ARQULE INC
Form 10-Q
November 06, 2009
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# SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

# FORM 10-Q

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the Quarter Ended September 30, 2009**

**Commission File No. 000-21429**

**ArQule, Inc.**

(Exact Name of Registrant as Specified in its Charter)

| | |
|---|---|
| **Delaware** | **04-3221586** |
| (State of Incorporation) | (I.R.S. Employer Identification Number) |

**19 Presidential Way, Woburn, Massachusetts 01801**

(Address of Principal Executive Offices)

**(781) 994-0300**

(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 Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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 (Section 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 o No o

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

| | |
|---|---|
| Large accelerated filer o | Accelerated filer x |
| Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company o |

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

Number of shares outstanding of the registrant s Common Stock as of October 30, 2009:

| | |
|---|---|
| Common Stock, par value $.01 | 44,688,240<br>shares outstanding |

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**ARQULE, INC.**

**QUARTER ENDED SEPTEMBER 30, 2009**

**PART I - FINANCIAL INFORMATION**

**Item 1. Unaudited Condensed Consolidated Financial Statements**

**ARQULE, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)**

| | September 30, 2009 | December 31, 2008 |
|---|---|---|
| | (IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA) | |
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 68,247 | $ 141,890 |
| Marketable securities-short term | 40,698 | |
| Prepaid expenses and other current assets | 950 | 772 |
| Total current assets | 109,895 | 142,662 |
| Marketable securities-long term | 69,161 | 64,219 |
| Property and equipment, net | 4,758 | 5,620 |
| Other assets | 1,334 | 1,711 |
| Total assets | $ 185,148 | $ 214,212 |
| | | |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | $ 13,761 | $ 14,260 |
| Note payable | 47,750 | 47,750 |
| Current portion of deferred revenue | 23,240 | 20,420 |
| Current portion of deferred gain on sale leaseback | 552 | 552 |
| Total current liabilities | 85,303 | 82,982 |
| Restructuring accrual, net of current portion | | 78 |
| Deferred revenue, net of current portion | 76,786 | 84,693 |
| Deferred gain on sale leaseback, net of current portion | 2,577 | 2,992 |
| Total liabilities | 164,666 | 170,745 |
| Commitments and contingencies | | |
| | | |
| Stockholders equity: | | |
| Preferred stock, $0.01 par value; 1,000,000 shares authorized; no shares issued or outstanding | | |
| Common stock, $0.01 par value; 100,000,000 shares authorized; 44,687,806 and 44,153,237 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively | 447 | 442 |
| Additional paid-in capital | 378,690 | 375,478 |
| Accumulated other comprehensive loss | 66 | |
| Accumulated deficit | (358,721) | (332,453) |
| Total stockholders equity | 20,482 | 43,467 |
| Total liabilities and stockholders equity | $ 185,148 | $ 214,212 |

The accompanying notes are an integral part of these interim unaudited financial statements.

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**ARQULE, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)**

| | THREE MONTHS ENDED September 30, | | NINE MONTHS ENDED September 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| | (IN THOUSANDS, EXCEPT PER SHARE DATA) | | | |
| Research and development revenue | $ 6,436 | $ 2,664 | $ 17,912 | $ 8,774 |
| Costs and expenses: | | | | |
| Research and development | 11,347 | 10,788 | 35,359 | 39,220 |
| General and administrative | 3,134 | 3,496 | 9,997 | 13,419 |
| Total costs and expenses | 14,481 | 14,284 | 45,356 | 52,639 |
| Loss from operations | (8,045) | (11,620) | (27,444) | (43,865) |
| Interest income | 174 | 557 | 841 | 2,848 |
| Interest expense | (169) | (218) | (505) | (218) |
| Other income (expense) | 352 | | 1,240 | |
| Net loss before taxes | (7,688) | (11,281) | (25,868) | (41,235) |
| Provision for income taxes | (400) | | (400) | |
| Net loss | $ (8,088) | $ (11,281) | $ (26,268) | $ (41,235) |
| Basic and diluted net loss per share: | | | | |
| Net loss per share | $ (0.18) | $ (0.26) | $ (0.60) | $ (0.94) |
| Weighted average basic and diluted common shares outstanding | 44,322 | 43,894 | 44,126 | 43,821 |

The accompanying notes are an integral part of these interim unaudited financial statements.

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**ARQULE, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**

| | NINE MONTHS ENDED September 30, | |
|---|---|---|
| | 2009 | 2008 |
| | (IN THOUSANDS) | |
| Cash flows from operating activities: | | |
| Net loss | $ (26,268) | $ (41,235) |
| | | |
| Adjustments to reconcile loss to net cash used in operating activities: | | |
| Depreciation and amortization | 1,289 | 1,241 |
| Amortization of premium/discount on marketable securities | 589 | 20 |
| Amortization of deferred gain on sale leaseback | (415) | (415) |
| Non-cash stock compensation | 2,761 | 5,060 |
| Gain on auction rate securities | (2,019) | |
| Loss on auction rate securities put option | 779 | |
| Loss on disposal of property and equipment | | 14 |
| Changes in operating assets and liabilities: | | |
| Prepaid expenses and other current assets | (178) | 546 |
| Other assets | 377 | 91 |
| Accounts payable and accrued expenses | (499) | 449 |
| Restructuring accrual, net of current portion | (78) | (494) |
| Deferred revenue | (5,087) | (3,255) |
| Net cash used in operating activities | (28,749) | (37,978) |
| Cash flows from investing activities: | | |
| Purchases of marketable securities | (58,610) | (8,819) |
| Proceeds from sale or maturity of marketable securities | 13,687 | 67,639 |
| Additions to property and equipment | (427) | (3,526) |
| Proceeds from disposal of property and equipment | | 94 |
| Net cash provided by (used in) investing activities | (45,350) | 55,388 |
| Cash flows from financing activities: | | |
| Proceeds from note payable | | 46,050 |
| Proceeds from issuance of common stock | 456 | 377 |
| Net cash provided by financing activities | 456 | 46,427 |
| Net increase (decrease) in cash and cash equivalents | (73,643) | 63,837 |
| Cash and cash equivalents, beginning of period | 141,890 | 10,835 |
| Cash and cash equivalents, end of period | $ 68,247 | $ 74,672 |

The accompanying notes are an integral part of these interim unaudited financial statements.

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**ARQULE, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)**

**1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION**

We are a clinical-stage biotechnology company organized as a Delaware corporation in 1993 and engaged in the research and development of innovative cancer therapeutics directed toward molecular targets that we believe play critical roles in the development of human cancers. Our mission is to discover and develop novel products that target multiple tumor types, act selectively against cancer cells and are well tolerated by patients.

Our lead product is ARQ 197, an orally administered inhibitor of the c-Met receptor tyrosine kinase. ARQ 197 is currently being evaluated as monotherapy and in combination therapy in a Phase 2 clinical development program. We have licensed commercial rights to ARQ 197 for human cancer indications to Daiichi Sankyo Co., Ltd. ( Daiichi Sankyo ) in the U.S., Europe, South America and the rest of the world, excluding Japan and certain other Asian countries, where we have licensed commercial rights to Kyowa Hakko Kirin Co. Ltd. ( Kyowa Hakko Kirin ).

Our product pipeline offers the potential for multiple therapeutic candidates based on diverse biological targets, mechanisms of action and chemistry. The most advanced of these programs is focused on the development of inhibitors of the Eg5 kinesin motor protein, which include ARQ 621, in Phase 1 clinical development.

Our drug discovery efforts are focused primarily on the ArQule Kinase Inhibitor Platform ( AKIP ), which we are leveraging to generate compounds designed to inhibit a variety of kinases potently, selectively and without competing with adenosine triphosphate ( ATP ), an energy source for cells. We have maintained the know-how associated with our combinatorial chemistry expertise, developed and validated in the course of our previous chemistry services collaborations with companies in the pharmaceutical and biotechnology industries, and combined it with our biology expertise.

We have prepared the accompanying condensed consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to these rules and regulations. These condensed consolidated financial statements should be read in conjunction with our audited financial statements and footnotes related thereto for the year ended December 31, 2008 included in our annual report on Form 10-K filed with the SEC on March 6, 2009.

The unaudited condensed consolidated financial statements include, in our opinion, all adjustments (consisting only of normal recurring adjustments) necessary to present fairly our financial position as of September 30, 2009, the results of our operations for the three and nine months ended September 30, 2009 and September 30, 2008 and cash flows for the nine months ended September 30, 2009 and September 30, 2008. The results of operations for such interim periods are not necessarily indicative of the results to be achieved for the full year.

**2. COLLABORATIONS AND ALLIANCES**

*Daiichi Sankyo Co., Ltd. ARQ 197 Agreement*

On December 18, 2008, we entered into a license, co-development and co-commercialization agreement with Daiichi Sankyo to conduct research, clinical trials and commercialization of ARQ 197 in human cancer indications in the U.S., Europe, South America and the rest of the world, excluding Japan, China (including Hong Kong), South Korea and Taiwan, where Kyowa Hakko Kirin has exclusive rights for development and commercialization.

The agreement provides for a $60 million cash upfront licensing payment from Daiichi Sankyo to us, which we received in December 2008, and an additional $560 million in potential development and sales milestone payments. We and Daiichi Sankyo will share equally the costs of Phase 2 and Phase 3 clinical studies, with our share of Phase 3 costs payable solely from milestone and royalty payments from Daiichi Sankyo. Upon commercialization, we will receive tiered, double-digit royalties from Daiichi Sankyo on net sales of ARQ 197 commensurate with the magnitude of the transaction. We retain the option to participate in the commercialization of ARQ 197 in the U.S.

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The duration and termination of the agreement is tied to future events. Unless earlier terminated due to breach, insolvency or upon 90 days notice if prior to phase 3 clinical trials or 180 days notice if on or after the beginning of phase 3 clinical trials by Daiichi Sankyo, the agreement shall continue until the later of (i) such time as Daiichi Sankyo is no longer developing at least one licensed product or (ii) if Daiichi Sankyo has commercialized a licensed product or products, such time as all royalty terms for all licensed products have ended. The royalty term, on a country-by country basis for a product, ends as of the later of (i) the expiration of the last valid claim under a patent covering the manufacture, use, or sale of a licensed product or (ii) a certain number of years from the date of the commercial sale of the licensed product in such country.

Revenue for this agreement is recognized using the contingency-adjusted performance model with an estimated development period through December 2013. For the quarter and nine months ended September 30, 2009, $3.5 million and $9.8 million was recognized as revenue. As of September 30, 2009, $55.0 million remains in deferred revenue.

*Daiichi Sankyo Co., Ltd. Kinase Inhibitor Discovery Agreement*

On November 7, 2008, we entered into a research collaboration, exclusive license and co-commercialization agreement with Daiichi Sankyo under which we will apply our proprietary technology and know-how from our AKIP platform for the discovery of therapeutic compounds that selectively inhibit certain kinases. The agreement defines two such kinase targets and Daiichi Sankyo will have an option to license compounds directed to these targets following the completion of certain pre-clinical studies.

The agreement provides for a $15 million upfront payment, which we received in November 2008, research support payments for the first two years of the collaboration, licensing fees for compounds discovered as a result of this research, milestone payments related to clinical development, regulatory review and sales, and royalty payments on net sales of compounds from the collaboration. We retain the option to co-commercialize licensed products developed under this agreement in the U.S.

The duration and termination of the agreement is tied to future events. Unless earlier terminated due to breach, insolvency or upon 90 days notice by Daiichi Sankyo, the agreement terminates on the later of (i) the expiration of the research collaboration period, or (ii) various periods specified in the agreement for development and commercialization of products. If Daiichi Sankyo has commercialized a licensed product or products, the agreement will continue in force until such time as all royalty terms for all licensed products have ended. The royalty term, on a country-by country basis for a product, ends as of the later of (i) the expiration of the last valid claim under a patent covering the manufacture, use, or sale of a licensed product or (ii) a certain number of years from the date of the commercial sale of the licensed product in such country.

Revenue for this agreement is recognized using the contingency-adjusted performance model with an estimated performance period through November 2012. For the quarter and nine months ended September 30, 2009, $1.9 million and $5.0 million was recognized as revenue. As of September 30, 2009, $19.6 million remains in deferred revenue.

*Kyowa Hakko Kirin Co., Ltd. Licensing Agreement*

On April 27, 2007, we entered into an exclusive license agreement with Kyowa Hakko Kirin to develop and commercialize ARQ 197 in Japan and parts of Asia. A $3 million portion of an upfront licensing fee was received by the Company under this agreement in the first quarter of 2007 and an additional $27 million in upfront licensing fees was received on May 7, 2007. The agreement includes $123 million in upfront and potential development milestone payments from Kyowa Hakko Kirin to ArQule, including the $30 million cash upfront licensing payments. In February 2008, we received a $3 million milestone payment from Kyowa Hakko Kirin. Upon commercialization, ArQule will receive tiered royalties in the mid-teen to low-twenty percent range from Kyowa Hakko Kirin on net sales of ARQ 197. Kyowa Hakko Kirin will be responsible for all clinical development costs and commercialization of the compound in certain Asian countries, consisting of Japan, China (including Hong Kong), South Korea and Taiwan.

In addition to the upfront and possible regulatory milestone payments totaling $123 million, the Company will be eligible for future milestone payments based on the achievement of certain levels of net sales. The Company will recognize the payments, if any, as revenue in accordance with its revenue recognition policies. As of September 30, 2009, the Company has not recognized any revenue from these sales milestone payments, and there can be no assurance that it will do so in the future.

The duration and termination of the agreement is tied to future events. Unless earlier terminated due to breach, insolvency or upon 90 days notice by Kyowa Hakko Kirin, the agreement terminates on the date that the last royalty term expires in all countries in the territory. The royalty term ends as of the later of (i) the expiration of the last pending patent application or expiration of the patent in the country covering the manufacture, use, or sale of a licensed product or (ii) a certain number of years from the date of the commercial launch in such country of such license product.

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Revenue for this agreement is recognized using the contingency-adjusted performance model with an estimated development period through April 2016. For the quarter and nine months ended September 30, 2009, $1.0 million and $3.1 million was recognized as revenue. As of September 30, 2009, $25.5 million remains in deferred revenue.

**3. MARKETABLE SECURITIES AND FAIR VALUE MEASUREMENTS**

We generally classify our marketable securities as available-for-sale at the time of purchase and re-evaluate such designation as of each consolidated balance sheet date. Since we generally intend to convert them into cash as necessary to meet our liquidity requirements our marketable securities are classified as cash equivalents if the original maturity, from the date of purchase, is ninety days or less and as short-term investments if the original maturity, from the date of purchase, is in excess of ninety days but less than one year. Our marketable securities are classified as long-term investments if the maturity date is in excess of one year of the balance sheet date.

We report available-for-sale investments at fair value as of each balance sheet date and include any unrealized gains and, to the extent deemed temporary, unrealized losses in stockholders equity. Realized gains and losses are determined using the specific identification method and are included in other income (expense) in the statement of operations. Certain of our marketable securities are classified as trading securities and any changes in the fair value of those securities are recorded as other income (expense) in the statement of operations.

Investments are considered to be impaired when a decline in fair value below cost basis is determined to be other-than-temporary. We evaluate whether a decline in fair value below cost basis is other-than-temporary using available evidence regarding our investments. In the event that the cost basis of a security exceeds its fair value, we evaluate, among other factors, the duration of the period that, and extent to which, the fair value is less than cost basis, the financial health of and business outlook for the issuer, including industry and sector performance, and operational and financing cash flow factors, overall market conditions and trends, our intent to sell the investment and if it is more likely than not that we would be required to sell the investment before its anticipated recovery. Once a decline in fair value is determined to be other-than-temporary, a write-down is recorded in the condensed consolidated statements of operations and a new cost basis in the security is established. In April 2009, additional authoritative guidance was issued to provide greater clarity about the credit and noncredit component of an other-than-temporary impairment event and to more effectively communicate when an other-than-temporary impairment event has occurred. The new guidance applies to debt securities. The new guidance was effective for periods ending after June 15, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

We invest our available cash primarily in money market mutual funds, commercial paper fully guaranteed by the FDIC under the Temporary Liquidity Guarantee Program (TLGP), commercial paper, and U.S. federal and state agency backed certificates, including auction rate securities, that have strong credit ratings. Auction rate securities are structured with short-term interest reset dates of generally less than 90 days, but with contractual maturities that can be well in excess of ten years. At the end of each reset period, which occurs every seven to twenty-eight days, investors can sell or continue to hold the securities at par value. If any of our auction rate securities were to fail an auction, due to sell orders exceeding buy orders, the funds associated with a failed auction would not be accessible until a successful auction occurred, a buyer was found outside the auction process, the underlying securities matured or a settlement with the underwriter is reached.

Beginning in the first quarter of 2008 and continuing through the third quarter of 2009, certain auction rate securities failed auction due to sell orders exceeding buy orders. On November 3, 2008, the Company accepted an offer ( Offering ) by UBS AG ( UBS ) of certain rights ( Put Option ) to cause UBS to purchase auction rate securities owned by the Company. The repurchase rights were offered in connection with UBS s obligations under settlement agreements with the U.S. Securities and Exchange Commission and other federal and state regulatory authorities.

The offering, the settlement agreements, and the respective rights and obligations of the parties, including a release by the Company of UBS and its employees and agents from all claims except claims for consequential damages relating to UBS s marketing and sale of auction rate securities, are described in a prospectus issued by UBS dated October 7, 2008.

As a result of accepting the Offering, the Company received a Put Option from UBS to repurchase the securities at par value at any time during the period from June 30, 2010 through July 2, 2012, if the Company s auction rate securities have not previously been sold by the Company or by UBS on its behalf. The Company has accounted for the Put Option as a freestanding financial instrument and elected to record the value under the fair value option for financial assets and financial liabilities. The Company has classified its auction rate securities as trading securities reflecting the Company s intent to exercise the Put Option during the period June 30, 2010 to July 2, 2012. The increase in value of our Put Option and auction rate securities totaling $0.4 million in the three months ended September 30, 2009 was recorded as a gain in other income (expense) in the statement of operations.

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ArQule s marketable securities portfolio as of December 31, 2008 included $65.3 million (at cost) and $64.0 million (at cost) at September 30, 2009 invested in auction rate securities all of which were associated with auctions that failed subsequent to February 12, 2008.

On July 8, 2008, we entered into a collateralized, revolving credit line agreement for up to $47.5 million with UBS Bank USA (the Facility ). In July 2008, we drew down $46.1 million under the Facility. In accordance with the Offering by UBS, the Facility remains payable on demand; however, if UBS Bank USA should exercise its right to demand repayment of any portion of the Company s indebtedness prior to the date the Company can exercise its repurchase rights (other than for reasons specified in the prospectus), UBS and certain of its affiliates will arrange for alternative financing on terms and conditions substantially the same as those contained in the Facility. If alternative financing cannot be established, then UBS or one of its affiliates will purchase the Company s pledged auction rate securities at par.

The following is a summary of the fair value of available-for-sale marketable securities we held at September 30, 2009. The Company had no available-for-sale marketable securities at December 31, 2008.

| **September 30, 2009** | **Amortized Cost** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Value** |
|---|---|---|---|---|
| *Security type* | | | | |
| U.S. Federal Treasury and U.S. government agencies securities | $ 38,152 | $ 46 | $ | $ 38,198 |
| Corporate debt securities-short term | 2,499 | 1 | | 2,500 |
| | 40,651 | 47 | | 40,698 |
| Corporate debt securities-long term | 5,213 | 23 | (4) | 5,232 |
| Total available-for-sale marketable securities | $ 45,864 | $ 70 | $ (4) | $ 45,930 |

The following is a summary of the fair value of trading securities we held at September 30, 2009 and December 31, 2008:

| **September 30, 2009** | **Amortized Cost** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Value** |
|---|---|---|---|---|
| *Security type* | | | | |
| Auction rate securities | $ 64,017 | $ | $ (5,993) | $ 58,024 |
| Auction rate put option | | 5,905 | | 5,905 |
| Total trading securities | $ 64,017 | $ 5,905 | $ (5,993) | $ 63,929 |

| **December 31, 2008** | **Amortized Cost** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Value** |
|---|---|---|---|---|
| *Security type* | | | | |
| Auction rate securities | $ 65,547 | $ | $ (8,012) | $ 57,535 |
| Auction rate put option | | 6,684 | | 6,684 |
| Total trading securities | $ 65,547 | $ 6,684 | $ (8,012) | $ 64,219 |

The underlying collateral of our auction rate securities consists primarily of student loans, the majority of which are supported by the federal government as part of the Federal Family Education Loan Program (FFELP). The credit ratings for all of our auction rate securities were AAA when originally purchased. At September 30, 2009, $53.0 million at par value were rated AAA and $11.0 million at par value were rated A.

The Company s marketable securities long-term at September 30, 2009 and December 31, 2008 include auction rate securities and auction rate put option which are classified as trading securities and any future gains and losses will be recorded as other income (expense) in the statement of operations.

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The following tables present information about our assets that are measured at fair value on a recurring basis for the periods presented and indicates the fair value hierarchy of the valuation techniques we utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs utilize data points that are observable such as quoted prices, interest rates and yield curves. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability:

| | September 30, 2009 | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Cash equivalents | $ 64,958 | $ 64,958 | $ | $ |
| Marketable securities | 40,698 | | 40,698 | |
| Marketable securities long term | 69,161 | | 5,232 | 63,929 |
| Total | $ 174,817 | $ 64,958 | $ 45,930 | $ 63,929 |

| | December 31, 2008 | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Cash equivalents | $ 139,370 | $ 139,370 | $ | $ |
| Marketable securities long term | 64,219 | | | 64,219 |
| Total | $ 203,589 | $ 139,370 | $ | $ 64,219 |

Certain of our marketable securities-long term consist of auction rate securities and the related Put Option. Due to the lack of market quotes relating to our auction rate securities, the fair value measurements for our auction rate securities have been estimated using an income approach model (discounted cash flow analysis), which is exclusively based on Level 3 inputs. The model considers factors that reflect assumptions market participants would use in pricing including, among others, the collateralization underlying the investments, the creditworthiness of the counterparty, the expected future cash flows, liquidity premiums, the probability of successful auctions in the future, and interest rates. The assumptions used are subject to volatility and may change as the underlying sources of these assumptions and markets conditions change.

Due to the lack of market quotes relating to our Put Option, the fair value measurements for our Put Option have been estimated using a valuation approach commonly used for forward contracts in which one party agrees to sell a financial instrument (generating cash flows) to another party at a particular time for a predetermined price, which is based on Level 3 inputs. In this approach the present value of all expected future cash flows is subtracted from the current fair value of the security, and the resulting value is calculated as a future value at an interest rate reflective of counterparty risk. The assumptions used are subject to volatility and may change as the underlying sources of these assumptions and markets conditions change.

The following tables roll forward the fair value of our auction rate securities, whose fair value is determined by Level 3 inputs for the 2009 periods presented:

| | Amount ($ in millions) |
|---|---|
| Balance at December 31, 2008 | $ 64.2 |

| | | |
|---|---|---|
| Gain on auction rate securities and put option | | 1.2 |
| Settlements | | (1.5) |
| Balance at September 30, 2009 | $ | 63.9 |

| | Amount ($ in millions) | |
|---|---|---|
| Balance at June 30, 2009 | $ | 64.7 |
| Gain on auction rate securities and put option | | 0.4 |
| Settlements | | (1.2) |
| Balance at September 30, 2009 | $ | 63.9 |

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The following tables roll forward the fair value of our auction rate securities, whose fair value is determined by Level 3 inputs for the 2008 periods presented:

| | | Amount ($ in millions) |
|---|---|---|
| Balance at December 31, 2007 | $ | 92.9 |
| Total unrealized losses included in other comprehensive income | | (3.8) |
| Settlements | | (27.5) |
| Balance at September 30, 2008 | $ | 61.6 |

| | | Amount ($ in millions) |
|---|---|---|
| Balance at June 30, 2008 | $ | 61.3 |
| Total unrealized gain included in other comprehensive income | | 0.3 |
| Settlements | | |
| Balance at September 30, 2008 | $ | 61.6 |

**4. COMPREHENSIVE LOSS**

Comprehensive loss is comprised of net loss and other comprehensive gain (loss). Other comprehensive gain (loss) includes unrealized gains (losses) on our available-for-sale securities that are excluded from net loss. Total comprehensive loss for the three and nine months ended September 30, 2009 and September 30, 2008 was as follows:

| | Three Months Ended September 30, | | Nine months Ended September 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Net loss | $ (8,088) | $ (11,281) | $ (26,268) | $ (41,235) |
| Unrealized gain (loss) on marketable securities | 11 | 230 | 66 | (3,824) |
| Comprehensive loss | $ (8,077) | $ (11,051) | $ (26,202) | $ (45,059) |

**5. ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

Accounts payable and accrued expenses include the following at September 30, 2009 and December 31, 2008:

| | September 30, 2009 | December 31, 2008 |
|---|---|---|
| Accounts payable | $ 296 | $ 495 |
| Accrued payroll | 2,534 | 2,671 |
| Accrued outsourced pre-clinical and clinical fees | 8,465 | 8,669 |
| Accrued professional fees | 719 | 1,037 |
| Accrued restructuring-current portion | 244 | 660 |
| Other accrued expenses | 1,103 | 728 |
| | $ 13,361 | $ 14,260 |

**6. RESTRUCTURING CHARGES**

In 2002, we recorded a restructuring charge associated with abandoning our facility in Redwood City, California, which was comprised of the difference between the remaining lease obligation, which runs through the first quarter of 2010, and our estimate of potential future sublease income. The accrual balance was adjusted in 2003 to reflect a change in estimate due to continued deterioration in the local real estate market. The accrual balance was adjusted again in 2004 as a result of us entering into a sublease for the facility. The remaining facility-related restructuring accrual is primarily comprised of the difference between our lease obligation for this facility, which will be paid out through the first quarter of 2010, and the amount of sublease payments we will receive under our sublease agreement.

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Activities against the restructuring accrual in the nine months ended September 30, 2009 and September 30, 2008 were as follows:

| | Balance as of December 31, 2008 | 2009 Provisions | 2009 Payments | Balance as of September 30, 2009 |
|---|---|---|---|---|
| Facility-related | $ 738 | $ | $ (494) | $ 244 |

| | Balance as of December 31, 2007 | 2008 Provisions | 2008 Payments | Balance as of September 30, 2008 |
|---|---|---|---|---|
| Facility-related | $ 1,366 | $ | $ (471) | $ 895 |

**7. NET LOSS PER SHARE**

Net loss per share is computed using the weighted average number of common shares outstanding. Basic and diluted net loss per share amounts are equivalent for the periods presented as the inclusion of potential common shares in the number of shares used for the diluted computation would be anti-dilutive to loss per share. Potential common shares, the shares that would be issued upon the exercise of outstanding stock options, were 5,279,389 and 5,715,532 for the three and nine months ended September 30, 2009 and 2008, respectively.

**8. STOCK-BASED COMPENSATION AND STOCK PLANS**

Our stock-based compensation cost is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the employees requisite service period (generally the vesting period of the equity grant).

We estimate the fair value of stock options using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price of the award, expected option term, expected volatility of our stock over the option s expected term, risk-free interest rate over the option s expected term, and the expected annual dividend yield. We believe that the valuation technique and approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of our stock options granted in the three and nine months ended September 30, 2009 and September 30, 2008.

The following table presents stock-based compensation expense included in our Condensed Consolidated Statements of Operations:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Research and development | $ 348 | $ 468 | $ 1,102 | $ 1,314 |
| General and administrative | 419 | 361 | 1,659 | 3,746 |
| Total stock-based compensation expense | $ 767 | $ 829 | $ 2,761 | $ 5,060 |

In the three and nine months ended September 30, 2009 and September 30, 2008, no stock-based compensation expense was capitalized and there were no recognized tax benefits associated with the stock-based compensation expense. Stock-based compensation expense of $639 related to the June 2008 employment agreement of the new chief executive officer and $2,237 resulting from amendments to the former chief executive officer s employment agreements is included in general and administrative in the nine months ended September 30, 2008. Stock-based compensation expense of $140 related to the July 2008 separation agreement of our former chief medical officer is included in research and development in the three and nine months ended September 30, 2008.

Option activity under our stock plans for the nine months ended September 30, 2009 was as follows:

| Stock Options | Number of Shares | Weighted Average Exercise Price |
|---|---|---|
| Outstanding as of December 31, 2008 | 5,600,583 | $ 5.99 |
| Granted | 137,500 | 3.95 |
| Exercised | (48,141) | 4.59 |
| Cancelled | (410,553) | 4.88 |
| | | |
| Outstanding as of September 30, 2009 | 5,279,389 | $ 6.03 |
| | | |
| Exercisable as of September 30, 2009 | 3,465,857 | $ 6.63 |

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The aggregate intrinsic value of options outstanding at September 30, 2009 was $1,144 of which $511 related to exercisable options. The weighted average fair value of options granted in the nine months ended September 30, 2009 and 2008 was $2.29 per share. The intrinsic value of options exercised in the nine months ended September 30, 2009 and 2008 was $53 and zero, respectively.

The total compensation cost not yet recognized as of September 30, 2009 related to non-vested option awards was $4.4 million, which will be recognized over a weighted-average period of 2.5 years. During the nine months ended September 30, 2009, there were 10,975 shares forfeited with a weighted average grant date fair value of $3.17 per share. The weighted average remaining contractual life for options exercisable at September 30, 2009 was 5.0 years.

In January 2009 and 2008, we granted 412,200 and 103,316 shares, respectively, of restricted stock to employees, vesting annually over a four year period.  Through September 30, 2009, 25,033 shares were forfeited, and 160,644 shares have vested.  The shares of restricted stock were issued at no cost to the recipients. The fair value of the restricted stock at the time of grant in January 2009 and 2008 was $3.54 and $4.75 respectively, per share, and is being expensed ratably over the vesting period. We recognized share-based compensation expense related to restricted stock of $333,629 and $79,120 for the nine months ended September 30, 2009 and 2008, respectively.

**9.  INCOME TAXES**

The Company recorded $0.4 million of federal income tax expense, attributable to alternative minimum tax ( AMT ), during the three months ended September 30, 2009 because it currently estimates that it will have taxable income for the year ending December 31, 2009, primarily resulting from timing differences related to recognition of research and development revenues. For purposes of AMT the Company can only offset 90% of its taxable income with net operating loss carryforwards. The remaining 10% is subject to AMT at a tax rate of 20%. Although the Company is entitled to an AMT credit against future federal regular income taxes, the Company recorded a valuation allowance against this credit since it is more likely than not that this tax credit will not be realized.

As of December 31, 2008, we had federal net operating losses ( NOL ), state NOL, and research and development credit carryforwards of approximately $203,285, $138,319 and $18,250 respectively, which can be used to offset future federal and state income tax liabilities and expire at various dates through 2028. Federal net capital loss carryforwards of approximately $5,000 can be used to offset future federal capital gains and expire in 2010. Approximately $17,450 of our federal NOL and $1,508 of our state NOL were generated from excess tax deductions from share-based awards, the tax benefit of which will be credited to additional paid-in-capital when the deductions reduce current taxes payable.

We adopted the authoritative guidance on accounting for uncertainty in income taxes on January 1, 2007. As a result, we recorded no adjustment for unrecognized income tax benefits. At the adoption date of January 1, 2007, at December 31, 2008, and September 30, 2009 we had no unrecognized tax benefits. We do not expect that the total amount of unrecognized tax benefits will significantly increase in the next twelve months. We recognize interest and penalties related to uncertain tax positions in income tax expense. As of December 31, 2008 and September 30, 2009, we had no accrued interest or penalties related to uncertain tax positions. The tax years 2005 through 2008 remain open to examination by the major taxing jurisdictions to which we are subject, which is primarily the U.S. Prior tax years remain open to the extent of net operating loss and tax credit carryforwards.

Utilization of NOL and R&D credit carryforwards may be subject to a substantial annual limitation due to ownership change limitations that have occurred previously or that could occur in the future pursuant to Section 382 of the Internal Revenue Code of 1986, as amended, as well as similar state provisions. These ownership changes may limit the amount of NOL and R&D credit carryforwards that can be utilized annually to offset future taxable income and tax, respectively. In general, an ownership change, as defined by Section 382, results from transactions increasing the ownership of certain shareholders or public groups in the stock of a corporation by more than 50 percentage points over a three-year period. Since the Company s formation, the Company has raised capital through the issuance of capital stock on several occasions which, combined with the purchasing shareholders subsequent disposition of those shares, may have resulted in a change of control, as defined by Section 382, or could result in a change of control in the future upon subsequent disposition. The Company has not currently completed a study to assess whether a change of control has occurred or whether there have been multiple changes of control since the Company s formation due to the significant complexity and cost associated with such study and that there could be additional changes in control in the future. If we have experienced a change of control at any time since Company formation, utilization of our NOL or R&D credit carryforwards would be subject to an annual limitation under Section 382. Any limitation may result in expiration of a portion of the NOL or R&D credit carryforwards before utilization. Further, until a study is completed and any limitation known, no amounts are being presented as an uncertain tax position.

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**10. NOTES PAYABLE**

On July 8, 2008, we entered into a collateralized, revolving credit line agreement for up to $47.5 million with UBS Bank USA (the Facility ). The Facility is secured by a first priority lien and security interest in the auction rate securities held by us in an account with UBS Financial Services Inc., an affiliate of UBS Bank USA. The credit line is uncommitted and any outstanding balance, including interest, is payable upon demand. Variable rate advances under the Facility currently bear interest at LIBOR plus 100 basis points and interest is payable monthly. The Facility replaced the $15 million standard margin loan agreement with UBS Financial Services Inc. that we entered into on May 8, 2008. The funds are available for research and development efforts, including clinical trials, and for general corporate purposes, including working capital. In July 2008, we drew down $46.1 million under the Facility and that amount is reported as a note payable.

On November 3, 2008, the Company accepted an offer ( Offering ) by UBS of certain rights to cause UBS to purchase auction rate securities owned by the Company. The repurchase rights were offered in connection with UBS s obligations under settlement agreements with the U.S. Securities and Exchange Commission and other federal and state regulatory authorities. The offering, the settlement agreements, and the respective rights and obligations of the parties, including a release by the Company of UBS and its employees and agents from all claims except claims for consequential damages relating to UBS s marketing and sale of auction rate securities, are described in a prospectus issued by UBS dated October 7, 2008.

In accordance with the offering by UBS, the Facility will be treated as a no net cost loan as defined in the prospectus. As such, the Facility will remain payable on demand; however, if UBS Bank USA should exercise its right to demand repayment of any portion of the Company s indebtedness prior to the date the Company can exercise its repurchase rights (other than for reasons specified in the prospectus), UBS and certain of its affiliates will arrange for alternative financing on terms and conditions substantially the same as those contained in the Facility. If alternative financing cannot be established, then UBS or one of its affiliates will purchase the Company s pledged auction rate securities at par.

In October 2008, we entered into a margin loan agreement with another financial institution collateralized by $2.9 million of our auction rate securities and borrowed $1.7 million which is the maximum amount allowed under this facility. Interest expense from notes payable was $0.2 million and $0.5 million for the three and nine months ended September 30, 2009, respectively. Interest expense for the three and nine months ended September 30, 2008 was $0.2 million. The carrying amount of notes payable at September 30, 2009 and December 31, 2008 approximates fair values.

**11. RECENT ACCOUNTING PRONOUNCEMENTS**

Effective January 1, 2009, we adopted the new authoritative guidance on fair value measurements for our nonfinancial assets and liabilities that are remeasured at fair value on a non-recurring basis. The adoption of the new guidance for our nonfinancial assets and liabilities that are remeasured at fair value on a non-recurring basis did not have a significant impact on our financial statements; however, could have an impact in future periods.

In December 2007, new authoritative guidance on accounting for collaborative arrangements related to the development and commercialization of intellectual property was issued, prescribing the accounting for collaborations. The new guidance requires certain transactions between collaborators to be recorded in the income statement on either a gross or net basis within expenses when certain characteristics exist in the collaboration relationship. The new guidance is effective for all of our collaborations existing after January 1, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

In December 2007, new authoritative guidance on accounting for business combinations and noncontrolling interests in consolidated financial statements was issued. The new guidance requires an acquiring company to measure all assets acquired and liabilities assumed, including contingent considerations and all contractual contingencies, at fair value as of the acquisition date. In addition, an acquiring company is required to capitalize IPR&D and either amortize it over the life of the product, or write it off if the project is abandoned or impaired. The new guidance is effective for transactions occurring on or after January 1, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

In April 2009, additional authoritative guidance was issued to provide fair market value measurement guidelines to determine whether a market is active or inactive and whether a transaction is distressed. The new guidance is applicable to all assets and liabilities (i.e. financial and nonfinancial) and requires enhanced disclosures. The new guidance was effective for periods ending after June 15, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

In April 2009, additional authoritative guidance was issued to provide greater clarity about the credit and noncredit component of an other-than-temporary impairment event and to more effectively communicate when an other-than-temporary impairment event has occurred. The new guidance applies to debt securities. The new guidance was effective for periods ending after June 15, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

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In April 2009, authoritative guidance was issued to require disclosures about fair value of financial instruments in interim as well as in annual financial statements. The new guidance was effective for periods ending after June 15, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

In June 2009, we adopted new authoritative guidance on accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The adoption of the new guidance did not impact our financial statements. We evaluated all events or transactions that occurred after September 30, 2009 through November 6, 2009, the date we issued these financial statements. During this period we did not have any material recognizable subsequent events.

In September 2009, the Financial Accounting Standards Board ( FASB ) issued the FASB Accounting Standards Codification ( Codification ) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in preparation of financial statements in conformity with Generally Accepted Accounting Principles ( GAAP ) in the United States. The Codification is effective for interim and annual periods ending after September 15, 2009. The adoption of the Codification did not impact on our financial position, results of operations, or liquidity.

In October 2009, the FASB approved for issuance Emerging Issues Task Force ( EITF ) issue 08-01, *Revenue Arrangements with Multiple Deliverables* (currently within the scope of FASB Accounting Standards Codification ( ASC ) Subtopic 605-25). This statement provides principles for allocation of consideration among its multiple-elements, allowing more flexibility in identifying and accounting for separate deliverables under an arrangement. The EITF introduces an estimated selling price method for valuing the elements of a bundled arrangement if vendor-specific objective evidence or third-party evidence of selling price is not available, and significantly expands related disclosure requirements. This standard is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Alternatively, adoption may be on a retrospective basis, and early application is permitted. The Company is currently evaluating the impact of adopting this pronouncement.

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

**OVERVIEW**

We are a clinical-stage biotechnology company organized as a Delaware corporation in 1993 and engaged in the research and development of innovative cancer therapeutics directed toward molecular targets that we believe play critical roles in the development of human cancers. Our mission is to discover and develop novel products that target multiple tumor types, act selectively against cancer cells and are well tolerated by patients. We believe our clinical stage products represent potential best-in-class or first-in-class small molecule candidates with differentiated mechanisms of action.

Our products and research programs are based on our understanding of biological processes that lead to the proliferation and metastasis of cancer cells, combined with our ability to generate product candidates possessing certain pre-selected, drug-like properties and designed to act with specificity against cancer cells. We believe that these qualities, when present from the earliest stages of product development, increase the likelihood of producing safe, effective and marketable drugs. We believe that our combined expertise in cancer biology and chemistry differentiates us from many companies at a similar stage of development.

Our lead product is ARQ 197, an orally administered inhibitor of the c-Met receptor tyrosine kinase. ARQ 197 is currently being evaluated as monotherapy and in combination therapy in a Phase 2 clinical development program that includes trials in Microphthalmia Transcription Factor ( MiT )-associated tumors, non-small cell lung cancer ( NSCLC ), pancreatic adenocarcinoma and hepatocellular carcinoma ( HCC ). We have licensed commercial rights to ARQ 197 for human cancer indications to Daiichi Sankyo Co., Ltd. ( Daiichi Sankyo ) in the U.S., Europe, South America and the rest of the world, excluding Japan and certain other Asian countries, where we have licensed commercial rights to Kyowa Hakko Kirin Co., Ltd. ( Kyowa Hakko Kirin ). Our separate agreements with these partners provide for possible future milestone payments, royalties on product sales, and development funding, in addition to payments that we have already received.

Our product pipeline offers the potential for multiple therapeutic candidates based on diverse biological targets, mechanisms of action and chemistry. The most advanced of these programs is focused on the development of inhibitors of the Eg5 kinesin motor protein, which include ARQ 621, in Phase 1 clinical development. We have completed certain Phase 2 proof-of-principle trials with ARQ 501, a first-generation, intravenously administered novel activator of the cell s DNA damage response mechanism mediated by the E2F-1 transcription factor, and we have filed an IND for ARQ 761, a second-generation molecule from our E2F-1 program. We are in pre-clinical development with an inhibitor of the BRAF kinase.

Our drug discovery efforts are focused primarily on the ArQule Kinase Inhibitor Platform ( AKIP ), which we employ to generate compounds designed to inhibit a variety of kinases potently, selectively and without competing with adenosine triphosphate ( ATP ), an energy source for cells. We are currently assessing the potential of multiple kinases in oncology and other therapeutic areas as targets for this drug discovery platform, and we are seeking to generate and validate compounds that inhibit these kinase targets. We have signed a drug discovery agreement with Daiichi Sankyo that utilizes the capabilities of the AKIP platform to discover compounds that inhibit two such kinase targets in the field of oncology.

Our drug discovery efforts, including our kinase platform, are supported by the expertise we have derived from our heritage as a combinatorial chemistry company. This expertise, which has been validated through collaborations with Pfizer Inc., Wyeth, Solvay and other corporate partners, is married to innovative biology to create a discovery engine marked by speed, efficiency and flexibility.

We have incurred a cumulative deficit of $358.7 million from inception through September 30, 2009. We expect research and development costs to increase during the course of 2009, due to clinical testing of our lead product candidates. We recorded a net loss for 2006, 2007 and 2008, and expect a net loss for 2009.

Our revenue consists primarily of development funding from our alliances with Daiichi Sankyo and Kyowa Hakko Kirin. Revenue and expenses fluctuate from quarter to quarter based upon a number of factors, notably the timing and extent of our cancer related research and development activities together with the length and outcome of our clinical trials. On December 17, 2008, Roche notified the Company of its intention not to exercise its option to license the E2F program. Roche s rights to develop and commercialize potential drugs under the agreement terminated as of December 31, 2008. As a result, the Company will not receive any further payments under this agreement.

On December 18, 2008, we entered into a license, co-development and co-commercialization agreement with Daiichi Sankyo to conduct research, clinical trials and commercialization of ARQ 197 in human cancer indications in the U.S., Europe, South America and the rest of the world, excluding Japan, China (including Hong Kong), South Korea and Taiwan, where Kyowa Hakko Kirin has exclusive rights for development and commercialization. The agreement provides for a $60 million cash upfront licensing payment from Daiichi Sankyo to us, which we received in December 2008, and an additional $560 million in potential development and sales milestone payments. We and Daiichi Sankyo will share equally the costs of Phase 2 and Phase 3 clinical studies, with our share of Phase 3 costs payable solely from milestone and royalty payments by Daiichi Sankyo. Upon commercialization, we will receive tiered, double-digit royalties from Daiichi Sankyo on net sales of ARQ 197 commensurate with the magnitude of the transaction. We retain the option to participate in the commercialization of ARQ 197 in the U.S. Revenue for this agreement is recognized using the contingency-adjusted performance model with an estimated development period through December 2013.

On November 7, 2008, we entered into a research collaboration, exclusive license and co-commercialization agreement with Daiichi Sankyo under which we will apply our proprietary technology and know-how from our AKIP platform for the discovery of therapeutic compounds that selectively inhibit certain kinases. The agreement defines two such kinase targets, and Daiichi Sankyo will have an option to license compounds directed to these targets following the completion of certain pre-clinical studies. The agreement provides for a $15 million upfront payment, which we received in November 2008, research support payments for the first two years of the collaboration, licensing fees for compounds discovered as a result of this research, milestone payments related to clinical development, regulatory review and sales, and royalty payments on net sales of compounds from the collaboration. We retain the option to co-commercialize licensed products developed under this agreement in the U.S. Revenue for this agreement is recognized using the contingency-adjusted performance model with an estimated performance period through November 2012.

On April 27, 2007, we entered into an exclusive license agreement with Kyowa Hakko Kirin to develop and commercialize ARQ 197, a small molecule, selective inhibitor of the c-Met receptor tyrosine kinase, in Japan and parts of Asia. A $3 million portion of an upfront licensing fee was received by the Company under this agreement in the first quarter of 2007, and an additional $27 million in upfront licensing fees was received on May 7, 2007. The agreement includes $123 million in upfront and potential development milestone payments from Kyowa Hakko Kirin to ArQule, including the $30 million cash upfront licensing payments. In February 2008, we received a $3 million milestone payment from Kyowa Hakko Kirin. Upon commercialization, ArQule will receive tiered royalties in the mid-teen to low-twenty percent range from Kyowa Hakko Kirin on net sales of ARQ 197. Kyowa Hakko Kirin will be responsible for all clinical development costs and commercialization of the compound in certain Asian countries, consisting of Japan, China (including Hong Kong), South Korea and Taiwan. In addition to the upfront and possible regulatory milestone payments totaling $123 million, the Company will be eligible for future milestone payments based on the achievement of certain levels of net sales. The Company will recognize the payments, if any, as revenue in accordance with its revenue recognition policies. As of December 31, 2008, the Company has not recognized any revenue from these sales milestone payments, and there can be no assurance that it will do so in the future. Revenue for this agreement is recognized using the contingency-adjusted performance model with an estimated development period through April 2016.

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**LIQUIDITY AND CAPITAL RESOURCES**

| | September 30, 2009 | December 31, 2008 | Increase (decrease) $ | % |
|---|---|---|---|---|
| | | (in millions) | | |
| Cash, cash equivalents and marketable securities-short term | $ 108.9 | $ 141.9 | $ (33.0) | (23.2)% |
| Marketable securities- long term | 69.2 | 64.2 | 5.0 | 7.7% |
| Notes payable | 47.8 | 47.8 | | |
| Working capital | 24.6 | 59.7 | (35.1) | (58.8)% |

| | Nine months Ended September 30, 2009 | September 30, 2008 | Increase (decrease) |
|---|---|---|---|
| | | (in millions) | |
| Cash flow from: | | | |
| Operating activities | $ (28.7) | $ (38.0) | $ 9.3 |
| Investing activities | (45.4) | 55.4 | (100.8) |
| Financing activities | 0.5 | 46.4 | (45.9) |

*Cash flow from operating activities.* Our uses of cash for operating activities have primarily consisted of salaries and wages for our employees, facility and facility-related costs for our offices and laboratories, fees paid in connection with preclinical and clinical studies, laboratory supplies and materials, and professional fees. The sources of our cash flow from operating activities have consisted primarily of payments from our collaborators for services performed or upfront payments for future services. For the nine months ended September 30, 2009, our net use of cash was primarily driven by the difference between cash receipts from our collaborators and payments for operating expenses, which resulted in a net cash outflow of $28.7 million.

*Cash flow from investing activities.* Our net cash used in investing activities of $45.4 million in the nine months ended September 30, 2009 was predominantly comprised of net purchases of marketable securities. The composition and mix of cash, cash equivalents and marketable securities may change frequently as a result of the Company s constant evaluation of conditions in financial markets, the maturity of specific investments, and our near term liquidity needs.

Our cash equivalents and marketable securities include U.S.Treasury bill funds, money market funds, commercial paper fully guaranteed by the FDIC under the Temporary Liquidity Guarantee Program (TLGP), commercial paper, and U.S. federal and state agency backed certificates, including auction rate securities that have investment grade ratings.

Our cash equivalents and our portfolio of marketable securities are subject to market risk due to changes in interest rates. Fixed rate interest securities may have their market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectation due to changes in interest rates or we may suffer losses in principal if we are forced to sell securities that decline in market value due to changes in interest rates.

Auction rate securities are structured with short-term interest reset dates of generally less than 90 days, but with contractual maturities that can be well in excess of ten years. At the end of each reset period, which occurs every seven to twenty-eight days, investors can sell or continue to hold the securities at par value. If any of our auction rate securities were to fail an auction, due to sell orders exceeding buy orders, the funds associated with a failed auction would not be accessible until a successful auction occurred, a buyer was found outside the auction process, the underlying securities matured or a settlement with the underwriter is reached.

Beginning in the first quarter of 2008 and continuing through the third quarter of 2009, certain auction rate securities failed auction due to sell orders exceeding buy orders. On November 3, 2008, the Company accepted an offer (the Offering ) by UBS AG ( UBS ) of certain rights ( Put Option ) to cause UBS to purchase auction rate securities owned by the Company. The repurchase rights were offered in connection with UBS s obligations under settlement agreements with the U.S. Securities and Exchange Commission and other federal and state regulatory authorities. The Offering, the settlement agreements, and the respective rights and obligations of the parties, including a release by the Company of UBS and its employees and agents from all claims except claims for consequential damages relating to UBS s marketing and sale of auction rate securities, are described in a prospectus issued by UBS dated October 7, 2008.

As a result of accepting the Offering, the Company received a Put Option from UBS to repurchase the securities at par value at any time during the period from June 30, 2010 through July 2, 2012, if the Company s auction rate securities have not previously been sold by the Company or by UBS on its behalf. The Company has accounted for the Put Option as a freestanding financial instrument and elected to record the value under the fair value option for financial assets and financial liabilities. The Company has classified its auction rate securities as trading securities reflecting the Company s intent to exercise the Put Option during the period

June 30, 2010 to July 2, 2012. The increase in value of our Put Option and auction rate securities totaling $0.4 million in the three months ended September 30, 2009 was recorded as a gain in other income (expense) in the statement of operations.

Our marketable securities portfolio as of December 31, 2008 included $65.3 million (at cost) and $64.0 million (at cost) at September 30, 2009 invested in auction rate securities all of which were associated with auctions that failed subsequent to February 12, 2008.

On July 8, 2008, we entered into a collateralized, revolving credit line agreement for up to $47.5 million with UBS Bank USA (the Facility ). The Facility is secured by a first priority lien and security interest in the auction rate securities held by us in an account with UBS Financial Services Inc., an affiliate of UBS Bank USA. The credit line is uncommitted and any outstanding balance, including interest, is payable upon demand. Variable rate advances under the Facility currently bear interest at LIBOR plus 100 basis points and interest will be payable monthly. The Facility replaced the $15 million standard margin loan agreement with UBS Financial Services Inc. that we entered into on May 8, 2008. In July 2008, we drew down $46.1 million under the Facility. The funds will be available for research and development efforts, including clinical trials, and for general corporate purposes, including working capital.

In accordance with the Offering by UBS, the $46.1 million borrowed under the Facility remains payable on demand; however, if UBS Bank USA should exercise its right to demand repayment of any portion of the Company s indebtedness prior to the date the Company can exercise its repurchase rights (other than for reasons specified in the prospectus), UBS and certain of its affiliates will arrange for alternative financing on terms and conditions substantially the same as those contained in the Facility. If alternative financing cannot be established, then UBS or one of its affiliates will purchase the Company s pledged auction rate securities at par.

In light of the above arrangement with our auction rate securities and the financial impact of our two agreements with Daiichi Sankyo, including a cumulative $75 million in cash and upfront payments received in the quarter ended December 31, 2008 and certain anticipated milestone and cost-sharing provisions, we expect that our available cash and cash equivalents, including cash received under our auction rate security credit line agreement (as described above), together with cash from operations and investment income, will be sufficient to finance our working capital and capital requirements through at least the end of 2011.

Our cash requirements may vary materially from those now planned depending upon the results of our drug discovery and development strategies, our ability to enter into additional corporate collaborations and the terms of such collaborations, results of research and development, unanticipated required capital expenditures, competitive and technological advances, acquisitions and other factors. We cannot guarantee that we will be able to develop any of our drug candidates into a commercial product. It is likely we will need to raise additional capital or incur indebtedness to continue to fund our operations in the future. Our ability to raise additional funds will depend on financial, economic and market conditions, and due to global capital and credit market conditions or for other reasons, we may be unable to raise capital when needed, or on terms favorable to us. If necessary funds are not available, we may have to delay, reduce the scope of, or eliminate some of our development programs, potentially delaying the time to market for any of our product candidates.

Our contractual obligations were comprised of the following as of September 30, 2009 (in thousands):

| | | Payment due by period | |
|---|---|---|---|
| **Contractual Obligations** | **Total** | **1 - 3 years** | **3 - 5 years** |

| | | Less than 1 year | | | More than 5 years |
|---|---|---|---|---|---|
| Notes payable | $ 47,750 | $ 47,750 | $ | $ | $ |
| Operating lease obligations | 18,895 | 3,603 | 7,072 | 6,355 | 1,865 |
| Purchase obligations | 8,735 | 8,735 | | | |
| Total | $ 75,380 | $ 60,088 | $ 7,072 | $ 6,355 | $ 1,865 |

Included in the total minimum payments for operating leases is approximately $244 related to abandoned real estate in California, net of contractual sublease income. This net amount has been accrued as a liability as a part of the Company s restructuring charge in 2002 and subsequently adjusted in 2003 and 2004. Purchase obligations are comprised primarily of outsourced preclinical and clinical trial expenses and payments to license certain intellectual property to support the Company s research efforts. Interest on notes payable is variable and is excluded from the table above. Notes payable of $46.1 million currently bear interest at a rate not to exceed our weighted average auction rate security coupon rate and $1.7 million currently bear interest at LIBOR plus 125 basis points.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

A critical accounting policy is one which is both important to the portrayal of the Company s financial condition and results and requires management s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the

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effect of matters that are inherently uncertain. For additional information, please see the discussion of our significant accounting policies in Note 2 to the Consolidated Financial Statements included in our Annual Report on Form 10-K filed with the SEC on March 6, 2009.

**Research and Development Revenue**

Research and development revenue is generated primarily through collaborative research and development agreements. The terms of the agreements may include nonrefundable upfront payments, funding for research and development, milestone payments and royalties on any product sales derived from collaborations.

Research and development payments from our collaborators are recognized as research and development revenue using the contingency adjusted performance model. Under this model, when payments are earned, revenue is immediately recognized on a pro-rata basis in the period we achieve the milestone based on the time elapsed from inception of the agreement to the time the milestone is earned over the estimated duration of the development period under the agreement. Thereafter, the remaining portion of the milestone payment is recognized on a straight-line basis over the remaining estimated development period under the agreement. This estimated development period may ultimately be shorter or longer depending upon the outcome of the development work, resulting in accelerated or deferred recognition of the development revenue. Royalty payments will be recognized as revenue when earned. The costs associated with satisfying research and development contracts are included in research and development expense as incurred.

**RESULTS OF OPERATIONS**

The following are the results of operations for the three and nine months ended September 30, 2009 and 2008:

**Revenue**

| | 2009 | 2008 | Increase (decrease) $ | % |
|---|---|---|---|---|
| | (in millions) | | | |
| *For the three months ended September 30:* | | | | |
| Research and development revenue | $ 6.4 | $ 2.7 | $ 3.7 | 142% |
| | | | | |
| *For the nine months ended September 30:* | | | | |
| Research and development revenue | $ 17.9 | $ 8.8 | $ 9.1 | 104% |

Research and development revenue in the three and nine months ended September 30, 2009 is comprised of revenue from the Daiichi Sankyo development and research collaboration agreements entered into in 2008 and the Kyowa Hakko Kirin exclusive license agreement. The increase in the three and nine month periods is primarily due to revenue from Daiichi Sankyo. Revenue of $1.7 million and $5.0 million was recognized in the comparable three and nine month periods of 2008, respectively, from the Roche alliance agreement that was terminated in December 2008.

**Research and development**

| | 2009 | 2008 | Increase (decrease) $ | % |
|---|---|---|---|---|
| | (in millions) | | | |
| *For the three months ended September 30:* | | | | |
| Research and development | $ 11.3 | $ 10.8 | $ 0.5 | 5% |
| | | | | |
| *For the nine months ended September 30:* | | | | |
| Research and development | $ 35.4 | $ 39.2 | $ (3.8) | (10)% |

Research and development expense in the third quarter of 2009 increased by $0.5 million primarily due to an increase in ARQ 197 clinical costs.

Research and development expense in the first nine months of 2009 decreased by $3.8 million. This decrease was primarily due to $2.0 million of ARQ 501clinical costs incurred in the first nine months of 2008 that did not recur in the first nine months of 2009, lower personnel related costs of $0.9 million and chief medical officer transition costs of $0.5 million incurred in the first nine months of 2008 that did not recur in the first nine months of 2009. At September 30, 2009 we had 82 employees dedicated to our research and development program, compared to 79 at September 30, 2008.

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*Overview*

Our research and development expense consists primarily of salaries and related expenses for personnel, costs of contract manufacturing services, costs of facilities and equipment, fees paid to professional service providers in conjunction with our clinical trials, fees paid to research organizations in conjunction with pre-clinical animal studies, costs of materials used in research and development, consulting, license, and sponsored research fees paid to third parties and depreciation of associated laboratory equipment. We expect our research and development expense to increase as we continue to develop our portfolio of oncology programs.

We have not accumulated and tracked our internal historical research and development costs or our personnel and personnel-related costs on a program-by-program basis. Our employee and infrastructure resources are allocated across several projects, and many of our costs are directed to broadly applicable research endeavors. As a result, we cannot state the costs incurred for each of our oncology programs on a program-by-program basis. The expenses incurred by us to third parties for pre-clinical and clinical trials in the current quarter and since inception of our lead clinical stage program were as follows (in millions):

| Oncology program | Current status | Nine Months Ended September 30, 2009 | Program-to-date |
|---|---|---|---|
| c-Met program ARQ 197 | Phase 2 | $ 13.3 | $ 47.5 |

Our future research and development expenses in support of our current and future programs will be subject to numerous uncertainties in timing and cost to completion. We test potential products in numerous pre-clinical studies for safety, toxicology, and efficacy. We may conduct multiple clinical trials for each product. As we obtain results from trials, we may elect to discontinue or delay clinical trials for certain products in order to focus our resources on more promising products. Completion of clinical trials may take several years or more, and the length of time generally varies substantially according to the type, complexity, novelty, and intended use of a product. It is not unusual for the pre-clinical and clinical development of each of these types of products to take nine years or more, and for total development costs to exceed $500 million for each product.

We estimate that clinical trials of the type generally needed to secure new drug approval are typically completed over the following timelines:

| Clinical Phase | Estimated Completion Period |
|---|---|
| Phase 1 | 1-2 years |
| Phase 2 | 2-3 years |
| Phase 3 | 2-4 years |

The duration and the cost of clinical trials may vary significantly over the life of a project as a result of differences arising during clinical development, including, among others, the following:

- the number of clinical sites included in the trials;
- the length of time required to enroll suitable patients;
- the number of patients that ultimately participate in the trials;

- the duration of patient follow-up to ensure the absence of long-term product-related adverse events; and

- the efficacy and safety profile of the product.

An element of our business strategy is to pursue the research and development of a broad pipeline of products. This is intended to allow us to diversify the risks associated with our research and development expenditures. As a result, we believe our future capital requirements and future financial success do not substantially depend on any one product. To the extent we are unable to build and maintain a broad pipeline of products, our dependence on the success of one or a few products increases.

Our strategy includes entering into alliance arrangements with third parties to participate in the development and commercialization of our products, such as our collaboration agreements with Daiichi Sankyo and Kyowa Hakko Kirin. In the event that third parties have control over the clinical trial process for a product, the estimated completion date would be under control of that third party rather than under our control. We cannot forecast with any degree of certainty whether our products will be subject to future collaborative arrangements or how such arrangements would affect our development plans or capital requirements.

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As a result of the uncertainties discussed above, we are unable to determine the duration and completion costs of our oncology programs or when and to what extent we will receive cash inflows from the commercialization and sale of a product. Our inability to complete our oncology programs in a timely manner or our failure to enter into appropriate collaborative agreements could significantly increase our capital requirements and could adversely impact our liquidity. These uncertainties could force us to seek additional, external sources of financing from time-to-time in order to continue with our product development strategy. Our inability to raise additional capital, or to do so on terms reasonably acceptable to us, would jeopardize the future success of our business.

**General and administrative**

| | 2009 | 2008 | Increase (decrease) $ | % |
|---|---|---|---|---|
| | (in millions) | | | |
| *For the three months ended September 30:* | | | | |
| General and administrative | $ 3.1 | $ 3.5 | (0.4) | (10)% |
| | | | | |
| *For the nine months ended September 30:* | | | | |
| General and administrative | $ 10.0 | $ 13.4 | (3.4) | (26)% |

General and administrative expense in the third quarter of 2009 decreased by $0.4 million due to lower personnel related costs of $0.3 million and lower facility costs of $0.1 million.

General and administrative expense in the first nine months of 2009 decreased by $3.4 million principally due to $2.7 million of personnel and stock compensation costs incurred in the first nine months of 2008 resulting from senior management transitions that did not recur in 2009, and due to lower professional fees of $0.4 million. General and administrative headcount was 30 at September 30, 2009, compared to 32 at September 30, 2008.

**Interest income**, interest expense and other income (expense)

| | 2009 | 2008 | Increase (decrease) $ | % |
|---|---|---|---|---|
| | (in millions) | | | |
| *For the three months ended September 30:* | | | | |
| Interest income | $ 0.2 | $ 0.6 | $ (0.4) | (69)% |
| Interest expense | (0.2) | (0.2) | | |
| Other income (expense) | 0.4 | | 0.4 | |
| | | | | |
| *For the nine months ended September 30:* | | | | |
| Interest income | $ 0.8 | $ 2.8 | $ (2.0) | (70)% |
| Interest expense | (0.5) | (0.2) | 0.3 | 132% |
| Other income (expense) | 1.2 | | 1.2 | |

Interest income is comprised primarily of interest income derived from our portfolio of cash, cash equivalents and investments. Interest income decreased in the three and nine month periods of 2009 due to lower interest rates earned on our portfolio. Interest expense was incurred on our notes payable. Other income (expense) in the three and nine months ended September 30, 2009 includes a $0.4 million gain and a $1.2 million gain, respectively, from recording our auction rate securities and Put Option at fair value.

**Provision for income taxes**

The Company recorded $0.4 million of federal income tax expense, attributable to alternative minimum tax ( AMT ), during the three months ended September 30, 2009 because it currently estimates that it will have taxable income for the year ending December 31, 2009, primarily resulting from timing differences related to recognition of research and development revenues. For purposes of AMT the Company can only offset 90% of its taxable income with net operating loss carryforwards. The remaining 10% is subject to AMT at a tax rate of 20%. Although the Company is entitled to an AMT credit against future federal regular income taxes, the Company recorded a valuation allowance against this credit since it is more likely than not that this tax credit will not be realized.

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**RECENT ACCOUNTING PRONOUNCEMENTS**

Effective January 1, 2009, we adopted the new authoritative guidance on fair value measurements for our nonfinancial assets and liabilities that are remeasured at fair value on a non-recurring basis. The adoption of the new guidance for our nonfinancial assets and liabilities that are remeasured at fair value on a non-recurring basis did not have a significant impact on our financial statements; however, could have an impact in future periods.

In December 2007, new authoritative guidance on accounting for collaborative arrangements related to the development and commercialization of intellectual property was issued, prescribing the accounting for collaborations. The new guidance requires certain transactions between collaborators to be recorded in the income statement on either a gross or net basis within expenses when certain characteristics exist in the collaboration relationship. The new guidance is effective for all of our collaborations existing after January 1, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

In December 2007, new authoritative guidance on accounting for business combinations and noncontrolling interests in consolidated financial statements was issued. The new guidance requires an acquiring company to measure all assets acquired and liabilities assumed, including contingent considerations and all contractual contingencies, at fair value as of the acquisition date. In addition, an acquiring company is required to capitalize IPR&D and either amortize it over the life of the product, or write it off if the project is abandoned or impaired. The new guidance is effective for transactions occurring on or after January 1, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

In April 2009, additional authoritative guidance was issued to provide fair market value measurement guidelines to determine whether a market is active or inactive and whether a transaction is distressed. The new guidance is applicable to all assets and liabilities (i.e. financial and nonfinancial) and requires enhanced disclosures. The new guidance was effective for periods ending after June 15, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

In April 2009, additional authoritative guidance was issued to provide greater clarity about the credit and noncredit component of an other-than-temporary impairment event and to more effectively communicate when an other-than-temporary impairment event has occurred. The new guidance applies to debt securities. The new guidance was effective for periods ending after June 15, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

In April 2009, authoritative guidance was issued to require disclosures about fair value of financial instruments in interim as well as in annual financial statements. The new guidance was effective for periods ending after June 15, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

In June 2009, we adopted new authoritative guidance on accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The adoption of the new guidance did not impact our financial statements. We evaluated all events or transactions that occurred after September 30, 2009 through November 6, 2009, the date we issued these financial statements. During this period we did not have any material recognizable subsequent events.

In September 2009, the Financial Accounting Standards Board ( FASB ) issued the FASB Accounting Standards Codification ( Codification ) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in preparation of financial statements in conformity with Generally Accepted Accounting Principles ( GAAP ) in the United States. The Codification is effective for interim and annual periods ending after September 15, 2009. The adoption of the Codification did not impact on our financial position, results of operations, or liquidity.

In October 2009, the FASB approved for issuance Emerging Issues Task Force ( EITF ) issue 08-01, *Revenue Arrangements with Multiple Deliverables* (currently within the scope of FASB Accounting Standards Codification ( ASC ) Subtopic 605-25). This statement provides principles for allocation of consideration among its multiple-elements, allowing more flexibility in identifying and accounting for separate deliverables under an arrangement. The EITF introduces an estimated selling price method for valuing the elements of a bundled arrangement if vendor-specific objective evidence or third-party evidence of selling price is not available, and significantly expands related disclosure requirements. This standard is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Alternatively, adoption may be on a retrospective basis, and early application is permitted. The Company is currently evaluating the impact of adopting this pronouncement.

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**FORWARD LOOKING STATEMENTS**

In addition to historical information, this report contains forward-looking statements. You can identify these forward-looking statements by their use of words such as anticipate, assume, believe, estimate, expect, forecast, intend, may, plan, project, target, will and c similar meaning. You also can identify them by the fact that they do not relate strictly to historical or current facts. All statements which address operating performance, events or developments that the Company expects or anticipates will occur in the future, such as projections about its future results of operations, its financial condition, research, development and commercialization of its products and anticipated trends in its business are forward-looking statements.

In this report we make forward-looking statements regarding our drug development pipeline and our clinical trials involving ARQ 197. Additional forward-looking statements relate to our agreements with Kyowa Hakko Kirin and Daiichi Sankyo, including potential future milestones and royalty payments that could result from the future development of ARQ 197.

Drug development involves a high degree of risk. Only a small number of research and development programs result in the commercialization of a product. For example, pre-clinical efforts associated with our product pipeline may fail or prove disappointing because our technology platform did not produce candidates with the desired characteristics. Animal xenograft pre-clinical studies may be unpredictive of human response. Positive information about early stage clinical trial results will not ensure that later stage or larger scale clinical trials will be successful.

Furthermore, our drugs may not demonstrate promising therapeutic effects; in addition, they may not demonstrate appropriate safety profiles in ongoing or later stage or larger scale clinical trials as a result of known or as yet unidentified side effects. The results achieved in later stage trials may not be sufficient to meet applicable regulatory standards. Problems or delays may arise during clinical trials or in the course of developing, testing or manufacturing our drugs that could lead us or our partner to discontinue development.

Even if later stage clinical trials are successful, the risk exists that unexpected concerns may arise from analysis of data or from additional data or that obstacles may arise or issues be identified in connection with review of clinical data with regulatory authorities or that regulatory authorities may disagree with the Company s view of the data or require additional data or information or additional studies. Also, the planned timing of initiation of clinical trials and the duration and conclusion of such trials for our drugs are subject to the ability of the company to enroll patients, enter into agreements with clinical trial sites and investigators, and other technical hurdles and issues that may not be resolved.

We also make forward-looking statements regarding the adequacy of our financial resources. Our capital resources may not be adequate because our cash requirements may vary materially from those now planned depending upon the results of our drug discovery and development strategies, the outcomes of our clinical trials, our ability to enter into additional corporate collaborations in the future and the terms of such collaborations, results of research and development, the need for currently unanticipated capital expenditures, competitive and technological advances, acquisitions, financial market conditions, our ability to liquidate our investments in auction rate securities and other factors. Additionally, our corporate collaborators may terminate their agreements with us, thereby eliminating that source of funding, because we may fail to satisfy the prescribed terms of the collaborations or for other reasons. Finally, we can not assure that UBS will have adequate financial resources to fulfill its repurchase obligations to us.

We cannot guarantee that we will be able to develop any of our drug candidates into a commercial product generating revenues. If we experience increased losses, we may have to seek additional financing from public and private sales of our securities, including equity securities. There can be no assurance that additional funding will be available when needed or on acceptable terms.

The factors, risks and uncertainties referred to above and others are more fully described under the heading Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008 filed with the SEC on March 6, 2009, as updated from time to time in our subsequent Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. The forward-looking statements contained herein represent the judgment of the Company as of the date of this report. We are not under any obligation, and we expressly disclaim any obligation, to update or alter any forward-looking statements, whether as a result of new information, future events or otherwise, except to the extent required by law.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We own financial instruments that are sensitive to market risk as part of our investment portfolio. We have implemented policies regarding the amount and credit ratings of investments. Our investment portfolio is used to preserve our capital until it is used to fund operations, including our research and development activities. Our investments are evaluated quarterly to determine the fair value of the portfolio.

Our cash and marketable securities include U.S.Treasury bill funds, money market funds, commercial paper fully guaranteed by the FDIC under the Temporary Liquidity Guarantee Program (TLGP), commercial paper, and U.S. federal and state agency backed certificates, including auction rate securities that have strong credit ratings.

Our cash equivalents and our portfolio of marketable securities are subject to market risk due to changes in interest rates. Fixed rate interest securities may have their market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectation due to changes in interest rates or we may suffer losses in principal if we are forced to sell securities that decline in market value due to changes in interest rates.

Auction rate securities are securities that are structured with short-term interest reset dates of generally less than 90 days, but with contractual maturities that can be well in excess of ten years. At the end of each reset period, which occurs every seven to twenty-eight days, investors can sell or continue to hold the securities at par value. If any of our auction rate securities were to fail an auction, due to sell orders exceeding buy orders, the funds associated with a failed auction would not be accessible until a successful auction occurred, a buyer was found outside the auction process, the underlying securities matured or a settlement with the underwriter is reached.

Beginning in the first quarter of 2008 and continuing through the third quarter of 2009, certain auction rate securities failed auction due to sell orders exceeding buy orders. On November 3, 2008, the Company accepted an offer (the Offering ) by UBS AG ( UBS ) of certain rights ( Put Option ) to cause UBS to purchase auction rate securities owned by the Company. The repurchase rights were offered in connection with UBS s obligations under settlement agreements with the U.S. Securities and Exchange Commission and other federal and state regulatory authorities. The offering, the settlement agreements, and the respective rights and obligations of the parties, including a release by the Company of UBS and its employees and agents from all claims except claims for consequential damages relating to UBS s marketing and sale of auction rate securities, are described in a prospectus issued by UBS dated October 7, 2008.

As a result of accepting the Offering, the Company received a Put Option from UBS to repurchase the securities at par value at any time during the period from June 30, 2010 through July 2, 2012, if the Company s auction rate securities have not previously been sold by the Company or by UBS on its behalf. The Company has accounted for the Put Option as a freestanding financial instrument and elected to record the value under the fair value option for financial assets and financial liabilities. The Company has classified its auction rate securities as trading securities reflecting the Company s intent to exercise the Put Option during the period June 30, 2010 to July 2, 2012. The increase in value of our Put Option and auction rate securities totaling $0.4 million in the three months ended September 30, 2009 was recorded as a gain in other income (expense) in the statement of operations.

ArQule s marketable securities portfolio as of December 31, 2008 included $65.3 million (at cost) and $64.0 million (at cost) at September 30, 2009 invested in auction rate securities all of which were associated with auctions that failed subsequent to February 12, 2008.

On July 8, 2008, we entered into a collateralized, revolving credit line agreement for up to $47.5 million with UBS Bank USA (the Facility ). In July 2008, we drew down $46.1 million under the Facility. In accordance with the offering by UBS, the Facility remains payable on demand;

however, if UBS Bank USA should exercise its right to demand repayment of any portion of the Company s indebtedness prior to the date the Company can exercise its repurchase rights (other than for reasons specified in the prospectus), UBS and certain of its affiliates will arrange for alternative financing on terms and conditions substantially the same as those contained in the Facility. If alternative financing cannot be established, then UBS or one of its affiliates will purchase the Company s pledged auction rate securities at par.

**ITEM 4. CONTROLS AND PROCEDURES**

Our management, with the participation of our Chief Executive Officer (Principal Executive Officer) and President and Chief Operating Officer (Principal Financial Officer), evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2009. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ( Exchange Act ), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s

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management, including its principal executive and financial officer, as appropriate to allow timely decisions regarding required disclosure. Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and our management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2009, our Chief Executive Officer (Principal Executive Officer) and President and Chief Operating Officer (Principal Financial Officer) concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

There have been no changes in the Company s internal control over financial reporting during the most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS.** None.

**ITEM 1A. RISK FACTORS.**

For information regarding factors that could affect the Company s results of operations, financial condition and liquidity, see the risk factors discussion provided under Risk Factors in Item 1A of ArQule s Annual Report on Form 10-K for the year ended December 31, 2008 filed with the SEC on March 6, 2009, as updated from time to time in our subsequent Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. See also, Forward-Looking Statements included in this Quarterly Report on Form 10-Q.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.** None

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.** None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**None

**ITEM 6. EXHIBITS**

| EXHIBIT NO. | DESCRIPTION |
|---|---|
| 31.1 | Rule 13a-14(a) Certificate of Chief Executive Officer, filed herewith. |
| 31.2 | Rule 13a-14(a) Certificate of Principal Financial Officer, filed herewith. |
| 32 | Rule 13a-14(b) Certificate of Chief Executive Officer and Chief Financial Officer, filed herewith. |

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**ARQULE, INC.**

**SIGNATURES**

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

ArQule, Inc.

Date: November 6, 2009

/s/ PETER S. LAWRENCE
Peter S. Lawrence
President and Chief Operating Officer
(Principal Financial Officer)

/s/ ROBERT J. WEISKOPF
Robert J. Weiskopf
Vice President of Finance,
Corporate Controller and Treasurer
(Principal Accounting Officer)