announced in January 2011 and is part of our revised corporate strategy and reduction in expenditures. We accounted for our restructuring activities in accordance with relevant guidance that requires that a liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. As a result of this restructuring, we recorded a charge of \$3.5 million for the three months ended March 31, 2011, including non-cash, share-based compensation charges of \$0.1 million, which is reflected as a separate line item in the accompanying condensed consolidated statements of operations. As of March 31, 2011, \$1.6 million of this charge has been paid, resulting in a remaining accrual of \$1.8 million, the majority of which will be paid in the second and third quarters of 2011.

**11. Net Loss Per Share**

We compute basic and diluted net loss per share allocable to common stockholders using the weighted-average number of shares of common stock outstanding during the period, less any shares subject to repurchase or forfeiture. There were no shares of our common stock subject to repurchase or forfeiture for the three months ended March 31, 2011 or 2010.

Because we are in a net loss position, we have excluded outstanding unvested performance-based restricted stock unit awards, which are subject to forfeiture, warrants, stock options and convertible preferred stock, as well as unvested restricted stock in our deferred compensation plan, from our calculation of diluted net loss per share because including these securities in the calculation would be antidilutive for the periods presented. The table below presents our securities that would otherwise be included in our diluted net loss per share allocable to common stockholders at March 31, 2011 and 2010.

|  | Three months ended<br>March 31, |            |
|--|---------------------------------|------------|
|  | 2011                            | 2010       |
| Warrants                                       | 30,868,111                      | 30,241,491 |
| Stock options                                  | 10,603,879                      | 8,632,260  |
| Performance-based restricted stock unit awards | 1,332,700                       | 1,703,250  |
| Unvested restricted stock                      | 79,169                          | 96,669     |
| Series C Preferred                             | 12,150,000                      | 0          |
| Total  | 55,033,859                      | 40,673,670 |

Had they been dilutive, these securities would have been included in our calculation of diluted net loss per share allocable to common stockholders.

**12. Comprehensive Income (Loss)**

We report all components of comprehensive income (loss), including foreign currency translation gain and loss and unrealized gains and losses on investment securities, in the financial statements in the period in which they are recognized. Comprehensive income (loss) is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. Below is a reconciliation, in thousands, of our net loss to comprehensive loss for the periods presented.





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|  | <b>Three months ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2011</b>               | <b>2010</b> |
| Net loss   | \$ (39,898)               | \$ (31,270) |
| Foreign currency translation gain (loss)                               | 383                       | (851)       |
| Unrealized gain on available-for-sale securities and other investments | 0                         | 9           |
| Comprehensive loss   | \$ (39,515)               | \$ (32,112) |

**13. Legal Proceedings**

Beginning on September 20, 2010, a number of complaints were filed in the US District Court for the Southern District of California against us and certain of our current and former employees and directors on behalf of certain purchasers of our common stock. The complaints have been brought as purported stockholder class actions, and, in general, include allegations that we and certain of our current and former employees and directors violated federal securities laws by making materially false and misleading statements regarding our lorcaseerin program, thereby artificially inflating the price of our common stock. The plaintiffs are seeking unspecified monetary damages and other relief. On November 19, 2010, eight prospective lead plaintiffs filed motions to consolidate, appoint a lead plaintiff, and appoint lead counsel. The Court took the motions to consolidate under submission on January 14, 2011. We expect the Court to consolidate the actions, appoint a lead plaintiff and lead counsel, and order the lead plaintiff to file a consolidated complaint. In addition to the class actions, a complaint involving similar legal and factual issues has been brought by at least one individual stockholder. We intend to defend against the claims advanced and to seek dismissal of these complaints. Due to the early stage of these proceedings, we are not able to predict or reasonably estimate the ultimate outcome or possible losses relating to these claims.

On September 24, 2010, a stockholder derivative complaint was filed in the Superior Court of California for the County of San Diego against certain of our current and former employees and directors, and other stockholder derivative complaints were subsequently filed in state court. On October 19, 2010, the Superior Court ordered the pending state derivative complaints be consolidated. We refer to such complaints as the State Derivative Action. The Superior Court also ordered that later filed, related derivative complaints be consolidated as well. In November 2010, plaintiffs in the State Derivative Action filed a consolidated stockholder derivative complaint. We filed a demurrer to the consolidated stockholder derivative complaint on February 15, 2011. On October 6, 2010, a stockholder derivative suit was filed in the US District Court for the Southern District of California. Thereafter, a number of other stockholder derivative actions were filed in federal court. We refer to the federal derivative complaints as the Federal Derivative Action. The court consolidated the Federal Derivative Action and appointed lead counsel, and we expect a consolidated derivative complaint will be filed. We refer to the State Derivative Action and the Federal Derivative Action collectively as the Derivative Actions. The Derivative Actions allege breaches of fiduciary duties by the defendants and other violations of law. In general, the Derivative Actions allege that certain of our current and former employees and directors caused or allowed for the dissemination of materially false and misleading statements regarding our lorcaseerin program, thereby artificially inflating the price of our common stock. The plaintiffs are seeking unspecified monetary damages and other relief, including reforms and improvements to our corporate governance and internal procedures. We intend to defend against the claims advanced and to seek dismissal of the Derivative Actions. Due to the early stage of these proceedings, we are not able to predict or reasonably estimate the ultimate outcome or possible losses relating to the Derivative Actions.

**14. Subsequent Event**

We have evaluated subsequent events after the balance sheet date of March 31, 2011 and up to the date we filed this report.

On April 25, 2011, Deerfield converted all of its shares of our Series C Preferred into 12,150,000 shares of our common stock. As of the date of this conversion, which had no cash impact, we have no shares of Series C Preferred outstanding and 145,894,281 shares of common stock outstanding.

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

This discussion and analysis should be read in conjunction with our financial statements and notes thereto included in this quarterly report on Form 10-Q, or Quarterly Report, and the audited consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2010, or 2010 Annual Report, as filed with the Securities and Exchange Commission, or SEC. Operating results are not necessarily indicative of results that may occur in future periods.

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This Quarterly Report includes forward-looking statements, which involve a number of risks and uncertainties. These forward-looking statements can generally be identified as such because the context of the statement will include words such as may, will, intend, plan, believe, anticipate, expect, estimate, predict, potential, continue, likely, or opportunity, the negative of

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these words or other similar words. Similarly, statements that describe our future plans, strategies, intentions, expectations, objectives, goals or prospects and other statements that are not historical facts are also forward-looking statements. For such statements, we claim the protection of the Private Securities Litigation Reform Act of 1995. Readers of this Quarterly Report are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the time this Quarterly Report was filed with the SEC. These forward-looking statements are based largely on our expectations and projections about future events and future trends affecting our business, and are subject to risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. These risks and uncertainties include, without limitation, the risk factors identified in our SEC reports, including this Quarterly Report. In addition, past financial or operating performance is not necessarily a reliable indicator of future performance, and you should not use our historical performance to anticipate results or future period trends. We can give no assurances that any of the events anticipated by the forward-looking statements will occur or, if any of them do, what impact they will have on our results of operations and financial condition. Except as required by law, we undertake no obligation to update publicly or revise our forward-looking statements.

## **OVERVIEW AND RECENT DEVELOPMENTS**

We are a clinical-stage biopharmaceutical company focused on discovering, developing and commercializing oral drugs that target G protein-coupled receptors, or GPCRs, an important class of validated drug targets, in four major therapeutic areas: cardiovascular, central nervous system, inflammatory and metabolic diseases. Our most advanced drug candidate is lorcaserin hydrochloride, or lorcaserin, which is intended for weight management.

In December 2009, we submitted a New Drug Application, or NDA, to the US Food and Drug Administration, or FDA, for regulatory approval of lorcaserin. In October 2010, the FDA issued a Complete Response Letter, or CRL, with respect to the lorcaserin NDA. In the CRL, the FDA stated that it completed its review of the NDA and determined that it could not approve the application in its present form. Our primary focus is working to submit our response to the lorcaserin CRL, and we believe we may be able to make such submission by the end of 2011. However, such submission may take up to an additional year or more, depending on the results of our ongoing and planned activities, any new guidance and feedback we receive from the FDA, and the need for any additional activities. Our wholly owned subsidiary, Arena Pharmaceuticals GmbH, or Arena GmbH, has granted Eisai Inc., or Eisai, exclusive rights to commercialize lorcaserin in the United States and its territories and possessions subject to FDA approval of the lorcaserin NDA, and we are working closely with Eisai in planning and conducting studies and other activities in support of our response to the lorcaserin CRL.

### **Lorcaserin Regulatory Update**

We are engaged in activities to address the issues raised by the FDA in the lorcaserin CRL and subsequent communications, and following is an update:

A pathology working group has completed a blinded reassessment of the mammary tumors found in the rat carcinogenicity study, and the final report is being prepared;

We expect to initiate preclinical prolactin studies of three months and shorter duration once discussions with the FDA to finalize protocols are complete;

We believe that prolactin studies of three months and shorter duration will be sufficient to test the hypothesis that lorcaserin causes mammary tumors in rats by increasing prolactin effects on the mammary gland, and currently do not anticipate initiating a 12-month study in female rats;

To address the finding of brain astrocytoma in male rats, we have completed dosing, and analyses are ongoing, of a Phase 1 clinical trial that involved collecting cerebrospinal fluid to provide an alternative means of estimating human brain levels at the intended therapeutic doses of lorcaserin; and

Further assessments of receptor pharmacology and abuse liability are ongoing.

Our recent and first quarter 2011 developments include:

**Lorcaserin**

Published results from a clinical trial evaluating lorcaserin's abuse potential in the March 16, 2011, issue of *Clinical Pharmacology & Therapeutics*. The randomized, placebo-controlled, double-blind, crossover trial was conducted in subjects with a history of recreational drug use and compared the relative abuse potential of lorcaserin against three comparators: placebo, 15 and 30 mg of zolpidem (a schedule IV controlled substance) and 100 mg of ketamine (a schedule III controlled substance).

Published results from a randomized, placebo-controlled, double-blind mechanism of action study evaluating the contributions of energy intake, appetite and energy expenditure on weight loss with lorcaserin treatment in the March 2011 issue of *The Journal of Clinical Endocrinology and Metabolism*.

**Other**

Craig M. Audet joined us as our Vice President, Regulatory Affairs. Mr. Audet has 25 years of experience directing global pharmaceutical and medical device registration and marketed product activities, most recently as Vice President, US Regulatory Affairs, for Sanofi-Aventis. Prior to Sanofi-Aventis, he was Senior Director, Global Therapeutic Area Leader, for Pfizer Inc., where he provided strategic direction and oversight across the cardiovascular/metabolic product portfolio.

Completed a US workforce reduction of approximately 25%, or 65 employees, which we expect will result in annual operating cost savings of approximately \$13.5 million.

Received gross proceeds of approximately \$35.5 million from the sale of 12,150,000 shares of common stock at \$1.46 per share and 12,150 shares of Series C Convertible Preferred Stock, or Series C Preferred, at \$1,460 per share to certain Deerfield entities. As part of this transaction, we prepaid approximately \$17.7 million of the loan principal that otherwise would have been required to be repaid to Deerfield in June 2013. We also reduced the exercise price from \$3.45 to \$1.68 per share and extended the end of the exercise term from June 17, 2013 to June 17, 2015 for approximately 14.4 million of the 16.2 million outstanding warrants to purchase common stock that Deerfield received in connection with a June 2010 investment in Arena.

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Announced the issuance of US Reissue Patent No. RE42,190 with claims to methods of identifying compounds that modulate the activity of the GPR119 receptor, a target for identifying small molecules for the treatment of diabetes

Appointed Jack Lief, our President and Chief Executive Officer, as principal financial officer and Jennifer K. Bielasz, our Senior Director, Accounting and Contoller, as principal accounting officer upon the departure of Robert E. Hoffman, our former Vice President, Finance and Chief Financial Officer.

We refer you to our previously filed Current Reports on Form 8-K for a more complete discussion of certain of these developments.

The drug development and approval process is long, uncertain and expensive, and our ability to achieve our goals, including obtaining regulatory approval for lorcaserin and other of our drug candidates, depends on numerous factors, many of which we do not control. We will continue to seek to balance our high costs of research, development and manufacturing against the need to sustain our operations long enough to commercialize the results of our efforts. We do not expect any of our drug candidates to be commercially available until at least late in 2012, if ever. We expect to continue to incur substantial losses, and do not expect to generate positive operating cash flows, for at least the short term. Accordingly, we will need to raise additional funds through equity, debt or other financing transactions or receive additional funds under our marketing and supply agreement with Eisai or under future collaborative agreements for one or more of our drug candidates or programs. Although we expect our cash used in operations to be significantly lower in 2011 compared to 2010 due to our expected lower clinical trial expenses, cost savings from our recent workforce reduction and reduced research and development activities and expenses, we will continue to use substantial cash as we work to obtain regulatory approval of lorcaserin, continue advancing certain of our earlier-stage research and development programs and continue to incur general and administrative expenses.

**RESULTS OF OPERATIONS**

We are providing the following summary of our revenues, research and development expenses and general and administrative expenses to supplement the more detailed discussion below. The dollar values in the following tables are in millions.

**Revenues**

| <b>Source of revenue</b>         | <b>Three months ended<br/>March 31,</b> |               |
|----------------------------------|---|---------------|
|                                  | <b>2011</b>                             | <b>2010</b>   |
| Manufacturing services agreement | \$ 1.4                                  | \$ 2.0        |
| Collaborative agreements         | 2.5                                     | 0.5           |
| <b>Total revenues</b>            | <b>\$ 3.9</b>                           | <b>\$ 2.5</b> |

**Research and development expenses**

| <b>Type of expense</b>  | <b>Three months ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2011</b>                             | <b>2010</b> |
| Salary and other personnel costs (excluding non-cash share-based compensation)                    | \$ 7.0                                  | \$ 8.5      |
| External clinical and preclinical study fees and expenses, including external manufacturing costs | 1.7                                     | 2.1         |
| Internal research and development manufacturing costs for Swiss facility                          | 1.9                                     | 1.0         |
| Facility and equipment costs  | 3.2                                     | 3.7         |
| Research supplies   | 0.8                                     | 0.9         |
| Non-cash share-based compensation   | 0.5                                     | 0.9         |
| Other   | 0.8                                     | 1.2         |

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|   |         |         |
|---|---------|---------|
| Total research and development expenses | \$ 15.9 | \$ 18.3 |
|---|---------|---------|

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| Type of expense  | Three months ended<br>March 31, |        |
|--|---------------------------------|--------|
|  | 2011                            | 2010   |
| Salary and other personnel costs (excluding non-cash share-based compensation) | \$ 2.3                          | \$ 2.3 |
| Legal, accounting and other professional fees                                  | 2.3                             | 1.8    |
| Facility and equipment costs   | 1.1                             | 0.9    |
| Non-cash share-based compensation  | 0.7                             | 1.0    |
| Other  | 0.5                             | 1.0    |
| Total general and administrative expenses                                      | \$ 6.9                          | \$ 7.0 |

**THREE MONTHS ENDED MARCH 31, 2011 AND 2010**

**Revenues.** We recognized revenues of \$3.9 million during the three months ended March 31, 2011, compared to \$2.5 million during the three months ended March 31, 2010. Our revenues for the three months ended March 31, 2011 included (i) \$1.4 million in manufacturing services revenue under our manufacturing services agreement with Siegfried Ltd, or Siegfried, (ii) \$1.0 million under our marketing and supply agreement with Eisai in reimbursements for additional lorcaserin pre-approval development work, (iii) \$1.0 million from amortization of the \$50.0 million non-refundable, upfront payment we received in July 2010 from Eisai and (iv) \$0.5 million, primarily for patent activities, related to our former collaboration with Ortho-McNeil-Janssen Pharmaceuticals, Inc., or Ortho-McNeil-Janssen, that was terminated effective December 28, 2010. Our revenues for the three months ended March 31, 2010 included \$2.0 million of manufacturing services revenues and \$0.5 million of patent fee revenue from Ortho-McNeil-Janssen.

Absent any new collaborations, we expect our 2011 revenues will primarily consist of amortization of the \$50.0 million non-refundable, upfront payment we received from Eisai, research funding and reimbursement from Eisai for 50% of the cost of certain of the additional development expenses incurred in connection with responding to the lorcaserin CRL, and manufacturing services revenue under our agreement with Siegfried. We expect the revenues we recognize in 2011 under our manufacturing services agreement will be lower than in 2010.

Revenues for milestones that may be achieved in the future are difficult to predict, and our revenues may vary significantly from quarter to quarter and year to year. We expect that any significant revenues for at least the short term will depend on whether and when we enter into any agreements to commercialize lorcaserin outside of the United States, collaborate on or license any of our other drug candidates or intellectual property, and receive US marketing approval for lorcaserin, as well as revenues under our manufacturing services agreement with Siegfried and our marketing and supply agreement with Eisai.

**Cost of manufacturing services.** Cost of manufacturing services is comprised of direct costs associated with manufacturing drug products for Siegfried under our manufacturing services agreement, including related salaries, other personnel costs and machinery depreciation costs. We recognized cost of manufacturing services of \$2.4 million and \$1.9 million for the three months ended March 31, 2011 and 2010, respectively. The amount recognized for the three months ended March 31, 2011 includes \$0.8 million representing the estimated contract loss provision for services to be rendered through June 30, 2012 related to the amendment to the manufacturing services agreement, which was effective January 1, 2011.

**Research and development expenses.** Research and development expenses, which account for the majority of our expenses, consist primarily of salaries and other personnel costs, clinical trial costs (including payments to contract research organizations, or CROs), preclinical study fees, manufacturing costs for non-commercial products, costs for the development of our earlier-stage programs and technologies, research supply costs and facility and equipment costs. We expense research and development costs to operations as they are incurred when these expenditures relate to our research and development efforts and have no alternative future uses. We generally do not track our earlier-stage research and development expenses by project; rather, we track such expenses by the type of cost incurred.

Research and development expenses decreased by \$2.4 million to \$15.9 million for the three months ended March 31, 2011, from \$18.3 million for the three months ended March 31, 2010. This was primarily due to decreases of (i) \$1.5 million in salary and other personnel costs and (ii) \$0.5 million in facility and equipment costs, both the result of the workforce reduction we completed around the end of the first quarter of 2011 and our cost-containment efforts. These decreases were partially offset by a \$0.9 million increase in internal research and development



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manufacturing costs for our Swiss facility due to a decrease in manufacturing services under our manufacturing services agreement with Siegfried, which resulted in an increase in our unused manufacturing capacity. Internal research and development manufacturing costs for our Swiss facility include costs related to lorcaserin activities as well as unused manufacturing capacity. Although we expect to continue to incur substantial research and development expenses in 2011, we expect our research and development expenses will be significantly lower than the 2010 level, primarily due to lower external clinical and preclinical study fees and expenses, including manufacturing costs, and cost savings from our 2011 workforce reduction. We expect to incur manufacturing costs for lorcaserin and that such costs will be substantial if the FDA

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approves our NDA for lorcaserin. However, if the NDA for lorcaserin is approved, we will begin to record our lorcaserin manufacturing costs as cost of goods sold as the related inventory is sold, instead of as part of our research and development expenses. Pre-launch inventory manufactured is being charged to expense until we believe that the likelihood of approval is such that we should begin recording the production costs related to the inventory produced as an asset.

Included in the \$1.7 million total external clinical and preclinical study fees and expenses noted in the table above for the three months ended March 31, 2011 was \$0.3 million related to our lorcaserin program, \$0.9 million related to our APD811 program for the potential treatment of pulmonary arterial hypertension and \$0.3 million related to our APD334 program for the potential treatment of autoimmune diseases, including multiple sclerosis. Included in the \$2.1 million total external clinical and preclinical study fees and expenses for the three months ended March 31, 2010 was \$1.5 million related to our lorcaserin program, \$0.3 million related to our APD811 program and \$0.1 million related to our APD916 program for the potential treatment of narcolepsy with cataplexy.

**General and administrative expenses.** General and administrative expenses decreased by \$0.1 million to \$6.9 million for the three months ended March 31, 2011, from \$7.0 million for the three months ended March 31, 2010. This was primarily due to a decrease of \$0.6 million in market research expenses, which was partially offset by a \$0.5 million increase in both patent and corporate legal fees. We expect that our 2011 general and administrative expenses will be lower than in 2010, primarily as a result of our cost-containment efforts, including our recent workforce reduction and lower legal fees, primarily patent legal fees.

**Restructuring charges.** We recognized \$3.5 million of restructuring charges in connection with one-time employee termination costs, including severance and other benefits for the three months ended March 31, 2011, and no such charge in the three months ended March 31, 2010. On January 27, 2011, we announced a reduction in our US workforce of approximately 25%, or 65 employees, which we completed around the end of March 2011. We expect this workforce reduction will result in annual operating cost savings of approximately \$13.5 million.

**Amortization of acquired technology and other intangibles.** We recognized \$0.4 million for amortization of acquired technology and other intangibles for the three months ended March 31, 2011, compared to \$0.5 million for the three months ended March 31, 2010. This decrease is primarily due to reaching the end of the 10-year estimated useful life of the Melanophore screening technology in the first quarter of 2011. The remaining amortization expense relates to the manufacturing facility production licenses we acquired in January 2008, which are being amortized over their estimated useful life of 20 years. Using the exchange rate in effect on March 31, 2011, we expect to record amortization expense of \$0.7 million per year through 2027 for the manufacturing facility production licenses.

**Interest and other expense, net.** Interest and other expense, net, increased by \$8.6 million to \$14.7 million for the three months ended March 31, 2011, from \$6.1 million for the three months ended March 31, 2010. This increase was primarily due to a (i) \$10.5 million non-cash loss on extinguishment of debt and (ii) \$1.0 million reduction in the non-cash gain from revaluation of our derivative liabilities. These increases were partially offset by a \$3.0 million decrease in interest expense primarily related to the Deerfield loan as a result of principal repayments totaling \$67.7 million that were made subsequent to the first quarter of 2010. The interest expense recognized for the three months ended March 31, 2011 includes \$0.9 million we paid to Deerfield in cash, compared to \$1.7 million paid for the three months ended March 31, 2010. Although we expect the two debt prepayments of \$20.0 million and \$17.7 million made in the first quarter of 2011 to reduce our future interest expense by \$3.7 million, we expect that our interest expense will continue to be substantial due to both the \$22.3 million remaining principal balance on the Deerfield loan and, to a lesser degree, payments on our lease financing obligations. At March 31, 2011, we expect interest expense of \$3.9 million to be paid in cash over the remaining term of the Deerfield loan.

**Deemed dividend related to beneficial conversion feature of convertible preferred stock.** We recorded a deemed dividend of \$2.3 million upon the issuance of our Series C Preferred in the three months ended March 31, 2011 related to the beneficial conversion feature of the Series C Preferred. We did not record any such dividends for the three months ended March 31, 2010, and we do not expect to record any in the future.

**LIQUIDITY AND CAPITAL RESOURCES***Short term*

As of March 31, 2011, we had \$119.9 million in cash and cash equivalents, which we believe will be sufficient to fund our operations for at least the next 12 months. Other potential sources of liquidity in the short term include (i) entering into collaborative, licensing or commercial agreements for one or more of our drug candidates or programs or our patent portfolios, (ii) equity, debt or other financing, (iii) the sale of facilities we own and (iv) payments from collaborators.

To date, we have obtained cash and funded our operations primarily through the sale of equity, the issuance of debt and related financial instruments, payments from collaborators and sale leaseback transactions. We will continue to be opportunistic in our efforts to obtain cash, and

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expect to evaluate various funding alternatives on an ongoing basis. There is no guarantee that additional funding will be available or that, if available, such funding will be adequate or available on terms that we or our stockholders view as favorable.

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In October 2010, the FDA issued us a CRL regarding our NDA for lorcaserin. Our marketing and supply agreement with Eisai provides that Eisai and we will share equally the cost of certain additional development work required by the FDA prior to approval of lorcaserin. We expect to incur expenses in 2011 for development activities in response to the CRL and such activities could continue beyond 2011. However, we expect that the costs we incur in connection with such response will be substantially less than the external development expenses we incurred for lorcaserin in 2010.

In January 2008, Arena GmbH acquired from Siegfried certain drug product manufacturing assets under an asset purchase agreement, and, in connection with such purchase, Arena GmbH and Siegfried also entered into a manufacturing services agreement. Pursuant to the asset purchase agreement, Arena GmbH paid Siegfried CHF 21.8 million, or \$19.6 million, of the cash purchase price in January 2008 and CHF 3.3 million, or \$3.4 million, in January 2011. The asset purchase agreement required Arena GmbH to pay Siegfried the remaining CHF 6.7 million of the cash purchase price in two equal installments, with the first due in January 2012 and the second due in January 2013. In March 2011, Arena GmbH amended its agreements with Siegfried, effective January 1, 2011, whereby, among other changes, Arena GmbH agreed to pay to Siegfried these remaining two installments in June 2011 and October 2011, respectively, and Siegfried agreed (i) to order from Arena GmbH 400 million units of drug product for manufacture by Arena GmbH in 2011, (ii) to use its reasonable commercial effort to order from Arena GmbH 200 million units of drug product for manufacture by Arena GmbH from January 1, 2012 to June 30, 2012, and (iii) to reduce its fees for providing Arena GmbH with certain technical and business services. The prices Siegfried will pay per unit of drug product in 2011 and 2012 will be less than cost and the amount it paid in 2010, and we expect the cash we receive in 2011 under the manufacturing services agreement will be lower than in 2010.

Although our March 31, 2011 condensed consolidated balance sheet reflects a total balance of \$12.2 million for our note payable to Deerfield due to the requirement to separately value the components of the note, warrants and related financial instruments, the principal balance outstanding on this loan was \$22.3 million at March 31, 2011. In January 2011, we prepaid the \$20.0 million principal repayment that was due to Deerfield in July 2011, which is expected to save us \$0.7 million in interest payments. In addition, in March 2011, as part of a financing with Deerfield, we prepaid \$17.7 million of the \$40.0 million principal repayment that was due to Deerfield in June 2013, which is expected to save us \$3.0 million in interest payments.

We are continuing to fund activities in support of obtaining regulatory approval of lorcaserin, and, at the same time, advancing certain of our earlier-stage research and development programs, including an ongoing Phase 1a clinical trial for APD811 and advancing APD334 toward clinical development. We also plan to continue development of our research programs on cannabinoid receptor 2, or CB2, agonists (intended for the treatment of osteoarthritis and pain) and GPR119 agonists (intended for the treatment of type 2 diabetes). We expect that our research and development expenditures will continue to be high in 2011, but substantially less than they were in 2010. We are continuing our cost-containment efforts, including through our recent workforce reduction of 65 employees. We expect this workforce reduction will result in annual operating cost savings of approximately \$13.5 million. Even with this workforce reduction and other cost-containment efforts, we may not have sufficient cash to meet all of our objectives beyond the next 12 months which, in addition to our primary focus on seeking regulatory approval for lorcaserin, include maintaining our manufacturing capabilities for lorcaserin and select research and development capabilities. If we do not generate sufficient funding, we may need to further eliminate or postpone or scale back some or all of our research and development programs and further reduce our expenses.

We will continue to monitor and evaluate the level of our research, development and manufacturing expenditures, and may further adjust such expenditures based upon a variety of factors, such as our available cash, our ability to obtain additional cash, the results and progress in our lorcaserin and earlier-stage programs, the time and costs related to clinical trials, nonclinical studies and regulatory decisions, as well as the global economic environment.

### *Long term*

We will need substantial cash to achieve our objectives of discovering, developing and commercializing drugs, which typically take many years and potentially several hundreds of millions of dollars to develop. We do not have adequate internal liquidity to meet these objectives in the long term. To do so, we will need to obtain significant funds under our marketing and supply agreement with Eisai, under new collaborative, licensing or commercial agreements for our drug candidates and programs and patent portfolios, or from other potential sources of liquidity, which may include the public and private financial markets.

With respect to lorcaserin, we expect to continue to incur substantial costs, including manufacturing costs, prior to and after receiving marketing approval for lorcaserin, if ever. If lorcaserin is approved for marketing in the United States, we expect Eisai to commercialize lorcaserin under our marketing and supply agreement. With respect to commercializing lorcaserin outside of the United States, we will need additional funds or a collaborative or other agreement with one or more pharmaceutical companies.

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In addition to the public and private financial markets, potential sources of liquidity in the long term include revenues based on Eisai's annual net sales of lorcaserin and milestone and other payments under our marketing and supply agreement, if we receive marketing approval, as well as milestone and royalty payments from future collaborators or licensees and revenues from sales of any drugs we commercialize on our own. The length of time that our current cash and cash equivalents and any available borrowings will sustain our operations will be based on, among other things, our prioritization decisions regarding funding for our programs, progress in our

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clinical and earlier-stage programs, the time and costs related to current and future clinical trials, nonclinical studies and regulatory decisions, our research, development, manufacturing and commercialization costs (including personnel costs), our progress in any programs under collaborations, costs associated with intellectual property, our capital expenditures, and costs associated with securing any in-licensing opportunities. Any significant shortfall in funding may result in us further reducing our development and/or research activities, which, in turn, would affect our development pipeline and ability to obtain cash in the future. If we determine it is advisable to raise additional funds, we do not know whether adequate funding will be available to us or, if available, that such funding will be available on acceptable terms.

The final principal repayment on the Deerfield loan of \$22.3 million is due in June 2013. At any time we may prepay any or all of this outstanding principal at par.

We evaluate from time to time potential acquisitions and in-licensing and other opportunities. Any such transaction may impact our liquidity as well as affect our expenses if, for example, our operating expenses increase as a result of such license or acquisition or we use our cash to finance the license or acquisition.

### *Sources and Uses of Our Cash*

Net cash used in operating activities decreased by \$5.6 million to \$24.4 million in the three months ended March 31, 2011, compared to \$30.0 million in the three months ended March 31, 2010. This decrease is primarily the result of changes in our operating assets and liabilities.

Net cash of \$0.1 million was used in investing activities during the three months ended March 31, 2011, due primarily to purchases of equipment and improvements to our facilities. Net cash of \$2.2 million was used in investing activities during the three months ended March 31, 2010, due primarily to \$1.9 million used for equipment and improvements to our facilities. We expect that our 2011 capital expenditures will be less than the 2010 amount due to our continuing cost-containment efforts.

Net cash of \$6.0 million was used in financing activities during the three months ended March 31, 2011, due primarily to principal repayments to Deerfield of \$20.0 million and \$17.7 million in January 2011 and March 2011, respectively, and \$3.4 million paid to Siegfried in January 2011. These repayments were partially offset by net proceeds of \$35.3 million from the sale of 12,150,000 shares of common stock and 12,150 shares of Series C Preferred to Deerfield in March 2011. Net cash provided by financing activities was \$24.3 million during the three months ended March 31, 2010, due primarily to net proceeds of \$24.2 million from the sale of 8.3 million shares of common stock under an equity financing commitment with Azimuth.

## **CRITICAL ACCOUNTING POLICIES AND MANAGEMENT ESTIMATES**

The SEC defines critical accounting policies as those that are, in management's view, important to the portrayal of our financial condition and results of operations and demanding of management's judgment. Our discussion and analysis of financial condition and results of operations is based on our consolidated financial statements, which have been prepared in accordance with US generally accepted accounting principles, or GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures. We base our estimates on historical experience and on various assumptions that we believe are 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 significantly from those estimates.

Our critical accounting policies include:

**Revenue recognition.** Our revenues to date have been generated primarily through collaborative agreements and a manufacturing services agreement. Our collaborative agreements can include multiple elements including licenses, research services and manufacturing. Consideration we receive under these arrangements may include upfront payments, research funding and milestone payments. For our multiple element transactions, if fair value exists for the undelivered and delivered elements whereby such elements have stand-alone value, we allocate the consideration to the elements based on their relative fair values. In cases where fair value exists for the undelivered elements but does not exist for the delivered elements, we use the residual method to allocate the arrangement consideration. In cases where fair value does not exist for the undelivered elements in an arrangement, we account for the transaction as a single unit of accounting. We typically defer non-refundable upfront payments under our collaborations and recognize them over the period in which we have significant involvement or perform services, using various factors specific to each collaboration. Amounts we receive for research funding for a specified number of full-time researchers are recognized as revenue as the services are performed. Revenue from a milestone payment is recognized when earned, as evidenced by acknowledgment from our collaborator, provided that (i) the milestone event is substantive and its achievability was not reasonably assured at the inception of the agreement, (ii) the milestone represents the culmination of an earnings process, (iii) the milestone payment is non-refundable and (iv) our performance obligations after the milestone achievement will continue to be funded by our collaborator at a level comparable to the

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level before the milestone achievement. If all of these criteria are not met, the milestone payment is recognized over the remaining minimum period of our performance obligations under the agreement. Any advance payments we receive in excess of amounts earned are classified as deferred revenues until earned.

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We manufacture drug products under a manufacturing services agreement for a single customer, Siegfried. Upon Siegfried's acceptance of drug products manufactured by us, we recognize manufacturing services revenues at agreed upon prices for such drug products. We have also contracted with Siegfried for them to provide us with administrative and other services in exchange for a fee paid to Siegfried. We determined that we are receiving an identifiable benefit for these services from Siegfried, and are recording such fees in the operating expense section of our consolidated statement of operations.

**Clinical trial expenses.** We accrue clinical trial expenses based on work performed. In determining the amount to accrue, we rely on estimates of total costs incurred based on the enrollment of subjects, the completion of trials and other events. We follow this method because we believe reasonably dependable estimates of the costs applicable to various stages of a clinical trial can be made. However, the actual costs and timing of clinical trials are highly uncertain, subject to risks and may change depending on a number of factors. Differences between the actual clinical trial costs and the estimated clinical trial costs that we have accrued in any prior period are recorded in the subsequent period in which the actual costs become known. Historically, these differences have not been material; however, material differences could occur in the future.

**Derivative liabilities.** We account for our warrants and other derivative financial instruments as either equity or liabilities based upon the characteristics and provisions of each instrument. Warrants classified as equity are recorded as additional paid-in capital on our consolidated balance sheet and no further adjustments to their valuation are made. Some of our warrants were determined to be ineligible for equity classification because of provisions that may result in an adjustment to their exercise price. Warrants classified as derivative liabilities and other derivative financial instruments that require separate accounting as liabilities are recorded on our consolidated balance sheet at their fair value on the date of issuance and will be revalued on each subsequent balance sheet date until such instruments are exercised or expire, with any changes in the fair value between reporting periods recorded as other income or expense. We estimate the fair value of these liabilities using option pricing models that are based on the individual characteristics of the warrants or instruments on the valuation date, as well as assumptions for expected volatility, expected life and risk-free interest rate. Changes in the assumptions used could have a material impact on the resulting fair value.

**Share-based compensation.** We recognize compensation expense for all of our share-based awards based on the grant-date fair value. We determine the grant-date fair value of share-based awards by using the Black-Scholes option pricing model, which is affected by our stock price on the date of grant, as well as assumptions regarding other subjective variables. These assumptions include, but are not limited to, our expected stock price volatility over the term of the awards, the risk-free interest rate and the expected term of awards. Changes in the assumptions used could have a material impact on the compensation expense we recognize.

Stock-based compensation expense recognized is based on awards ultimately expected to vest, and, therefore, is reduced by expected forfeitures. We estimate forfeitures based upon historical forfeiture rates, and will adjust our estimate of forfeitures if actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative adjustment in the period of the change and will also impact the amount of stock-based compensation expense in future periods.

**Accounting for lease financing obligations.** We account for our sale and leaseback transactions using the financing method because our options to repurchase these properties in the future are considered continued involvement requiring such method. Under the financing method, the book value of the properties and related accumulated depreciation remain on our balance sheet and no sale is recognized. Instead, the sales price of the properties is recorded as a financing obligation, and a portion of each lease payment is recorded as interest expense. We estimated the borrowing rate that we use to impute interest expense on our lease payments.

*The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP. See our audited consolidated financial statements and notes thereto included in our 2010 Annual Report, which contain additional accounting policies and other disclosures required by GAAP.*

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

There have been no material changes from the information we included in this section of our annual report on Form 10-K for the year ended December 31, 2010.

### **Item 4. Controls and Procedures.**

Based on an evaluation carried out as of the end of the period covered by this quarterly report, under the supervision and with the participation of our management, including our President and Chief Executive Officer (our principal executive and financial officer), of the effectiveness of our



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disclosure controls and procedures, our President and Chief Executive Officer has concluded that, as of the end of such period, our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) were effective at the reasonable assurance level. There was no change in our internal control over financial reporting that occurred during the quarter covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings.**

Beginning on September 20, 2010, a number of complaints were filed in the US District Court for the Southern District of California against us and certain of our current and former employees and directors on behalf of certain purchasers of our common stock. The complaints have been brought as purported stockholder class actions, and, in general, include allegations that we and certain of our current and former employees and directors violated federal securities laws by making materially false and misleading statements regarding our lorcaserin program, thereby artificially inflating the price of our common stock. The plaintiffs are seeking unspecified monetary damages and other relief. On November 19, 2010, eight prospective lead plaintiffs filed motions to consolidate, appoint a lead plaintiff, and appoint lead counsel. The Court took the motions to consolidate under submission on January 14, 2011. We expect the Court to consolidate the actions, appoint a lead plaintiff and lead counsel, and order the lead plaintiff to file a consolidated complaint. In addition to the class actions, a complaint involving similar legal and factual issues has been brought by at least one individual stockholder. We intend to defend against the claims advanced and to seek dismissal of these complaints. Due to the early stage of these proceedings, we are not able to predict or reasonably estimate the ultimate outcome or possible losses relating to these claims.

On September 24, 2010, a stockholder derivative complaint was filed in the Superior Court of California for the County of San Diego against certain of our current and former employees and directors, and other stockholder derivative complaints were subsequently filed in state court. On October 19, 2010, the Superior Court ordered the pending state derivative complaints be consolidated. We refer to such complaints as the State Derivative Action. The Superior Court also ordered that later filed, related derivative complaints be consolidated as well. In November 2010, plaintiffs in the State Derivative Action filed a consolidated stockholder derivative complaint. We filed a demurrer to the consolidated stockholder derivative complaint on February 15, 2011. On October 6, 2010, a stockholder derivative suit was filed in the US District Court for the Southern District of California. Thereafter, a number of other stockholder derivative actions were filed in federal court. We refer to the federal derivative complaints as the Federal Derivative Action. The court consolidated the Federal Derivative Action and appointed lead counsel, and we expect a consolidated derivative complaint will be filed. We refer to the State Derivative Action and the Federal Derivative Action collectively as the Derivative Actions. The Derivative Actions allege breaches of fiduciary duties by the defendants and other violations of law. In general, the Derivative Actions allege that certain of our current and former employees and directors caused or allowed for the dissemination of materially false and misleading statements regarding our lorcaserin program, thereby artificially inflating the price of our common stock. The plaintiffs are seeking unspecified monetary damages and other relief, including reforms and improvements to our corporate governance and internal procedures. We intend to defend against the claims advanced and to seek dismissal of the Derivative Actions. Due to the early stage of these proceedings, we are not able to predict or reasonably estimate the ultimate outcome or possible losses relating to the Derivative Actions.

**Item 1A. Risk Factors.****RISK FACTORS**

*Investment in our stock involves a high degree of risk. You should consider carefully the risks described below, together with other information in this quarterly report on Form 10-Q and our other public filings, before making investment decisions regarding our stock. If any of the following events actually occur, our business, operating results, prospects or financial condition could be materially and adversely affected. This could cause the trading price of our common stock to decline and you may lose all or part of your investment. Moreover, the risks described below are not the only ones that we face. Additional risks not presently known to us or that we currently deem immaterial may also affect our business, operating results, prospects or financial condition.*

*The risk factors set forth below with an asterisk (\*) before the title are risk factors containing substantive changes, including any material changes, from the risk factors previously disclosed in Item 1A to Part I of our annual report on Form 10-K for the year ended December 31, 2010, as filed with the Securities and Exchange Commission, or SEC.*

***Risks Relating to Our Business***

**We will need additional funds to conduct our planned research, development and commercialization efforts, we may not be able to obtain such funds and we may never become profitable.**

We have accumulated a large deficit since inception that has primarily resulted from the significant research and development expenditures we have made in seeking to identify and validate new drug targets and develop compounds that could become marketed drugs. We expect that our

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losses and operating expenses will continue to be substantial, even if we are successful in advancing our most advanced drug candidate, lorcasein, including under our marketing and supply agreement with Eisai Inc., or Eisai, or our other compounds and drug candidates, independently or with another company.

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We do not have any commercially available drugs, and may not have adequate funds to develop our compounds into marketed drugs. It takes many years and potentially hundreds of millions of dollars to successfully develop a preclinical or early clinical compound into a marketed drug, and our efforts may not result in any marketed drugs.

Our wholly owned subsidiary, Arena Pharmaceuticals GmbH, or Arena GmbH, has entered into a marketing and supply agreement with Eisai for the commercialization of lorcaserin in the United States and its territories and possessions following approval by the US Food and Drug Administration, or FDA, of our lorcaserin New Drug Application, or NDA. We will need additional funds or a collaborative or other agreement with a pharmaceutical company or companies to commercialize lorcaserin outside of the United States, and we may not be able to secure adequate funding or find a pharmaceutical company to commercialize lorcaserin outside the United States at all or on terms we or others believe are favorable. Even if we receive approval of our lorcaserin NDA and commence commercialization of lorcaserin under our marketing and supply agreement with Eisai, we cannot assure you that any additional payments we receive under such agreement will be sufficient to fund our planned research and development and other activities or to result in profitability. We also believe that it may be difficult for us to obtain additional financing or enter into strategic relationships on terms that we or third parties, including investors, analysts, or potential collaborators, view as acceptable, if at all. If adequate funding is not available, we may eliminate or postpone or scale back some or all of our research or development programs or delay the advancement of one or more of such programs. Any such reductions may adversely impact our lorcaserin development and commercialization timeline or narrow or slow the development of our pipeline, which we believe would reduce our opportunities for success and result in a decline in the market price of our common stock. We will continue to be opportunistic in our efforts to obtain cash, and expect to evaluate various financing alternatives on an ongoing basis. If we do obtain additional funding through equity sales, your ownership may be substantially diluted and result in a decline in the market price of our common stock.

**\*We are focusing a significant portion of our activities and resources on lorcaserin and depend on its marketing approval and commercial success.**

We are focusing a significant portion of our activities and resources on lorcaserin, and we believe a significant portion of the value of our company relates to our ability to obtain marketing approval for, and commercialize, this drug candidate. The marketing approval and successful commercialization of lorcaserin is subject to many risks, including the risks discussed in other risk factors. If the results of clinical trials and preclinical studies of lorcaserin, our and regulatory authorities' actions and decisions related to lorcaserin, the anticipated or actual timing and plan for commercializing lorcaserin, or, ultimately, the market acceptance of lorcaserin do not meet our, your, analysts' or others' expectations, the market price of our common stock could decline significantly.

For example, in October 2010, the FDA issued a Complete Response Letter, or CRL, regarding our NDA for lorcaserin. In the CRL, the FDA stated that it completed its review of the NDA and determined that it could not approve the application in its present form. We are working to address the FDA's concerns, including by conducting nonclinical studies and a clinical trial with a small number of volunteers, and believe that we may be able to submit our response to the lorcaserin CRL by the end of 2011. However, such submission may take up to an additional year or more, depending on the results of our ongoing and planned activities, any new guidance and feedback we receive from the FDA, and the need for any additional activities, which may include a 12-month study in rats. We may ultimately determine not to submit a response to the CRL.

Our response to the CRL may require other nonclinical studies or clinical trials in addition to the studies and trials that are ongoing or planned, may not be submitted in a timely manner or the data and other information provided or learned in connection with such response may not be satisfactory to the FDA. The FDA may request additional information or have additional recommendations prior to approval of our NDA for lorcaserin, and lorcaserin may never receive marketing approval from the FDA or any other regulatory agency.

**\*Our ability to generate significant revenues, for at least the short term, depends upon the regulatory approval of lorcaserin, the commercialization of lorcaserin, activities and payments under the marketing and supply agreement with Eisai and our entry into new collaborations.**

We expect that, for at least the short term, our ability to generate significant revenues will depend on the regulatory approval of lorcaserin, the success of Eisai in commercializing lorcaserin, if approved, in the United States, and our ability to enter into new collaborations. Future revenues under our marketing and supply agreement with Eisai will depend on the achievement of milestones under the agreement and Eisai's commercialization of lorcaserin, and, other than possible reimbursement for pre-approval development work, we may receive no additional revenues from Eisai if our NDA for lorcaserin is not approved by the FDA or further development of lorcaserin is unfavorable. In addition, we intend to commercialize lorcaserin outside of the United States with one or more pharmaceutical companies or independently. Lorcaserin may not be approved for sale outside of the United States, and, even if it is approved, we or any collaborator may not be successful in commercializing lorcaserin outside of the United States.

We cannot guarantee that any development, approval or sales milestones in our existing or future collaborations will be achieved in the future, or that we will receive any payments for the achievement of any milestones or product sales. In addition, our marketing and supply agreement with

Eisai may be terminated early in certain circumstances, in which case we may not receive milestone or other payments under the agreement.

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Moreover, our ability to enter into new collaborations may depend on the outcomes of our preclinical and clinical testing. We do not control these outcomes. In addition, even if our testing is successful, pharmaceutical companies may not enter into agreements with us on terms that we believe are acceptable until we have advanced our drug candidates into the clinic and, possibly, through later-stage clinical trials, approval or successful commercialization, if at all. With respect to lorcaserin, our ability to enter into additional collaborative agreements may also depend on the FDA's approval of our NDA for lorcaserin as well as our interactions with, and decisions by, regulatory agencies outside of the United States.

### **\*Our development and commercialization of lorcaserin may be adversely impacted by cardiovascular side effects previously associated with fenfluramine and dexfenfluramine.**

We developed lorcaserin to more selectively stimulate the serotonin 2C receptor than did fenfluramine or dexfenfluramine because we believe this may avoid the cardiovascular side effects associated with fenfluramine and dexfenfluramine (often used in combination with phentermine, the combination of which was commonly referred to as fen-phen). These two drugs were serotonin-releasing agents and non-selective serotonin receptor agonists, and were withdrawn from the market in 1997 after reported incidences of heart valve disease and pulmonary hypertension associated with their usage. In *in vitro* studies examining affinity, activity and serotonin receptor subtype specificity, lorcaserin demonstrated affinity for, and activity at, serotonin 2A, 2B and 2C receptors, but demonstrated greater affinity, activity and selectivity for the serotonin 2C receptor than for the serotonin 2A and 2B receptors. Activation of the latter two receptors has been associated with undesirable effects. Activation of the 2A receptor has been associated with central nervous system, or CNS, effects, including altered perception, mood and abuse potential, and activation of the 2B receptor has been associated with cardiac valvulopathy.

We may not be correct in our belief that more selectively stimulating the serotonin 2C receptor will avoid these undesired side effects, or lorcaserin's selectivity profile may not be adequate to avoid these side effects. Lorcaserin's selectivity profile and the potential relationship between the activity of lorcaserin and the activity of fenfluramine and dexfenfluramine may result in increased FDA regulatory scrutiny of the safety of lorcaserin and may raise potential adverse publicity, which could affect enrollment of any future clinical trials or sales if lorcaserin is approved for commercialization.

Our two large pivotal Phase 3 lorcaserin trials of one and two years' duration, BLOOM (Behavioral modification and Lorcaserin for Overweight and Obesity Management) and BLOSSOM (Behavioral modification and Lorcaserin Second Study for Obesity Management) supported our original NDA submission for lorcaserin. Data from these two trials, including the proportions of patients that developed FDA-defined valvulopathy, were included in the original NDA. There are different ways of analyzing the valvulopathy data from our trials. The pre-specified statistical analysis plan for the NDA provided that the risk difference between lorcaserin and placebo would be evaluated using a non-inferiority model that would rule out a greater than 50% increase over the assumed placebo risk of FDA-defined valvulopathy. The assumed placebo risk of FDA-defined valvulopathy was derived from the Data Safety Monitoring Board (DSMB) interim review of six-month data from the BLOOM trial. Using this analysis, the combined data from the BLOOM and BLOSSOM trials demonstrated that lorcaserin was non-inferior to placebo. Using a relative risk analysis, which the FDA has used previously and may favor over the above analysis, these trials ruled out an increase of more than 55% in the relative risk for FDA-defined valvulopathy with lorcaserin. We plan to integrate into our response to the CRL the results of our one-year, Phase 3 BLOOM-DM (Behavioral modification and Lorcaserin for Overweight and Obesity Management in Diabetes Mellitus) trial of lorcaserin, which include additional data relating to heart valves and pulmonary artery pressures. Using the analysis of risk difference that we used for our original NDA, the pooled data from the BLOOM, BLOSSOM and BLOOM-DM trials would rule out a greater than 50% increase over the assumed placebo risk of FDA-defined valvulopathy. Using a relative risk analysis, the pooled data from all three trials ruled out an increase of more than 67% in the relative risk of FDA-defined valvulopathy. Our Phase 3 trials were not designed to rule out a risk for pulmonary hypertension, which due to the rarity of this event would require a very large database.

We cannot guarantee that the FDA will find the data relating to heart valves and pulmonary artery pressures supportive of approval. In addition, our plans for our response to the CRL for lorcaserin include conducting nonclinical studies, including receptor pharmacology studies. At the FDA's recommendation, we will expand the receptor pharmacology studies to more fully characterize lorcaserin's activity at the serotonin 2A, 2B and 2C receptors. The FDA may not find our data favorable, may request additional data or other information or analysis, may decline to approve our NDA for lorcaserin, or may impose post-approval requirements that adversely impact the commercialization of lorcaserin. For example, the FDA could require additional preclinical studies or clinical trials pre- or post-approval to continue to assess risks relating to cardiac or other side effects, or the FDA could require screening or follow-up echocardiograms for patients being prescribed lorcaserin.

### **We are dependent on the marketing and supply agreement with Eisai to commercialize lorcaserin in the United States and, if applicable, to further develop lorcaserin, and the failure to maintain such agreement, or poor performance under such agreement, could negatively impact our business.**

Our ability to generate payments under our marketing and supply agreement with Eisai substantially depends on the regulatory approval and market acceptance of lorcaserin in the United States. Eisai has primary responsibility for the marketing and sale of lorcaserin in the United States

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and responsibility for compliance with certain US regulatory requirements, and we have limited control over the amount and timing of resources that Eisai will dedicate to the commercialization of lorcaserin. In March 2011, Eisai

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announced plans to realign its operations in the United States, including reducing its workforce by approximately 20% across all US functions by April 1, 2011. Such realignment and workforce reduction may have a negative impact on our marketing and supply agreement with Eisai, including on Eisai's performance of its obligations under the agreement.

We are subject to a number of other risks associated with our dependence on our marketing and supply agreement, including:

Eisai may not comply with applicable regulatory guidelines with respect to commercializing lorcaserin, which could adversely impact sales or any development of lorcaserin;

there could be disagreements regarding the agreement or the development of lorcaserin, including activities in response to the lorcaserin CRL, that delay or terminate the research, development or commercialization of lorcaserin, delay or eliminate potential payments under the agreement or increase our costs under the agreement; or

Eisai may not perform as expected, including with regard to making payments under the agreement, and such agreement may not provide adequate protection or may not be effectively enforced.

Eisai and we each have the right to terminate the agreement in certain circumstances. Eisai and we could also agree to amend the terms of the agreement, and we or others, including investors and analysts, may not view the amendments as favorable. If the agreement is terminated early, we may not be able to find another company to further develop and commercialize lorcaserin in the United States on acceptable terms, if at all, and even if we elected to pursue further development or commercialization of lorcaserin on our own, we might not have the funds, or otherwise be able, to do so successfully.

We may enter into additional agreements for the commercialization of lorcaserin or other of our drug candidates, and may be similarly dependent on the performance of third parties with similar risk.

### **Negative global economic conditions may pose challenges to our business strategy, which relies on access to capital from the markets or collaborators, and creates other financial risks for us.**

Negative conditions in the global economy, including credit markets and the financial services industry, have generally made equity and debt financing more difficult to obtain, and may negatively impact our ability to complete financing transactions. The duration and severity of these conditions is uncertain, as is the extent to which they may adversely affect our business and the business of current and prospective vendors or our distributors, licensees and collaborators, which we sometimes refer to generally as our collaborators. If negative global economic conditions persist or worsen, we may be unable to secure additional funding to sustain our operations or to find suitable collaborators to advance our internal programs, even if we achieve positive results from our research and development or business development efforts.

From time to time, we may maintain a portfolio of investments in marketable debt securities, which are recorded at fair value. Although we have established investment guidelines relative to diversification and maturity with the objectives of maintaining safety of principal and liquidity, we rely on credit rating agencies to help evaluate the riskiness of investments, and such agencies may not accurately predict such risk. In addition, such agencies may reduce the credit quality of our individual holdings, which could adversely affect their value. Lower credit quality and other market events, such as changes in interest rates and further deterioration in the credit markets, may have an adverse effect on the fair value of our investment holdings and cash position.

### **\*We and certain of our current and former employees and directors have been named as defendants in litigation that could result in substantial costs and divert management's attention.**

Beginning in September 2010, a number of lawsuits were filed against us and certain of our employees and directors on behalf of certain purchasers of our common stock. The lawsuits in general include allegations that we and certain of our employees and directors violated laws by making materially false and misleading statements regarding our lorcaserin trials, thereby artificially inflating the price of our common stock. The plaintiffs are seeking unspecified monetary damages and other relief. Several derivative lawsuits also have been filed.

There is no guarantee that we will be successful in defending these lawsuits. Also, our insurance coverage may be insufficient, our assets may be insufficient to cover any amounts that exceed our insurance coverage, and we may have to pay damage awards or otherwise may enter into



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settlement arrangements in connection with such claims. Any such payments or settlement arrangements could have material adverse effects on our business, operating results or financial condition. Even if the plaintiffs' claims are not successful, this litigation could result in substantial costs and significantly and adversely impact our reputation and divert management's attention and resources, which could have a material adverse effect on our business, operating results or financial condition. In addition, such lawsuits may make it more difficult to finance our operations.

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### **Our stock price could decline significantly based on the results and timing of clinical trials and preclinical studies of, and decisions affecting, our most advanced drug candidates.**

The results and timing of clinical trials and preclinical studies can affect our stock price. Preclinical studies include experiments performed in test tubes, in animals, or in cells or tissues from humans or animals. These studies, which are sometimes referred to as nonclinical studies, include all drug studies except those conducted in human subjects, and may occur before or after initiation of clinical trials for a particular compound. Results of clinical trials and preclinical studies of lorcaserin or our other drug candidates may not be viewed favorably by us or third parties, including investors, analysts, current or potential collaborators, the academic and medical communities, and regulators. The same may be true of how we design the development programs of our most advanced drug candidates and regulatory decisions (including by us or regulatory authorities) affecting those development programs. Stock prices of companies in our industry have declined significantly when such results and decisions were unfavorable or perceived negatively or when a drug candidate did not otherwise meet expectations.

From time to time we have drug programs in clinical trials. In addition to successfully completing clinical trials, to conduct long-term clinical trials and gain regulatory approval to commercialize drug candidates, regulatory authorities require that all drug candidates complete short- and long-term preclinical toxicity and carcinogenicity studies. These preclinical, animal studies are required to help us and regulatory authorities assess the potential risk that drug candidates may be toxic or cause cancer in humans. The results of clinical trials and preclinical studies are uncertain and subject to different interpretations, and the design of these trials and studies (which may change significantly and be more expensive than anticipated depending on results and regulatory decisions) may also be viewed negatively by us, regulatory authorities or other third parties and adversely impact the development and opportunities for regulatory approval and commercialization of our drug candidates and those under collaborative agreements.

For example, we conducted long-term carcinogenicity preclinical studies of lorcaserin. In the CRL for lorcaserin, the FDA identified issues related to such studies. We intend to provide in our response to the CRL data and other information to support our view related to such issues, but the FDA may disagree with our view or impose conditions that could significantly delay or preclude approval of our lorcaserin NDA.

We may not be successful in advancing our programs on our projected timetable, if at all. Failure to initiate or delays in the development programs for any of our drug candidates, or unfavorable results or decisions or negative perceptions regarding any of such programs, could cause our stock price to decline significantly. This is particularly the case with respect to lorcaserin.

We may report top-line data from time to time, which is based on a preliminary analysis of then-available efficacy and safety data, and such findings and conclusions are subject to change following a more comprehensive review of the data related to the particular study or trial.

### **\*We have significant indebtedness and debt service obligations as a result of our Deerfield secured loan, which may adversely affect our cash flow, cash position and stock price.**

In July 2009, we received under a facility agreement, or the Facility Agreement, a loan from Deerfield Private Design Fund, L.P., Deerfield Private Design International, L.P., Deerfield Partners, L.P., Deerfield International Limited, Deerfield Special Situations Fund, L.P., and Deerfield Special Situations Fund International Limited, or collectively Deerfield, which substantially increased our total debt and debt service obligations. This loan matures on June 17, 2013, and the outstanding principal, which is \$22.3 million, accrues interest at a rate of 7.75% per annum on the stated principal balance, payable quarterly in arrears. Unless paid earlier, we are required to repay the outstanding principal at maturity.

We may be required to repay the outstanding debt earlier under certain circumstances. For example, we are required to repay the loan upon certain changes of control. The Facility Agreement also places certain restrictions on our business, including our ability to incur additional indebtedness and to undertake certain business transactions.

In the future, if we are unable to generate cash from operations sufficient to meet this debt obligation, we will need to obtain additional funds from other sources, which may include one or more financings. However, we may be unable to obtain sufficient additional funds when we need them on favorable terms or at all. The sale of equity or convertible debt securities in the future may be dilutive to our stockholders, and debt-financing arrangements may require us to enter into covenants that would further restrict certain business activities or our ability to incur additional indebtedness, and may contain other terms that are not favorable to our stockholders or us.

Also, if we are unable to generate cash from operations or obtain additional funds from other sources sufficient to meet this debt obligation, or we need to use existing cash to fund these debt obligations, we may have to delay or curtail some or all of our research, development and commercialization programs or sell or license some or all of our assets. Our indebtedness could have significant additional negative consequences, including, without limitation:

increasing our vulnerability to general adverse economic conditions;

limiting our ability to obtain additional funds; and

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placing us at a possible competitive disadvantage to less leveraged competitors and competitors that have better access to capital resources.

If an event of default occurs under our loan documents, including in certain circumstances under the warrants issued in connection with the loan, the lenders may declare the outstanding principal balance and accrued but unpaid interest owed to them immediately due and payable, which would have a material adverse affect on our financial position. We may not have sufficient cash to satisfy this obligation. Also, if a default occurs under our secured loan, and we are unable to repay the lenders, the lenders could seek to enforce their rights under their security interests in our assets. If this were to happen, we may lose or be forced to sell some or all of our assets to satisfy our debt, which could cause our business to fail.

**If we do not commercialize lorcaserin outside of the United States with one or more pharmaceutical companies or raise additional funds, we may have to commercialize lorcaserin outside of the United States on our own and curtail certain of our activities.**

We expect to commercialize lorcaserin outside of the United States, following regulatory approval, with one or more pharmaceutical companies or independently. We may not be able to enter into agreements to commercialize lorcaserin outside of the United States on acceptable terms, if at all. If we are unable to enter into such agreements, and we develop our own capabilities to commercialize lorcaserin outside of the United States, we may require additional capital to develop such capabilities and the marketing and sale of lorcaserin outside of the United States may be delayed or limited. Even if we were able to develop our own commercialization capabilities, we have not previously commercialized a drug, and our limited experience may make us less effective at marketing and selling lorcaserin than a pharmaceutical company. Our lack of corporate experience and adequate resources may impede our efforts to successfully commercialize lorcaserin.

We face competition in our search for pharmaceutical companies to commercialize lorcaserin outside of the United States. In addition, if our competitors are able to establish commercialization arrangements with companies who have substantially greater resources than we have (or, with respect to commercializing lorcaserin in the United States, Eisai has), our competitors may be more successful in marketing and selling their drugs, and our ability to successfully commercialize lorcaserin will be limited.

**Our drug candidates are subject to extensive regulation, and we may not receive required regulatory approvals, or timely approvals, for any of our drug candidates.**

The preclinical, clinical development, manufacturing, labeling, packaging, storage, recordkeeping, advertising, promotion, export, marketing and distribution, and other possible activities relating to our drug candidates are, and any resulting drugs will be, subject to extensive regulation by the FDA and other regulatory agencies. We are subject to periodic unannounced inspections by the FDA, the Drug Enforcement Administration of the US Department of Justice, or DEA, and other regulatory agencies in the United States, and are also subject to inspections at Arena GmbH by the FDA, Swissmedic and other regulatory agencies. Swissmedic, a public service organization of the Swiss federal government, is the central Swiss agency for the authorization and supervision of therapeutic products. Failure to comply with FDA and other applicable regulatory requirements may, either before or after product approval, if any, subject our company to administrative or judicially imposed sanctions that may delay the advancement or potential approval of our drug candidates or otherwise negatively impact our business. Regulatory agencies have in the past inspected certain aspects of our business in the United States and Switzerland, and we were provided with observations of objectionable conditions or practices with respect to our business in the United States. We believe we satisfactorily addressed such observations, but there is no assurance that regulatory agencies will not provide us with observations in future inspections or that we satisfactorily addressed observations provided to us in past inspections.

Neither collaborators nor we are permitted to market a drug candidate in the United States until the particular drug candidate is approved for marketing by the FDA. Specific preclinical data, chemistry, manufacturing and controls data, a proposed clinical trial protocol and other information must be submitted to the FDA as part of an investigational new drug, or IND, application, and clinical trials may commence only after the IND application becomes effective. None of our drug candidates has received marketing approval. To market a new drug in the United States, we must submit to the FDA and obtain FDA approval of an NDA. An NDA must be supported by extensive clinical and preclinical data, as well as extensive information regarding chemistry, manufacturing and controls to demonstrate the safety and effectiveness of the drug candidate. Following its review of an NDA, the FDA may approve the NDA or issue a CRL.

Obtaining approval of an NDA can be a lengthy, expensive and uncertain process. As part of the Prescription Drug User Fee Act, or PDUFA, the FDA has a goal to review and act on a percentage of all submissions in a given time frame. The FDA's review goals are subject to change, and it is unknown whether any particular FDA review will be completed within the FDA's review goals or will be delayed. Moreover, the duration of the FDA's review may depend on the number and types of other submissions with the FDA around the same time period. The review of such other submissions may impact the regulatory review of our submissions related to lorcaserin. Furthermore, any drug that acts on the CNS, such as lorcaserin, has the potential to be scheduled as a controlled substance by the DEA. DEA scheduling is an independent process that can delay drug launch beyond an NDA approval date. DEA scheduling ranges from I to V, with I being the most tightly controlled category. The FDA has expressed concern over the abuse potential of lorcaserin



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and the available data related to such potential, and has recommended that we, as part of our response to the CRL for lorcaserin, modify and repeat two nonclinical studies to provide additional safety information for labeling and scheduling decisions. If lorcaserin were to be scheduled in a tightly controlled category, such scheduling could negatively impact the ability or willingness to prescribe or dispense lorcaserin, the likelihood that patients will use it and other aspects of our and Eisai's ability to commercialize it.

Regulatory approval of an NDA or NDA supplement is not guaranteed. The number and types of preclinical studies and clinical trials that will be required for FDA approval varies depending on the drug candidate, the disease or condition that the drug candidate is designed to target and the regulations applicable to any particular drug candidate. Despite the time and expense exerted in preclinical and clinical studies, failure can occur at any stage, and we could encounter problems that cause us to abandon clinical trials or to repeat or perform additional preclinical studies and clinical trials. The FDA can delay, limit or deny approval of a drug candidate for many reasons, including:

a drug candidate may not be deemed adequately safe and effective;

FDA officials may not find the data from preclinical studies and clinical trials sufficient;

the FDA's interpretation and our interpretation of data from preclinical studies and clinical trials may differ significantly;

our or our contractors' or collaborators' failure to comply with applicable FDA and other regulatory requirements, including those identified in other risk factors;

the FDA may not approve the manufacturing processes or facilities;

the FDA may change its approval policies or adopt new regulations; or

the FDA may not accept an NDA or other submission due to, among other reasons, the content or formatting of the submission. With respect to lorcaserin, the FDA draft guidance document "Developing Products for Weight Management" dated February 2007 provides two alternate benchmarks for the development of drugs for the indication of weight management. The guidance provides that, in general, a product can be considered effective for weight management if after one year of treatment either of the following occurs: (1) the difference in mean weight loss between the active-product and placebo-treated groups is at least 5% and the difference is statistically significant, or (2) the proportion of patients who lose at least 5% of baseline body weight in the active-product group is at least 35%, is approximately double the proportion in the placebo-treated group, and the difference between groups is statistically significant. While we believe the results of our Phase 3 clinical trials of lorcaserin satisfy the latter of the two alternate efficacy benchmarks, the FDA may disagree with our view, not follow its draft guidance or impose other approval conditions that could delay or preclude approval of our lorcaserin NDA. For example, the FDA stated in the CRL for lorcaserin that the weight loss efficacy of lorcaserin in obese and overweight individuals without type 2 diabetes is marginal and recommended that we submit the final study report of our BLOOM-DM trial. The FDA also stated in the CRL that in the event evidence cannot be provided to alleviate the FDA's concern regarding the clinical relevance of certain tumor findings in rats, additional clinical studies may be required to obtain a more robust assessment of lorcaserin's benefit-to-risk profile. In addition, the FDA may revise its guidance document on obesity drugs and any new guidance may include recommendations or requirements that make it cost-prohibitive or otherwise difficult or impossible for us to continue seeking regulatory approval for lorcaserin in the United States.

With the exception of the NDA we submitted for lorcaserin in December 2009, we have not previously submitted an NDA to the FDA. We have also not previously submitted a response to a CRL. This lack of corporate experience may impede our ability to obtain FDA approval in a timely manner, if at all, for lorcaserin or our other drug candidates for which development and commercialization are our responsibility. Even if we believe that data collected from our preclinical studies and clinical trials of our drug candidates are promising and that our information and procedures regarding chemistry, manufacturing and controls are sufficient, our data may not be sufficient to support approval by the FDA or any other US or foreign regulatory authority, or regulatory interpretation of these data and procedures may be unfavorable. In addition, we believe that the regulatory review of NDAs for drug candidates intended for widespread use by a large proportion of the general population is becoming

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increasingly focused on safety. In this regard, it is possible that some of our drug candidates, including lorcaserin, will be subject to increased scrutiny to show adequate safety than would drug candidates for more acute or life-threatening diseases such as cancer. Even if approved, drug candidates may not be approved for all indications requested and such approval may be subject to limitations on the indicated uses for which the drug may be marketed, restricted distribution methods or other limitations, such as those required by a Risk Evaluation and Mitigation Strategies, or REMS. Our business and reputation may be harmed by any failure or significant delay in receiving regulatory approval for the sale of any drugs resulting from our drug candidates. As a result, we cannot predict when or whether regulatory approval will be obtained for any drug we or our collaborators develop.

To market any drugs outside of the United States, we and current or future collaborators must comply with numerous and varying regulatory requirements of other countries. Approval procedures vary among countries and can involve additional product testing and additional administrative review periods. The time required to obtain approval in other countries might differ from that required to obtain FDA approval. The regulatory approval process in other countries may include all of the risks associated with FDA approval as well as additional risks, some of which may be unanticipated.

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We plan to submit an application for EU approval of lorcaserin, and the data from our lorcaserin studies and trials may not be sufficient for EU approval, including due to different approval requirements. For example, the European Medicines Agency, or EMA, guidelines provide that clinical trials assessing drug candidates intended for weight control should subject patients to a weight reducing diet run-in period, and our Phase 3 clinical trials did not include a run-in period.

Regulatory approval in one country does not ensure regulatory approval in another, but a failure or delay in obtaining regulatory approval in one country may negatively impact the regulatory process in others. Failure to obtain regulatory approval in other countries or any delay or setback in obtaining such approval could have the same adverse effects associated with regulatory approval in the United States, including the risk that our drug candidates may not be approved for all indications requested and that such approval may be subject to limitations on the indicated uses for which the drug may be marketed.

### **Even if any of our drug candidates receives regulatory approval, our drug candidates will still be subject to extensive post-marketing regulation.**

If we or collaborators receive regulatory approval for our drug candidates in the United States or other jurisdictions, we and our collaborators will be subject to ongoing obligations and continued regulatory review from the FDA and other applicable regulatory agencies, such as continued adverse event reporting requirements. There may also be additional FDA post-marketing obligations, all of which may result in significant expense and limit the ability to commercialize such drugs in the United States or other jurisdictions.

If any of our drug candidates receive US regulatory approval or approval in other jurisdictions, the FDA or other regulatory agencies may also require that the sponsor of the NDA conduct additional clinical trials to further assess the drug after NDA approval under a post-approval commitment. Such additional studies may be costly and may impact the commercialization of the drug. The FDA or other regulatory agencies may also impose significant restrictions on the indicated uses for which such drug may be marketed.

If the FDA or other regulatory agencies approve any of our drug candidates, the labeling, packaging, adverse event reporting, storage, advertising and promotion for the drug will be subject to extensive regulatory requirements. We and the manufacturers of our products are also required to comply with Current Good Manufacturing Practices, or CGMPs, regulations, which include requirements relating to quality control and quality assurance as well as the corresponding maintenance of records and documentation. Further, regulatory agencies must approve these manufacturing facilities before they can be used to manufacture our products, and these facilities are subject to ongoing regulatory inspections. In addition, regulatory agencies subject a drug, its manufacturer and the manufacturer's facilities to continual review and inspections. The subsequent discovery of previously unknown problems with a drug, including adverse events of unanticipated severity or frequency, or problems with the facility where the drug is manufactured, may result in restrictions on the marketing of that drug, up to and including withdrawal of the drug from the market. In the United States, the DEA and comparable state-level agencies also heavily regulate the manufacturing, holding, processing, security, recordkeeping and distribution of drugs that are considered controlled substances. If any of our drug candidates are scheduled by the DEA as controlled substances, we will also become subject to the DEA's regulations. The FDA has expressed concern over the abuse potential of lorcaserin and the available data related to such potential, and has recommended that we, as part of our response to the CRL for lorcaserin, modify and repeat two nonclinical studies to provide additional safety information for labeling and scheduling decisions. If lorcaserin were to be scheduled in a tightly controlled category, such scheduling could negatively impact the ability or willingness to prescribe or dispense lorcaserin, the likelihood that patients will use it and other aspects of our and Eisai's ability to commercialize it. The DEA periodically inspects facilities for compliance with its rules and regulations. If our manufacturing facilities or those of our suppliers fail to comply with applicable regulatory requirements, such noncompliance could result in regulatory action and additional costs to us. Failure to comply with applicable FDA and other regulatory requirements may, either before or after product approval, if any, subject our company to administrative or judicially imposed sanctions, including:

issuance of Form 483 notices or Warning Letters by the FDA or other regulatory agencies;

imposition of fines and other civil penalties;

criminal prosecutions;



injunctions, suspensions or revocations of regulatory approvals;

suspension of any ongoing clinical trials;

total or partial suspension of manufacturing;

delays in commercialization;

refusal by the FDA to approve pending applications or supplements to approved applications filed by us or collaborators;

refusals to permit drugs to be imported into or exported from the United States;

restrictions on operations, including costly new manufacturing requirements; and

product recalls or seizures.

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The FDA's and other regulatory agencies' policies may change and additional government regulations may be enacted that could prevent or delay regulatory approval of our drug candidates or further restrict or regulate post-approval activities. We cannot predict the likelihood, nature or extent of adverse government regulation that may arise from future legislation or administrative action, either in the United States or abroad. If we are not able to maintain regulatory compliance, we or our collaborators might not be permitted to market our drugs and our business could suffer.

**Even if we receive regulatory approval to commercialize our drug candidates, our ability to generate revenues from any resulting products will be subject to a variety of risks, many of which are out of our control.**

Even if our drug candidates obtain regulatory approval, resulting products may not gain market acceptance among physicians, patients, healthcare payers or the medical community. We believe that the degree of market acceptance and our ability to generate revenues from such products will depend on a number of factors, including:

timing of market introduction of our drugs and competitive drugs;

actual and perceived efficacy and safety of our drug candidates;

prevalence and severity of any side effects;

potential or perceived advantages or disadvantages over alternative treatments;

strength of sales, marketing and distribution support;

price of our future products, both in absolute terms and relative to alternative treatments;

the effect of current and future healthcare laws on our drug candidates;

availability of coverage and reimbursement from government and other third-party payers; and

product labeling or product insert requirements of the FDA or other regulatory authorities.

If our approved drugs, if any, fail to achieve market acceptance, we may not be able to generate significant revenue to achieve or sustain profitability.

In addition, if lorcaserin is approved for marketing, regulatory authorities may determine that lorcaserin will be a scheduled drug if it is found to have abuse potential or for other reasons. If lorcaserin were to be scheduled in a tightly controlled category, such scheduling could negatively impact the ability or willingness to prescribe or dispense lorcaserin, the likelihood that patients will use it, and other aspects of our ability to commercialize it and generate revenue.

**\*The development programs for our drug candidates are expensive, time consuming, uncertain and susceptible to change, interruption, delay or termination.**

Drug development programs are very expensive, time consuming and difficult to design and implement. Our drug candidates are in various stages of research and development and are prone to the risks of failure inherent in drug development. Clinical trials and preclinical studies are

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needed to demonstrate that drug candidates are safe and effective to the satisfaction of the FDA and similar non-US regulatory authorities. These trials and studies are expensive and uncertain processes that may take years to complete. Failure can occur at any stage of the process, and successful early preclinical studies or clinical trials do not ensure that later studies or trials will be successful. In addition, the commencement or completion of our planned preclinical studies or clinical trials could be substantially delayed or prevented by several factors, including the following:

limited number of, and competition for, suitable patients required for enrollment in our clinical trials or animals to conduct our preclinical studies;

limited number of, and competition for, suitable sites to conduct our clinical trials or preclinical studies;

delay or failure to obtain FDA approval or agreement to commence a clinical trial or FDA approval of a study protocol;

delay or failure to obtain sufficient supplies of our drug candidates or other drugs or materials for the trial or study;

delay or failure to reach agreement on acceptable agreement terms or protocols; and

delay or failure to obtain institutional review board, or IRB, approval to conduct a clinical trial at a prospective site.

Even if the results of our development programs are favorable, the development programs of our most advanced drug candidates, including those being developed by collaborators, may take significantly longer than expected to complete. In addition, the FDA, other regulatory authorities, collaborators, or we may suspend, delay or terminate our development programs at any time for various reasons, including:

lack of effectiveness of any drug candidate during clinical trials;

side effects experienced by study participants or other safety issues;

slower than expected rates of patient recruitment and enrollment or lower than expected patient retention rates;

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delays or inability to manufacture or obtain sufficient quantities of materials for use in clinical trials;

inadequacy of or changes in our manufacturing process or compound formulation;

delays in obtaining regulatory approvals to commence a study, or clinical holds, or delays requiring suspension or termination of a study by a regulatory authority, such as the FDA, after a study is commenced;

changes in applicable regulatory policies and regulations;

delays in identifying and reaching agreement on acceptable terms with prospective clinical trial sites;

uncertainty regarding proper dosing;

unfavorable results from ongoing clinical trials and preclinical studies;

failure of our clinical research organizations to comply with all regulatory and contractual requirements or otherwise perform their services in a timely or acceptable manner;

scheduling conflicts with participating clinicians and clinical institutions;

failure to design appropriate clinical trial protocols;

insufficient data to support regulatory approval;

termination of clinical trials by one or more clinical trial sites;

inability or unwillingness of medical investigators to follow our clinical protocols;

difficulty in maintaining contact with subjects during or after treatment, which may result in incomplete data;

lack of sufficient funding to continue clinical trials and preclinical studies; or

changes in business priorities or perceptions of the value of the program.

There is typically a high rate of attrition from the failure of drug candidates proceeding through clinical trials, and many companies have experienced significant setbacks in advanced development programs even after promising results in earlier studies or trials. We have experienced setbacks in our internal and partnered development programs and may experience additional setbacks in the future. If we or our collaborators abandon or are delayed in our development efforts related to lorcaserin or any other drug candidate, we may not be able to generate

sufficient revenues to continue our operations at the current level or become profitable, our reputation in the industry and in the investment community would likely be significantly damaged, additional funding may not be available to us or may not be available on terms we or others believe are favorable, and our stock price would likely decrease significantly.

**The results of preclinical studies and completed clinical trials are not necessarily predictive of future results, and our current drug candidates may not have favorable results in later studies or trials.**

Preclinical studies and Phase 1 and Phase 2 clinical trials are not primarily designed to test the efficacy of a drug candidate, but rather to test safety, to study pharmacokinetics and pharmacodynamics, and to understand the drug candidate's side effects at various doses and schedules. Favorable results in early studies or trials may not be repeated in later studies or trials, including continuing preclinical studies and large-scale clinical trials, and our drug candidates in later-stage trials may fail to show desired safety and efficacy despite having progressed through earlier-stage trials. Unfavorable results from ongoing preclinical studies or clinical trials could result in delays, modifications or abandonment of ongoing or future clinical trials, or abandonment of a clinical program. Preclinical and clinical results are frequently susceptible to varying interpretations that may delay, limit or prevent regulatory approvals or commercialization. For example, in the CRL for lorcaserin, the FDA identified issues that indicate that the FDA disagreed with our interpretation of certain of the data from our clinical trials and preclinical studies. Negative or inconclusive results or adverse medical events during a clinical trial could cause a clinical trial to be delayed, repeated or terminated, or a clinical program to be abandoned.

**Many of our research and development programs are in early stages of development, and may not result in the commencement of clinical trials.**

Many of our research and development programs are in the discovery or preclinical stage of development. The process of discovering compounds with therapeutic potential is expensive, time consuming and unpredictable. Similarly, the process of conducting preclinical studies of compounds that we discover requires the commitment of a substantial amount of our technical and financial resources and personnel. We may not discover additional compounds with sufficient therapeutic potential, and any of our preclinical compounds may not result in the commencement of clinical trials. We cannot be certain that results sufficiently favorable to justify commencement of Phase 1 clinical trials will be obtained in these preclinical investigations. Even if such favorable preclinical results are obtained, our financial resources may not allow us to commence Phase 1 clinical trials. If we are unable to identify and develop new drug candidates, we may not be able to maintain a clinical development pipeline or generate revenues.

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### **We may participate in new strategic transactions that could impact our liquidity, increase our expenses and present significant distractions to our management.**

From time to time we consider strategic transactions, such as out-licensing or in-licensing of compounds or technologies, acquisitions of companies and asset purchases. Additional potential transactions we may consider include a variety of different business arrangements, including strategic collaborations, joint ventures, spin-offs, restructurings, divestitures, business combinations and investments. In addition, another entity may pursue us as an acquisition target. Any such transactions may require us to incur non-recurring or other charges, may increase our near- and long-term expenditures and may pose significant integration challenges, require additional expertise or disrupt our management or business, which could harm our operations and financial results.

As part of an effort to enter into significant transactions, we conduct business, legal and financial due diligence with the goal of identifying and evaluating material risks involved in the transaction. Despite our efforts, we ultimately may be unsuccessful in ascertaining or evaluating all such risks and, as a result, might not realize the intended advantages of the transaction. If we fail to realize the expected benefits from any transaction we may consummate, whether as a result of unidentified risks, integration difficulties, regulatory setbacks or other events, our business, results of operations and financial condition could be adversely affected.

### **Drug discovery and development is intensely competitive in the therapeutic areas on which we focus. If our competitors develop treatments that are approved faster, marketed better, less expensive or demonstrated to be more effective or safer than our drug candidates, our commercial opportunities will be reduced or eliminated.**

Many of the drugs we or our collaborators are or may attempt to discover and develop may compete with existing therapies. In addition, many companies are pursuing the development of new drugs that target the same diseases and conditions that we target. Many of our competitors, particularly large pharmaceutical companies, have substantially greater research, development and marketing capabilities and greater financial, scientific and human resources than we do. Companies that complete clinical trials, obtain required regulatory agency approvals and commence commercial sale of their drugs before we do for the same indication may achieve a significant competitive advantage, including certain patent and FDA marketing exclusivity rights. In addition, our competitors may develop drugs with fewer side effects, more desirable characteristics (such as route of administration or frequency of dosing) or better efficacy than our drug candidates or drugs, if any, for the same indication. Our competitors may also market generic or other drugs that compete with our drugs at a lower price than our drugs, which may negatively impact our drug sales, if any. Any results from our research and development efforts, or from our joint efforts with our existing or any future collaborators, may not compete successfully with existing or newly discovered products or therapies.

### **Collaborative relationships may lead to disputes and delays in drug development and commercialization, and we may not realize the full commercial potential of our drug candidates.**

We have had conflicts with collaborators and may in the future have conflicts with our prospective, current or past collaborators, such as conflicts concerning the interpretation of preclinical or clinical data, the achievement of milestone or other payments, the ownership of intellectual property, or research and development or commercialization strategy. Collaborators may stop supporting our drug candidates or drugs if they develop or obtain rights to competing drug candidates or drugs. In addition, collaborators may fail to effectively develop or commercialize our drug candidates, which may result in us not realizing the full commercial potential of our drug candidates. If any conflicts arise with Eisai or any other prospective, current or past collaborator, such collaborator may act in a manner that is adverse to our interests. Any such disagreement could result in one or more of the following, each of which could delay, or lead to termination of, development or commercialization of our drug candidates, and in turn prevent us from generating revenues:

unwillingness on the part of a collaborator to pay us research funding, milestone payments, royalties or other payments that we believe are due to us under a collaboration;

uncertainty regarding ownership of intellectual property rights arising from our collaborative activities, which could prevent us from entering into additional collaborations;

unwillingness on the part of a collaborator to keep us informed regarding the progress of its development and commercialization activities or to permit public disclosure of the results of those activities;

slowing or cessation of a collaborator's research, development or commercialization efforts with respect to our drug candidates; or

litigation or arbitration.

**Table of Contents****Setbacks, including those relating to drugs and drug candidates intended for weight management, and consolidation in the pharmaceutical and biotechnology industries and inadequate third-party coverage and reimbursement could make entering into agreements with pharmaceutical companies to collaborate or commercialize our drugs more difficult and diminish our revenues.**

Setbacks in the pharmaceutical and biotechnology industries, such as those caused by safety concerns relating to drugs like Meridia, Avandia, Vioxx and Celebrex, or drug candidates, as well as competition from generic drugs, litigation, and industry consolidation, may have an adverse effect on us. For example, the FDA may be more cautious in approving our drug candidates based on safety concerns relating to these or other drugs or drug candidates, or pharmaceutical companies may be less willing to enter into new collaborations or continue existing collaborations if they are integrating a new operation as a result of a merger or acquisition or if their therapeutic areas of focus change following a merger.

Moreover, our and our collaborators' ability to commercialize any of our drugs that may be approved will depend in part on government regulation and the availability of coverage and adequate reimbursement from third-party payers, including private health insurers and government payers, such as the Medicaid and Medicare programs, increases in government-run, single-payer health insurance plans and compulsory licenses of drugs. Government and third-party payers are increasingly attempting to contain healthcare costs by limiting coverage and reimbursement levels for new drugs. In addition, in March 2010, the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Affordability Act, or collectively, PPACA, was passed, which will significantly affect the pharmaceutical industry. In addition to extending coverage to patients otherwise uninsured, PPACA includes, among several other provisions relating to pharmaceuticals, measures that impose a new nondeductible fee on certain branded drugs based on market share in government health care programs, increases in rebates for government programs such as Medicaid, and the creation of a new Patient-Centered Outcomes Research Institute to oversee, identify priorities in, and conduct comparative clinical effectiveness research, along with funding for such research. Many of the details regarding the implementation of PPACA are yet to be determined, and we cannot predict with certainty whether or to what extent such implementation or adoption of reforms may impair our business. In addition, legal challenges to the PPACA are being made, and the ultimate outcome of such challenges and the impact on our business are unknown. Given the continuing discussion regarding the cost of healthcare, managed care, universal healthcare coverage and other healthcare issues, we also cannot predict with certainty what additional healthcare initiatives, if any, will be implemented or the effect any future legislation or regulation will have on our business. PPACA and any additional legislation or regulations may limit our commercial opportunities by reducing the amount a potential collaborator is willing to pay to license our programs or drug candidates in the future due to a reduction in the potential revenues from drug sales. Moreover, legislation and regulations affecting the pricing of pharmaceuticals may change before regulatory agencies approve our drug candidates for marketing. Adoption of such legislation and regulations could further limit pricing approvals for, and reimbursement of, drugs. A government or third-party payer decision not to approve pricing for, or provide adequate coverage and reimbursements of, our drugs, if any, could limit market acceptance of such drugs.

**We rely on other companies, including third-party manufacturers, and we or such other companies may encounter failures or difficulties that could delay the clinical development or regulatory approval of our drug candidates, or their ultimate commercial production if approved.**

We and third parties manufacture our drug candidates. We do not have manufacturing facilities that can produce sufficient quantities of active pharmaceutical ingredient, or API, and finished drug product for large-scale clinical trials. Accordingly, we must either develop such facilities, which will require substantial additional funds, or rely, at least to some extent, on third-party manufacturers for the production of drug candidates. Furthermore, should we obtain FDA approval for any of our drug candidates, we expect to rely, at least to some extent, on third-party manufacturers for commercial production. Our dependence on others for the manufacture of our drug candidates may adversely affect our ability to develop and deliver such drug candidates on a timely and competitive basis.

Any performance failure on the part of us or a third-party manufacturer could delay clinical development, regulatory approval or, ultimately, sales of our drug candidates. We or third-party manufacturers may encounter difficulties involving production yields, regulatory compliance, lot release, quality control and quality assurance, as well as shortages of qualified personnel. Approval of our drug candidates could be delayed, limited or denied if the FDA does not approve our or a third-party manufacturer's processes or facilities. Moreover, the ability to adequately and timely manufacture and supply drug candidates is dependent on the uninterrupted and efficient operation of the manufacturing facilities, which is impacted by many manufacturing variables including:

availability or contamination of raw materials and components used in the manufacturing process, particularly those for which we have no other source or supplier;

capacity of our facilities or those of our contract manufacturers;



facility contamination by microorganisms or viruses or cross contamination;

compliance with regulatory requirements, including Form 483 notices and Warning Letters;

changes in forecasts of future demand;

timing and actual number of production runs;

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production success rates and bulk drug yields; and

timing and outcome of product quality testing.

In addition, we or our third-party manufacturers may encounter delays and problems in manufacturing our drug candidates or drugs for a variety of reasons, including accidents during operation, failure of equipment, delays in receiving materials, natural or other disasters, political or governmental changes, or other factors inherent in operating complex manufacturing facilities. Supply chain management is complex, and involves sourcing from a number of different companies and foreign countries. Commercially available starting materials, reagents and excipients may become scarce or more expensive to procure, and we may not be able to obtain favorable terms in agreements with subcontractors. We or our third-party manufacturers may not be able to operate our respective manufacturing facilities in a cost-effective manner or in a time frame that is consistent with our expected future manufacturing needs. If we or our third-party manufacturers cease or interrupt production or if our third-party manufacturers and other service providers fail to supply materials, products or services to us for any reason, such interruption could delay progress on our programs, or interrupt the commercial supply, with the potential for additional costs and lost revenues. If this were to occur, we may also need to seek alternative means to fulfill our manufacturing needs.

We may not be able to enter into agreements for the manufacture of our drug candidates with manufacturers whose facilities and procedures comply with applicable law. Manufacturers are subject to ongoing periodic unannounced inspection by the FDA, the DEA and corresponding state and foreign authorities to ensure strict compliance with CGMP and other applicable government regulations and corresponding foreign standards. We do not have control over a third-party manufacturer's compliance with these regulations and standards. In addition, Arena GmbH has contracted with Siegfried Ltd, or Siegfried, to provide safety, health and environmental services and assess compliance, train personnel and oversee Arena GmbH's compliance with the applicable safety, health and environmental regulations. We are, therefore, relying at least in part on Siegfried's judgment, experience and expertise. If we or one of our manufacturers fail to maintain compliance, we or they could be subject to civil or criminal penalties, the production of our drug candidates could be interrupted or suspended, or our product could be recalled or withdrawn, resulting in delays, additional costs and potentially lost revenues.

**We rely on third parties to conduct our clinical trials and many of our preclinical studies. If those parties do not successfully carry out their contractual duties or meet expected deadlines, our drug candidates may not advance in a timely manner or at all.**

In the course of our discovery, preclinical testing and clinical trials, we rely on third parties, including laboratories, investigators, clinical research organizations and manufacturers, to perform critical services for us. For example, we rely on third parties to conduct our clinical trials and many of our preclinical studies. Clinical research organizations are responsible for many aspects of the trials, including finding and enrolling subjects for testing and administering the trials. Although we rely on these third parties to conduct our clinical trials, we are responsible for ensuring that each of our clinical trials is conducted in accordance with its investigational plan and protocol. Moreover, the FDA and foreign regulatory authorities require us to comply with regulations and standards, commonly referred to as good clinical practices, or GCPs, for conducting, monitoring, recording and reporting the results of clinical trials to ensure that the data and results are scientifically credible and accurate and that the trial subjects are adequately informed of the potential risks of participating in clinical trials. Our reliance on third parties does not relieve us of these responsibilities and requirements. These third parties may not be available when we need them or, if they are available, may not comply with all regulatory and contractual requirements or may not otherwise perform their services in a timely or acceptable manner, and we may need to enter into new arrangements with alternative third parties and our clinical trials may be extended, delayed or terminated. These independent third parties may also have relationships with other commercial entities, some of which may compete with us. In addition, if such third parties fail to perform their obligations in compliance with our clinical trial protocols or GCPs, our clinical trials may not meet regulatory requirements or may need to be repeated. As a result of our dependence on third parties, we may face delays or failures outside of our direct control. These risks also apply to the development activities of collaborators, and we do not control their research and development, clinical trial or regulatory activities.

**Our efforts will be seriously jeopardized if we are unable to retain and attract key and other employees.**

Our success depends on the continued contributions of our principal management, development and scientific personnel, and the ability to hire and retain key and other personnel, particularly in the area of clinical development. We face competition for such personnel, and we believe that recent developments, including our receipt of the CRL for lorcaserin, the reduction of our US workforce initiated in January 2011, subsequent resignations of additional employees, pending and possible future litigation involving us, and our relatively low stock price may impact our ability to hire and retain key and other personnel. The loss of services of any principal member of our management or scientific staff or other personnel, particularly Jack Lief, our Chairman, President and Chief Executive Officer, and Dominic P. Behan, Ph.D., our Senior Vice President and Chief Scientific Officer, or a combination of different key employees, could adversely impact our operations and ability to raise additional capital. To our knowledge, neither Mr. Lief nor Dr. Behan plans to leave, retire or otherwise disassociate with us in the near future.



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**\*If we do not realize the expected benefits from the reduction in workforce we completed around the end of March 2011, our operating results and financial conditions would be negatively impacted.**

Around the end of March 2011, we completed a reduction in our US workforce of approximately 25% designed to focus our resources on selected drug candidates and reduce our future cash expenditures. If we are unable to realize the expected operational efficiencies and financial benefits from this reduction in force, our operating results and financial condition would be adversely affected. We cannot guarantee that we will not have to undertake additional restructuring activities, that we will be able to realize the cost savings and other anticipated benefits from such efforts, or that such efforts will not interfere with our ability to achieve our business objectives.

**We may incur substantial liabilities for any product liability claims or otherwise as a drug product manufacturer.**

We develop, test and manufacture drugs that are used by humans. We face an inherent risk of product liability exposure related to the testing of our drug candidates in clinical trials, and will face an even greater risk if we sell our own drugs commercially. In addition, under our marketing and supply agreement with Eisai, Arena GmbH has agreed to indemnify Eisai for certain losses resulting from product liability claims, except to the extent caused by Eisai's negligence, willful misconduct, or violation of law or Eisai's breach of such agreement.

Whether or not we are ultimately successful in any product liability or related litigation, such litigation would consume substantial amounts of our financial and managerial resources, and might result in adverse publicity, all of which would impair our business. In addition, damages awarded in a product liability action could be substantial and could have a negative impact on our financial condition.

An individual may bring a liability claim against us if one of our drug candidates or drugs causes, or merely appears to have caused, an injury. Regardless of merit or eventual outcome, liability claims may result in:

decreased demand for our drug;

injury to our reputation;

withdrawal of clinical trial subjects;

costs of related litigation;

substantial monetary awards to subjects or other claimants;

loss of revenues; and

the inability to commercialize our drug candidates.

We have limited product liability insurance that covers our clinical trials. We intend to expand our insurance coverage to include the sale of drugs if marketing approval is obtained for any of our drug candidates. However, insurance coverage is increasingly expensive. We may not be able to obtain or maintain insurance coverage at a reasonable cost, and we may not have insurance coverage that will be adequate to satisfy any liability that may arise, which could have an adverse effect on our capital sources and financial condition.

Arena GmbH manufactures drug products for Siegfried and will manufacture lorcaserin for Eisai if lorcaserin is approved. In addition to product liability, Arena GmbH is subject to liability for non-performance, product recalls and breaches of the agreements with Siegfried and Eisai.

**We may be subject, directly or indirectly, to federal and state healthcare fraud and abuse and false claims laws and regulations. Prosecutions under such laws have increased in recent years and we may become subject to such litigation. If we are unable to comply, or have not fully complied, with such laws, we could face substantial penalties.**

If we obtain FDA approval to commercialize any of our drug candidates in the United States, our operations may be directly or indirectly subject to various state and federal fraud and abuse laws, including, without limitation, the federal Anti-Kickback Statute and federal False Claims Act. These laws may impact, among other things, the sales, marketing and education programs for our drugs.

The federal Anti-Kickback Statute prohibits persons from knowingly and willingly soliciting, offering, receiving or providing remuneration, directly or indirectly, in exchange for or to induce either the referral of an individual, or the furnishing or arranging for a good or service, for which payment may be made under a federal healthcare program such as the Medicare and Medicaid programs. Several courts have interpreted the statute's intent requirement to mean that if any one purpose of an arrangement involving remuneration is to induce referrals of federal healthcare covered business, the statute has been violated. The Anti-Kickback Statute is broad and, despite a series of narrow safe harbors, prohibits many arrangements and practices that are lawful in businesses outside of the healthcare industry. Penalties for violations of the federal Anti-Kickback Statute include criminal penalties and civil sanctions such as fines, imprisonment and possible exclusion from Medicare, Medicaid and other federal healthcare programs. Many states have also adopted laws similar to the federal Anti-Kickback Statute, some of which apply to the referral of patients for healthcare items or services reimbursed by any source, not only the Medicare and Medicaid programs.

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The federal False Claims Act prohibits persons from knowingly filing, or causing to be filed, a false claim to, or the knowing use of false statements to obtain payment from the federal government. Suits filed under the False Claims Act, known as qui tam actions, can be brought by any individual on behalf of the government and such individuals, commonly known as whistleblowers, may share in any amounts paid by the entity to the government in fines or settlement. The filing of qui tam actions has caused a number of pharmaceutical, medical device and other healthcare companies to have to defend a False Claims Act action. When an entity is determined to have violated the False Claims Act, it may be required to pay up to three times the actual damages sustained by the government, plus civil penalties for each separate false claim. Various states have also enacted laws modeled after the federal False Claims Act.

We are unable to predict whether we could be subject to actions under any of these or other fraud and abuse laws, or the impact of such actions. If we are found to be in violation of any of the laws described above and other applicable state and federal fraud and abuse laws, we may be subject to penalties, including civil and criminal penalties, damages, fines, exclusion from government healthcare reimbursement programs and the curtailment or restructuring of our operations, all of which could have a material adverse effect on our business and results of operations.

### **We may not be able to effectively integrate or manage our international operations and such difficulty could adversely affect our stock price, business operations, financial condition and results of operations.**

The headquarters of our operations outside of the United States is in Switzerland. Activities conducted at this location include manufacturing, quality control, quality assurance, development of manufacturing processes, qualifying suppliers and otherwise managing the global supply chain, regulatory compliance, distribution of finished products, and European strategic planning and development. There are significant risks associated with foreign operations, including, but not limited to, compliance with local laws and regulations, the protection of our intellectual property, the ability to integrate our corporate culture with local customs and cultures, the distraction to our management, foreign currency exchange rates and the impact of shifts in the US and local economies on those rates, and integration of our policies and procedures, including disclosure controls and procedures and internal control over financial reporting, with our international operations.

### **We use biological materials, hazardous materials, chemicals and radioactive compounds.**

Our research and development and manufacturing activities involve the use of potentially harmful biological materials as well as materials, chemicals and various radioactive compounds that could be hazardous to human health and safety or the environment. These materials and various wastes resulting from their use are stored at our facility pending ultimate use and disposal. We cannot completely eliminate the risk of contamination, which could cause:

interruption of our research and development or manufacturing efforts;

injury to our employees and others;

environmental damage resulting in costly clean up; and

liabilities under domestic or foreign federal, state and local laws and regulations governing the use, storage, handling and disposal of these materials and specified waste products.

In such an event, we may be held liable for any resulting damages, and any such liability could exceed our resources. Although we carry insurance in amounts and type that we consider commercially reasonable, we cannot be certain that the coverage or coverage limits of our insurance policies will be adequate and we do not have insurance coverage for losses relating to an interruption of our research and development efforts caused by contamination.

### **Our operations might be interrupted by the occurrence of a natural disaster or other event.**

Our US operations, including laboratories, offices and a chemical development facility, are located in the same business park in San Diego. We also have a drug product facility in Zofingen, Switzerland, and we expect that, at least for the foreseeable future, this facility will be the sole location for the manufacturing of lorcaserin finished drug product. We depend on our facilities and on collaborators, contractors and vendors for the continued operation of our business, some of whom are located in Europe and Asia. Natural disasters or other catastrophic events, including

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interruptions in the supply of natural resources, political and governmental changes, severe weather conditions, wildfires and other fires, explosions, actions of animal rights activists, terrorist attacks, earthquakes and wars could disrupt our operations or those of our collaborators, contractors and vendors. Even though we believe we carry commercially reasonable business interruption and liability insurance, and our contractors may carry liability insurance that protect us in certain events, we might suffer losses as a result of business interruptions that exceed the coverage available under our and our contractors' insurance policies or for which we or our contractors do not have coverage. For example, we are not insured against a terrorist attack. Any natural disaster or catastrophic event could have a significant negative impact on our operations and financial results. Moreover, any such event could delay our research and development programs and adversely affect, which may include stopping, our commercial production.

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### **Our executive officers and directors may sell shares of their stock, and these sales could adversely affect our stock price.**

Sales of our stock by our executive officers and directors, or the perception that such sales may occur, could adversely affect the market price of our stock. Our executive officers and directors may sell stock in the future, either as part, or outside, of trading plans under SEC Rule 10b5-1.

### **Currency fluctuations may negatively affect our financial condition.**

We primarily spend and generate cash in US dollars, and present our consolidated financial statements in US dollars. However, a portion of our expected and potential payments and receipts under our agreements are in foreign currencies, including Swiss francs. For example, payments and receipts under our asset purchase agreement, manufacturing services agreement and long-term API manufacturing agreement with Siegfried are required to be paid in Swiss francs. A fluctuation of the exchange rates of foreign currencies versus the US dollar may, thus, adversely affect our financial results, including cash balances, expenses and revenues. We may enter into hedging transactions to try to reduce our foreign currency exposure in the future, but there is no assurance that such transactions will occur or be successful.

### **Laws, rules and regulations relating to public companies may be costly and impact our ability to attract and retain directors and executive officers.**

Laws and regulations affecting public companies, including rules adopted by the SEC and by NASDAQ, as well as the laws and regulations of foreign governments, may result in increased costs to us, particularly as we continue to develop the required capabilities in the United States and abroad to commercialize our products. These laws, rules and regulations could make it more difficult or costly for us to obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, on our board committees or as executive officers. We cannot estimate accurately the amount or timing of additional costs we may incur to respond to these laws, rules and regulations.

### ***Risks Relating to Our Intellectual Property***

#### **Our success is dependent on intellectual property rights held by us and third parties and our interest in these rights is complex and uncertain.**

Our success will depend on our own and on current or future collaborators' abilities to obtain, secure and defend patents. In particular, the patents directed to our most advanced drug candidates and other compounds discovered using our technologies or that are otherwise part of our collaborations are important to commercializing drugs. We have numerous US and foreign patent applications pending for our technologies. There is no assurance that any of our patent applications will issue, or that any of the patents will be enforceable or will cover a drug or other commercially significant technology or method, or that the patents will be held to be valid for their expected terms.

The procedures for obtaining a patent in the United States and in most foreign countries are complex. These procedures require an analysis of the scientific technology related to the invention and many sophisticated legal issues. Obtaining patent rights outside the United States often requires the translation of highly technical documents and an improper translation may lead to the loss of, or otherwise jeopardize, the patent protection of our inventions. Ensuring adequate quality of translators and foreign patent attorneys is often very challenging. Consequently, the process for having our pending patent applications issue as patents will be difficult, complex and time consuming. Our patent position is very uncertain and we do not know when, or if, we will obtain additional patents for our technologies, or if the scope of the patents obtained will be sufficient to protect our drugs, or be considered sufficient by parties reviewing our patent positions pursuant to a potential licensing or financing transaction.

In addition, other entities may challenge the validity or enforceability of our patents and patent applications in litigation or administrative proceedings. Even the issuance of a patent is not conclusive as to its validity or enforceability. We cannot make assurances as to how much protection, if any, will be given to our patents if we attempt to enforce them or they are challenged. It is possible that a competitor or a generic pharmaceutical provider may successfully challenge our patents and those challenges may result in reduction or elimination of our patents coverage.

We also rely on confidentiality agreements and trade secrets to protect our technologies. However, such information is difficult to protect. We require our employees to contractually agree not to improperly use our confidential information or disclose it to others, but we may be unable to determine if our employees have conformed or will conform to their legal obligations under these agreements. We also enter into confidentiality agreements with prospective collaborators, collaborators, service providers and consultants, but we may not be able to adequately protect our trade secrets or other proprietary information in the event of any unauthorized use or disclosure or the lawful development by others of this information. Many of our employees and consultants were, and many of them may currently be, parties to confidentiality agreements with other



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pharmaceutical and biotechnology companies, and the use of our technologies could violate these agreements. In addition, third parties may independently discover our trade secrets or proprietary information.

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Some of our academic institution licensors, research collaborators and scientific advisors have rights to publish data and information to which we have rights. We generally seek to prevent our collaborators from disclosing scientific discoveries before we have the opportunity to file patent applications on such discoveries. In some of our collaborations, we do not control our collaborators' ability to disclose their own discoveries under the collaboration and in some of our academic collaborations we are limited to relatively short periods to review a proposed publication and file a patent application. If we cannot maintain the confidentiality of our technologies and other confidential information in connection with our collaborations, our ability to receive patent protection or protect our proprietary information will be impaired.

We believe that the United States is by far the largest single market for pharmaceuticals in the world. Because of the critical nature of patent rights to our industry, changes in US patent laws could have a profound effect on our future profits, if any. Several of the patent law changes that are being considered could significantly weaken patent protections in the United States in general. They may also have a disproportionately large negative impact on our industry in particular, as well as tilt the balance of market control and distribution of profits between the manufacturers of patented pharmaceutical products and the manufacturers of generic pharmaceutical products towards the generics manufacturers. At present there is considerable uncertainty as to which patent laws will be changed and exactly how changes to the patent laws will ultimately be enforced by the courts.

### **A dispute regarding the infringement or misappropriation of our proprietary rights or the proprietary rights of others could be costly and result in delays or termination of our future research, development, manufacturing and sales activities.**

Our commercial success also depends upon our ability to develop and manufacture our drug candidates and market and sell drugs, if any, and conduct our research and development activities without infringing or misappropriating the proprietary rights of others. There are many patents and patent applications filed, and that may be filed, by others relating to drug discovery and development programs that could be determined to be similar, identical or superior to ours or our licensors or collaborators. We may be exposed to future litigation by others based on claims that our drug candidates, technologies or activities infringe the intellectual property rights of others. Numerous US and foreign issued patents and pending patent applications owned by others exist in the area of G protein-coupled receptors, or GPCRs, including some which purport to allow the patent holder to control the use of all drugs that modulate a particular drug target or GPCR, regardless of whether the infringing drug bears any structural resemblance to a chemical compound known to the patent holder at the time of patent filing. Numerous US and foreign issued patents and pending patent applications owned by others also exist in the therapeutic areas in, and for the therapeutic targets for, which we are developing drugs. There are also numerous issued patents and patent applications to chemical compounds or synthetic processes that may be necessary or useful to use in our research, development, manufacturing or commercialization activities. These could materially affect our ability to develop our drug candidates or manufacture, import or sell drugs, and our activities, or those of our licensors or collaborators, could be determined to infringe these patents. Because patent applications can take many years to issue, there may be currently pending applications, unknown to us, which may later result in issued patents that our drug candidates or technologies may infringe. There also may be existing patents, of which we are not aware, that our drug candidates or technologies may infringe. Further, there may be issued patents or pending patent applications in fields relevant to our business, of which we are or may become aware, that we believe (i) are invalid or we do not infringe; (ii) relate to immaterial portions of our overall drug discovery, development, manufacturing and commercialization efforts; or (iii) in the case of pending patent applications, the resulting patent would not be granted or, if granted, would not likely be enforced in a manner that would materially impact such efforts. We cannot assure you that others holding any of these patents or patent applications will not assert infringement claims against us for damages or seek to enjoin our activities. We also cannot assure you that, in the event of litigation, we will be able to successfully assert any belief we may have as to non-infringement, invalidity or immateriality, or that any infringement claims will be resolved in our favor.

In addition, others may infringe or misappropriate our proprietary rights, and we may have to institute costly legal action to protect our intellectual property rights. We may not be able to afford the costs of enforcing or defending our intellectual property rights against others.

Other organizations, companies and individuals are seeking proprietary positions on genomics information that overlap with the government-sponsored project to sequence the human genome. Our activities, or those of our licensors or collaborators, could be affected by conflicting positions that may exist between any overlapping genomics information made available publicly as a result of the government-sponsored project and genomics information that other organizations, companies or individuals consider to be proprietary. There could also be significant litigation and other administrative proceedings in our industry that affect us regarding patent and other intellectual property rights. Any legal action or administrative action against us, or our collaborators, claiming damages or seeking to enjoin commercial activities relating to our drug discovery, development, manufacturing and commercialization activities could:

require us, or our collaborators, to obtain a license to continue to use, manufacture or market the affected drugs, methods or processes, which may not be available on commercially reasonable terms, if at all;



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prevent us from importing, making, using, selling or offering to sell the subject matter claimed in patents held by others and subject us to potential liability for damages;

consume a substantial portion of our managerial, scientific and financial resources; or

be costly, regardless of the outcome.

Furthermore, because of the substantial amount of pre-trial document and witness discovery required in connection with intellectual property litigation, there is a risk that some of our confidential information could be compromised by disclosure during this type of litigation. In addition, during the course of this kind of litigation, there could be public announcements of the results of hearings, motions or other interim proceedings or developments. If securities analysts or investors perceive these results to be negative, it could have a substantial adverse effect on the trading price of our common stock.

We have been contacted from time to time by third parties regarding their intellectual property rights, sometimes asserting that we may need a license to use their technologies. If we fail to obtain any required licenses or make any necessary changes to our technologies, we may be unable to develop or commercialize some or all of our drug candidates.

**We cannot protect our intellectual property rights throughout the world.**

Filing, prosecuting, defending and enforcing patents on all of our drug discovery technologies and all of our potential drug candidates throughout the world would be prohibitively expensive. Competitors may use our technologies to develop their own drugs in jurisdictions where we have not obtained patent protection. These drugs may compete with our drugs, if any, and may not be covered by any of our patent claims or other intellectual property rights. The laws of some foreign countries do not protect intellectual property rights to the same extent as the laws of the United States, and many companies have encountered significant problems in protecting and defending such rights in foreign jurisdictions. Many countries, including certain countries in Europe, have compulsory licensing laws under which a patent owner may be compelled to grant licenses to third parties (for example, the patent owner has failed to work the invention in that country or the third party has patented improvements). In addition, many countries limit the enforceability of patents against government agencies or government contractors. In these countries, the patent owner may have limited remedies, which could materially diminish the value of the patent. Compulsory licensing of life-saving drugs is also becoming increasingly popular in developing countries either through direct legislation or international initiatives. Such compulsory licenses could be extended to include some of our drug candidates, which could limit our potential revenue opportunities. Moreover, the legal systems of certain countries, particularly certain developing countries, do not favor the aggressive enforcement of patents and other intellectual property protection, particularly those relating to biotechnology and/or pharmaceuticals, which makes it difficult for us to stop the infringement of our patents. Proceedings to enforce our patent rights in foreign jurisdictions could result in substantial cost and divert our efforts and attention from other aspects of our business.

***Risks Relating to Our Securities***

**\*Our stock price will likely be volatile, and your investment in our stock could decline in value.**

Our stock price has fluctuated historically. From January 1, 2009 to May 2, 2011, the market price of our stock was as low as \$1.21 per share and as high as \$8.00 per share.

Very few drug candidates being tested will ultimately receive FDA approval, and companies in our industry sometimes experience a significant drop in stock price. Our stock price may fluctuate significantly depending on a variety of factors, including:

regulatory actions affecting lorcaserin, including those relating to our response to the CRL for lorcaserin, or other drug candidates or drugs;

discussions or recommendations affecting lorcaserin or other drug candidates or drugs by FDA advisory committees or other reviewers of preclinical or clinical data or other information related to lorcaserin or other drug candidates or drugs;

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the success or failure of our clinical-stage development programs or other results or decisions affecting the development of our drug candidates, including the results of any studies, trials or analyses related to our response to the CRL for lorcaserin;

the timing of the discovery of drug leads and the development of our drug candidates;

the modification or termination of an existing collaboration or the entrance into, or failure to enter into, a new collaboration;

the timing and receipt by us of milestone or other payments or failing to achieve and receive the same;

changes in our research and development budget or the research and development budgets of our existing or potential collaborators;

the introduction, development or withdrawal of drug candidates or drugs by others that target the same diseases and conditions that we or our collaborators target or the introduction of new drug discovery techniques;

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the success, failure or setbacks of our or a perceived competitor's drug candidate or drug;

expenses related to, and the results of, litigation, other disputes and other proceedings;

financing strategy or decisions;

developments in intellectual property rights or related announcements;

capital market conditions; and

accounting changes.

We are not able to control many of these factors. If our financial or scientific results in a particular period do not meet stockholders' or analysts' expectations, our stock price may decline and such decline could be significant.

**\*There are a substantial number of shares of our common stock eligible for future sale in the public market, and the sale of these shares could cause the market price of our common stock to fall.**

There were 145,894,281 shares of our common stock outstanding as of May 2, 2011. We also had outstanding as of May 2, 2011, a seven-year warrant issued in June 2006 to purchase 1,227,743 shares of our common stock at an exercise price of \$10.47 per share and a seven-year warrant issued in August 2008 to purchase 1,640,368 shares of our common stock at an exercise price of \$5.20 per share. Such warrants were adjusted as a result of certain equity sales following their issuance to decrease the exercise price and increase the number of shares issuable upon exercise of the warrants. Certain future equity issuances below the pre-defined warrant adjustment price may result in additional adjustments to any such warrants then outstanding.

As of May 2, 2011, we had outstanding warrants we issued to Deerfield to purchase an aggregate of 28,000,000 shares of our common stock with a weighted-average exercise price of \$3.37 per share and expiration dates of June 17, 2013 and June 17, 2015.

Along with our outstanding warrants, as of May 2, 2011, there were (i) options to purchase 10,502,854 shares of our common stock outstanding under our equity incentive plans at a weighted-average exercise price of \$6.02 per share, (ii) 1,303,700 performance-based restricted stock unit awards outstanding under our 2006 Long-Term Incentive Plan, as amended, (iii) 3,778,941 additional shares of common stock remaining issuable under our 2009 Long-Term Incentive Plan, (iv) 753,171 shares of common stock remaining issuable under our 2009 Employee Stock Purchase Plan, and (v) 79,169 shares of common stock remaining issuable under our Deferred Compensation Plan.

The shares described above, when issued, will be available for immediate resale in the public market. The market price of our common stock could decline as a result of such resales due to the increased number of shares available for sale in the market.

**Any future equity or debt issuances by us may have dilutive or adverse effects on our existing stockholders.**

We have primarily financed our operations, and we expect to continue to finance our operations, by issuing and selling our common stock or securities convertible into or exercisable for shares of our common stock. In light of our need for additional funding, we may issue additional shares of common stock or convertible securities that could dilute your ownership in our company and may include terms that give new investors rights that are superior to yours. Moreover, any issuances by us of equity securities may be at or below the prevailing market price of our common stock and in any event may have a dilutive impact on your ownership interest, which could cause the market price of our common stock to decline. In addition, we may also raise additional funds through the incurrence of debt, and the holders of any debt we may issue would have rights superior to your rights in the event we are not successful and are forced to seek the protection of bankruptcy laws. For example, in July 2009 we issued debt to Deerfield that is secured by our assets, and Deerfield's right to repayment would be senior to your rights to receive any proceeds from a liquidation in bankruptcy or otherwise.

**The holders of our common stock and other securities may take actions that are contrary to your interests, including selling their stock.**

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A small number of our stockholders hold or have rights to acquire a significant amount of our outstanding stock. These stockholders may support competing transactions and have interests that are different from yours. In addition, sales of a large number of shares of our stock by these large stockholders or other stockholders within a short period of time could adversely affect our stock price.

We may also be involved with disagreements with the holders of our stock, warrants or other securities in the future. Such disagreements may lead to litigation which may be expensive and consume management's time, or involve settlements, the terms of which may not be favorable to us.

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**Our rights agreement and certain provisions in our charter documents and Delaware law could delay or prevent a change in management or a takeover attempt that you may consider to be in your best interest.**

We have adopted certain anti-takeover provisions, including a stockholders' rights agreement, dated as of October 30, 2002, between us and Computershare Trust Company, Inc., as Rights Agent, as amended. The rights agreement will cause substantial dilution to any person who attempts to acquire us in a manner or on terms not approved by our board of directors.

The rights agreement, as well as other provisions in our certificate of incorporation and bylaws and under Delaware law, could delay or prevent the removal of directors and other management and could make more difficult a merger, tender offer or proxy contest involving us that you may consider to be in your best interest. For example, these provisions:

allow our board of directors to issue preferred stock without stockholder approval;

limit who can call a special meeting of stockholders;

eliminate stockholder action by written consent; and

establish advance notice requirements for nomination for election to the board of directors or for proposing matters to be acted upon at stockholders meetings.

**Item 6. Exhibits.**

| EXHIBIT NO. | DESCRIPTION   |
|-------------|---|
| 3.1         | Fifth Amended and Restated Certificate of Incorporation of Arena (incorporated by reference to Exhibit 3.1 to Arena's quarterly report on Form 10-Q for the quarter ended June 30, 2002, filed with the Securities and Exchange Commission on August 14, 2002, Commission File No. 000-31161)   |
| 3.2         | Certificate of Amendment of the Fifth Amended and Restated Certificate of Incorporation of Arena (incorporated by reference to Exhibit 4.2 to Arena's registration statement on Form S-8 filed with the Securities and Exchange Commission on June 28, 2006, Commission File No. 333-135398)  |
| 3.3         | Certificate of Amendment No. 2 of the Fifth Amended and Restated Certificate of Incorporation of Arena, as amended (incorporated by reference to Exhibit 4.3 to Arena's registration statement on Form S-8 filed with the Securities and Exchange Commission on June 30, 2009, Commission File No. 333-160329)                                    |
| 3.4         | Amended and Restated Bylaws of Arena (incorporated by reference to Exhibit 3.1 to Arena's current report on Form 8-K filed with the Securities and Exchange Commission on October 4, 2007, Commission File No. 000-31161)   |
| 3.5         | Certificate of Designations of Series A Junior Participating Preferred Stock of Arena, dated November 4, 2002 (incorporated by reference to Exhibit 3.3 to Arena's quarterly report on Form 10-Q for the quarter ended September 30, 2002, filed with the Securities and Exchange Commission on November 14, 2002, Commission File No. 000-31161) |
| 3.6         | Certificate of Designations of Series B-1 Convertible Preferred Stock and Series B-2 Convertible Preferred Stock of Arena, dated December 24, 2003 (incorporated by reference to Exhibit 3.1 to Arena's current report on Form 8-K filed with the Securities and Exchange Commission on December 30, 2003, Commission File No. 000-31161)         |
| 3.7         | Certificate of Designation of Preferences, Rights and Limitations of Series C Convertible Preferred Stock, dated March 30, 2011   |
| 4.1         | Rights Agreement, dated October 30, 2002, between Arena and Computershare Trust Company, Inc. (incorporated by reference to Exhibit 4.1 to Arena's current report on Form 8-K filed with the Securities and Exchange Commission on November 1, 2002,  |



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Commission File No. 000-31161)

- 4.2 Amendment No. 1, dated December 24, 2003, to Rights Agreement, dated October 30, 2002, between Arena and Computershare Trust Company, Inc. (incorporated by reference to Exhibit 4.1 to Arena's current report on Form 8-K filed with the Securities and Exchange Commission on December 30, 2003, Commission File No. 000-31161)
- 4.3 Amendment No. 2, dated November 16, 2006, to Rights Agreement, dated October 30, 2002, between Arena and Computershare Trust Company, Inc. (incorporated by reference to Exhibit 4.3 to Amendment No. 2 to Arena's registration statement on Form 8-A filed with the Securities and Exchange Commission on November 16, 2006, Commission File No. 000-31161)
- 4.4 Form of common stock certificate (incorporated by reference to Exhibit 4.2 to Arena's registration statement on Form S-1, as amended, filed with the Securities and Exchange Commission on July 19, 2000, Commission File No. 333-35944)

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| EXHIBIT<br>NO. | DESCRIPTION   |
|----------------|---|
| 10.1*          | Annual Incentive Plan (incorporated by reference to Exhibit 10.1 to Arena's current report on Form 8-K filed with the Securities and Exchange Commission on January 25, 2010, Commission File No. 000-31161)  |
| 10.2           | Amendment No. 1 to the Asset Purchase Agreement, dated effective as of January 1, 2011, by and between Arena Pharmaceuticals GmbH and Siegfried Ltd   |
| 10.3           | Amendment No. 3 to the Toll Manufacturing Agreement, dated effective as of January 1, 2011, by and between Arena Pharmaceuticals GmbH and Siegfried Ltd   |
| 10.4           | Securities Purchase Agreement, dated March 28, 2011, between Arena and Deerfield Private Design Fund, L.P., Deerfield Private Design International, L.P., Deerfield Partners, L.P., Deerfield International Limited, Deerfield Special Situations Fund, L.P., and Deerfield Special Situations Fund International Limited (incorporated by reference to Exhibit 99.1 to Arena's current report on Form 8-K filed with the Securities and Exchange Commission on March 29, 2011, Commission File No. 000-31161)          |
| 10.5           | Second Amendment to Facility Agreement, dated March 28, 2011, between Arena and Deerfield Private Design Fund, L.P., Deerfield Private Design International, L.P., Deerfield Partners, L.P., Deerfield International Limited, Deerfield Special Situations Fund, L.P., and Deerfield Special Situations Fund International Limited (incorporated by reference to Exhibit 99.2 to Arena's current report on Form 8-K filed with the Securities and Exchange Commission on March 29, 2011, Commission File No. 000-31161) |
| 10.6           | Exchange Agreement, dated March 28, 2011, between Arena and Deerfield Private Design Fund, L.P., Deerfield Private Design International, L.P., Deerfield Partners, L.P., Deerfield International Limited, Deerfield Special Situations Fund, L.P., and Deerfield Special Situations Fund International Limited (incorporated by reference to Exhibit 99.3 to Arena's current report on Form 8-K filed with the Securities and Exchange Commission on March 29, 2011, Commission File No. 000-31161)                     |
| 10.7           | Form of 2011 Warrant to Purchase Common Stock of Arena (incorporated by reference to Exhibit 99.4 to Arena's current report on Form 8-K filed with the Securities and Exchange Commission on March 29, 2011, Commission File No. 000-31161)   |
| 31.1           | Certification of principal executive and financial officer pursuant to Rule 13a-14(A) promulgated under the Securities Exchange Act of 1934   |
| 32.1           | Certification of principal executive and financial officer pursuant to 18 U.S.C. Section 1350 and Rule 13a-14(B) promulgated under the Securities Exchange Act of 1934  |

\* Management contract or compensatory plan or arrangement.

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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: May 10, 2011

ARENA PHARMACEUTICALS, INC.

By: /s/ Jack Lief  
Jack Lief  
President and Chief Executive Officer (principal executive  
and financial officer authorized to sign on behalf of the  
registrant)

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Situations Fund, L.P., and Deerfield Special Situations Fund International Limited (incorporated by reference to Exhibit 99.2 to Arena's current report on Form 8-K filed with the Securities and Exchange Commission on March 29, 2011, Commission File No. 000-31161)

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