XOMA LTD /DE/
Form 10-Q
November 09, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2011

or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from __________to__________

Commission File No. 0-14710

XOMA Ltd.
(Exact name of registrant as specified in its charter)

Bermuda	52-2154066
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2910 Seventh Street, Berkeley, California 94710	(510) 204-7200
(Address of principal executive offices, including zip code)	(Telephone Number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No 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 (§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 x 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 the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act).

Large accelerated filer o	Accelerated filer x	Non-accelerated filer o (Do not check if a smaller	Smaller reporting company o

reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act of 1934). Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at November 7, 2011
Common Shares, U.S. $0.0075 par value	34,246,279

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PART I - FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

XOMA Ltd.

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	September 30, 2011 (unaudited)	December 31, 2010 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 45,707	$ 37,304
Trade and other receivables, net	14,900	20,864
Prepaid expenses and other current assets	1,341	712
Total current assets	61,948	58,880
Property and equipment, net	13,357	14,869
Other assets	1,880	503
Total assets	$ 77,185	$ 74,252
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,083	$ 3,581
Accrued and other liabilities	10,434	10,658
Deferred revenue	6,006	17,044
Warrant liabilities	896	4,245
Total current liabilities	20,419	35,528
Deferred revenue – long-term	8,016	1,086
Interest bearing obligations – long-term	26,649	13,694
Other long-term liabilities	440	353
Total liabilities	55,524	50,661
Shareholders' equity:		
Preference shares, $0.05 par value, 1,000,000 shares authorized		
Series B, 8,000 designated, 0 and 2,959 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively	-	1
Common shares, $0.0075 par value, 92,666,666 shares authorized, 33,412,263 and 28,491,318 shares outstanding at September 30, 2011 and December 31, 2010, respectively	250	214
Additional paid-in capital	895,729	876,686
Accumulated deficit	(874,318)	(853,310)
Total shareholders' equity	21,661	23,591
Total liabilities and shareholders' equity	$ 77,185	$ 74,252

The accompanying notes are an integral part of these condensed consolidated financial statements.

(Note 1) The condensed consolidated balance sheet as of December 31, 2010 has been derived from the audited financial statements as of that date included in the Company's Annual Report on Form 10-K for the year ended

December 31, 2010.

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XOMA Ltd.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)
(in thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Revenues:				
License and collaborative fees	$ 4,859	$ 1,410	$ 16,725	$ 1,749
Contract and other revenue	11,349	5,733	31,477	18,025
Royalties	21	3,754	147	4,267
Total revenues	16,229	10,897	48,349	24,041
Operating expenses:				
Research and development	15,851	21,345	51,479	58,278
Selling, general and administrative	7,296	6,197	18,779	16,776
Total operating expenses	23,147	27,542	70,258	75,054
Loss from operations	(6,918)	(16,645)	(21,909)	(51,013)
Other income (expense):				
Interest expense	(652)	(104)	(1,818)	(281)
Other income	1,027	3,117	2,734	313
Net loss before taxes	(6,543)	(13,632)	(20,993)	(50,981)
Provision for income tax expense	-	(1)	(15)	(17)
Net loss	$ (6,543)	$ (13,633)	$ (21,008)	$ (50,998)
Basic and diluted net loss per common share	$ (0.20)	$ (0.69)	$ (0.69)	$ (2.87)
Shares used in computing basic and diluted net loss per common share	32,761	19,802	30,623	17,742

The accompanying notes are an integral part of these condensed consolidated financial statements.

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XOMA Ltd.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

	Nine Months Ended September 30,	
	2011	2010
Cash flows from operating activities:		
Net loss	$ (21,008)	$ (50,998)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	4,052	4,349
Common shares contribution to 401(k)	1,046	905
Share-based compensation expense	5,598	3,743
Accrued interest on interest bearing obligations	762	260
Revaluation of warrant liabilities	(3,349)	(4,811)
Warrant modification expense	-	4,500
Amortization of discount on long-term debt	1,019	-
Unrealized loss on foreign currency exchange	1,136	-
Unrealized gain on foreign exchange options	(157)	-
Other non-cash adjustments	47	19
Changes in assets and liabilities affecting cash:		
Trade and other receivables, net	5,964	(713)
Prepaid expenses and other assets	(1,850)	(615)
Accounts payable and accrued liabilities	(1,305)	2,217
Deferred revenue	(13,008)	(1,510)
Other liabilities	78	(256)
Net cash used in operating activities	(20,975)	(42,910)
Cash flows from investing activities:		
Purchase of property and equipment	(2,586)	(277)
Net cash used in investing activities	(2,586)	(277)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	20,102	-
Proceeds from issuance of common shares	12,435	40,638
Payment for modification of warrants	-	(4,500)
Net cash provided by financing activities	32,537	36,138
Effect of exchange rate changes on cash	(573)	-
Net increase (decrease) in cash and cash equivalents	8,976	(7,049)
Cash and cash equivalents at the beginning of the period	37,304	23,909
Cash and cash equivalents at the end of the period	$ 45,707	$ 16,860
Supplemental Cash Flow Information:		
Cash paid for income taxes	$ 15	$ 16
Non-cash investing and financing activities:		
Discount on long-term debt	$ (8,899)	$ -
Issuance and extinguishment of warrant liabilities	$ -	$ 1,767

Interest added to principal balance on Novartis note	$ 170	$ 164
Interest added to principal balance on Servier loan	$ 330	$ -

The accompanying notes are an integral part of these condensed consolidated financial statements.

XOMA Ltd.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Description of Business

XOMA Ltd. ("XOMA" or the "Company"), a Bermuda company, is a biopharmaceutical company focused on the discovery, development and manufacture of therapeutic antibodies designed to treat autoimmune, cardio-metabolic, infectious, inflammatory and oncological diseases. The Company's products are presently in various stages of development and are subject to regulatory approval before they can be commercially launched.

2. Basis of Presentation and Significant Accounting Policies

Basis of Presentation

The condensed consolidated financial statements include the accounts of XOMA and its subsidiaries. All intercompany accounts and transactions were eliminated during consolidation. The unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q. These financial statements and related disclosures have been prepared with the assumption that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year. Accordingly, these statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2010, filed with the U.S. Securities and Exchange Commission ("SEC") on March 10, 2011.

In the opinion of management, the unaudited condensed consolidated financial statements include all adjustments, consisting only of normal recurring adjustments, which are necessary to present fairly the Company's consolidated financial position as of September 30, 2011, the consolidated results of the Company's operations for the three and nine months ended September 30, 2011 and 2010, and the Company's cash flows for the nine months ended September 30, 2011 and 2010. The interim results of operations are not necessarily indicative of the results that may occur for the full fiscal year or future periods.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosures. On an on-going basis, management evaluates its estimates including, but not limited to, those related to revenue recognition, long-lived assets, warrant liabilities, derivative instruments and share-based compensation. The Company bases its estimates on historical experience and on various other market-specific and other relevant assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ significantly from these estimates, such as the Company's billing under government contracts. Under the Company's contracts with the National Institute of Allergy and Infectious Diseases ("NIAID"), a part of the National Institutes of Health ("NIH"), the Company bills using NIH provisional rates and thus are subject to future audits at the discretion of NIAID's contracting office. These audits can result in an adjustment to revenue previously reported.

Concentration of Risk

Cash equivalents and receivables are financial instruments, which potentially subject the Company to concentrations of credit risk, as well as liquidity risk for certain cash equivalents such as money market funds. The Company has not encountered such issues during 2011.

The Company has not experienced any significant credit losses and does not generally require collateral on receivables. For the nine months ended September 30, 2011, two customers represented 59% and 36% of total revenue and 45% and 52% of the accounts receivable balance.

For the nine months ended September 30, 2010, three customers represented 56%, 18%, and 14% of total revenues. As of December 31, 2010, there were receivables outstanding from two customers representing 72% and 23% of the accounts receivable balance.

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Recent Accounting Pronouncements

In June of 2011, Accounting Standards Codification Topic 220, Comprehensive Income was amended to increase the prominence of items reported in other comprehensive income. Accordingly, a company can present all nonowner changes in stockholders' equity either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The Company plans to adopt this guidance as of January 1, 2012 on a retrospective basis and does not expect the adoption thereof to have a material effect on the Company's consolidated financial statements. The Financial Accounting Standards Board has proposed deferral of the requirement and if finalized, the Company would not adopt this guidance until January 1, 2013.

In May of 2011, Accounting Standards Codification Topic 820, Fair Value Measurement was amended to develop common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. generally accepted accounting principles and International Financial Reporting Standards. The Company plans to adopt this guidance as of January 1, 2012 on a prospective basis and does not expect the adoption thereof to have a material effect on the Company's consolidated financial statements.

In March of 2010, Accounting Standards Codification Topic 605, Revenue Recognition was amended to define a milestone and clarify that the milestone method of revenue recognition is a valid application of the proportional performance model when applied to research or development arrangements. Accordingly, a company can make an accounting policy election to recognize a payment that is contingent upon the achievement of a substantive milestone in its entirety in the period in which the milestone is achieved. This guidance was adopted effective January 1, 2011 on a prospective basis and did not have a material effect on the Company's consolidated financial statements.

3. Condensed Consolidated Financial Statement Detail

Comprehensive Loss

Comprehensive loss is equal to net loss for the three and nine months ended September 30, 2011 and 2010.

Net Loss Per Common Share

Basic and diluted net loss per common share is based on the weighted average number of common shares outstanding during the period.

Potentially dilutive securities are excluded from the calculation of earnings per share if their inclusion is anti-dilutive. The following table shows the weighted average outstanding securities considered anti-dilutive and therefore excluded from the computation of diluted net loss per share (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Options for common shares	4,036	2,332	3,837	2,138
Convertible preference shares	-	254	90	254
Warrants for common shares	1,608	1,608	1,608	1,677
Total	5,644	4,194	5,535	4,069

For the three and nine months ended September 30, 2011 and 2010, all of the above outstanding securities were considered anti-dilutive, and therefore the calculations of basic and diluted net losses per share were the same.

Cash and Cash Equivalents

At September 30, 2011, cash equivalents consisted of demand deposits and money market funds with maturities of less than 90 days at the date of purchase. At December 31, 2010, cash equivalents consisted of demand deposits, money market funds and repurchase agreements with maturities of less than 90 days at the date of purchase.

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Cash and cash equivalent balances were recorded at fair value as follows as of September 30, 2011 and December 31, 2010 (in thousands):

	September 30, 2011			
	Cost Basis	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Cash	$15,062	$-	$-	$15,062
Cash equivalents	30,645	-	-	30,645
Total cash and cash equivalents	$45,707	$-	$-	$45,707

	December 31, 2010			
	Cost Basis	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Cash	$29,536	$-	$-	$29,536
Cash equivalents	7,768	-	-	7,768
Total cash and cash equivalents	$37,304	$-	$-	$37,304

Foreign Exchange Options

The Company holds debt and may incur expenses denominated in foreign currencies, which exposes it to market risk associated with foreign currency exchange rate fluctuations between the U.S. dollar and the Euro. The Company is required to make principal and accrued interest payments in Euros on its €15.0 million loan from Les Laboratoires Servier ("Servier") (refer to Note 6 below). In order to manage its foreign currency exposure related to these payments, in May of 2011, the Company entered into two foreign exchange option contracts to buy €15.0 million and €1.5 million on January 2016 and January 2014, respectively. By having these option contracts in place, the Company's foreign exchange rate risk is reduced if the U.S. dollar weakens against the Euro. However, if the U.S. dollar strengthens against the Euro, the Company is not required to exercise these options, but will not receive any refund on premiums paid.

Upfront premiums paid on these foreign exchange option contracts totaled $1.5 million. The fair values of these option contracts are re-valued at each reporting period and are estimated based on pricing models using readily observable inputs from actively quoted markets. The fair values of these option contracts are included in other assets on the condensed consolidated balance sheet and changes in fair value on these contracts are included in other income (expense) on the condensed consolidated statements of operations. The foreign exchange options were revalued at September 30, 2011 and had an aggregate fair value of $1.4 million, and the Company recognized losses of $0.3 million and $0.1 million related to the revaluation for the three and nine months ended September 30, 2011, respectively.

Receivables

Receivables consisted of the following at September 30, 2011 and December 31, 2010 (in thousands):

	September 30, 2011	December 31, 2010
Trade receivables, net	$ 14,107	$ 20,309
Other receivables	793	555

Total	$	14,900	$	20,864

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Property and Equipment

Property and equipment consisted of the following at September 30, 2011 and December 31, 2010 (in thousands):

	September 30, 2011	December 31, 2010
Furniture and equipment	$ 33,483	$ 31,700
Buildings, leasehold and building improvements	21,490	21,463
Construction-in-progress	420	203
Land	310	310
	55,703	53,676
Less: Accumulated depreciation and amortization	(42,346)	(38,807)
Property and equipment, net	$ 13,357	$ 14,869

Depreciation expense was $1.4 million and $4.1 million for the three and nine months ended September 30, 2011, respectively, compared with $1.4 million and $4.4 million, respectively, for the same periods in 2010.

Accrued Liabilities

Accrued liabilities consisted of the following at September 30, 2011 and December 31, 2010 (in thousands):

	September 30, 2011	December 31, 2010
Accrued payroll and other benefits	$ 2,906	$ 2,752
Accrued management incentive compensation	2,864	4,982
Accrued clinical trial costs	1,349	1,020
Accrued severance payments	1,076	-
Accrued professional fees	816	1,020
Other	1,423	884
Total	$ 10,434	$ 10,658

4. Fair Value Measurements

Fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions and risk of nonperformance.

A fair value hierarchy was established which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of inputs that may be used to measure fair value are as follows:

- Level 1: Quoted prices in active markets for identical assets or liabilities;

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

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

The following tables set forth the Company’s fair value hierarchy for its financial assets (cash equivalents) and liabilities measured at fair value on a recurring basis as of September 30, 2011 and December 31, 2010.

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Financial assets and liabilities carried at fair value as of September 30, 2011 and December 31, 2010 were classified as follows (in thousands):

	Fair Value Measurements at September 30, 2011 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:				
Money market funds (1)	$ 30,645	$ -	$ -	$30,645
Foreign exchange options	-	1,371	-	1,371
Total	$ 30,645	$ 1,371	$ -	$32,016
Liabilities:				
Warrant liabilities	$ -	$ -	$ 896	$896

	Fair Value Measurements at December 31, 2010 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:				
Repurchase agreements (1)	$ 1,428	$ -	$ -	$1,428
Money market funds (1)	6,340	-	-	6,340
Total	$ 7,768	$ -	$ -	$7,768
Liabilities:				
Warrant liabilities	$ -	$ -	$ 4,245	$4,245

(1) Included in cash and cash equivalents

The fair value of the foreign exchange options at September 30, 2011 was determined using readily observable market inputs from actively quoted markets obtained from various third party data providers. These inputs, such as spot rate, forward rate and volatility have been derived from readily observable market data, meeting the criteria for Level 2 in the fair value hierarchy.

The fair value of the warrant liabilities at September 30, 2011 and December 31, 2010 was determined using the Black-Scholes Model, which requires inputs such as the expected term of the warrants, share price volatility and risk-free interest rate. These inputs are subjective and generally require significant analysis and judgment to develop.

The fair value of the warrant liabilities was estimated using the following range of assumptions at September 30, 2011 and December 31, 2010:

	September 30, 2011		December 31, 2010	
Expected volatility	105.4 - 106.8	%	93.5 - 94.9	%
Risk-free interest rate	0.4	%	2.0	%
Expected term	3.2 - 3.4 years		3.9 - 4.1 years	

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The following table provides a summary of changes in the fair value of the Company's Level 3 financial liabilities for the nine months ended September 30, 2011 (in thousands):

	Warrant Liabilities at September 30, 2011
Balance at December 31, 2010	$ 4,245
Net decrease in fair value of warrant liabilities on revaluation	(3,349)
Balance at September 30, 2011	$ 896

For the three and nine months ended September 30, 2011, the Company recognized net decreases of $0.5 million and $3.3 million, respectively, in the estimated fair value of the warrant liabilities resulting in recognized gains in the other income (expense) line of the condensed consolidated statements of operations.

For the three and nine months ended September 30, 2010, the Company recognized net decreases of $3.1 million and $4.8 million, respectively, in the estimated fair value of the warrant liabilities resulting in recognized gains in the other income (expense) line of the condensed consolidated statements of operations.

5. Licensing, Collaborative and Other Arrangements

Servier

In December of 2010, the Company entered into a license and collaboration agreement with Servier, to jointly develop and commercialize gevokizumab (formerly referred to as XOMA 052) in multiple indications, which provided for a non-refundable upfront payment of $15.0 million that was received by the Company in January of 2011. The upfront payment was recognized over the eight month period that the initial group of deliverables were provided to Servier. The Company recognized $3.9 million and $14.9 million in revenue relating to this upfront payment during the three and nine months ended September 30, 2011, respectively. In addition, the Company received a loan of €15.0 million, which was fully funded in January of 2011, with the proceeds converting to $19.5 million at the date of funding (refer to Note 6 below). Also, the Company retains development and commercialization rights for Behcet's uveitis and other inflammatory and oncology indications in the U.S. and Japan, and an option to reacquire rights to diabetes and cardiovascular disease indications from Servier in those territories. Servier will fully fund activities to advance the global clinical development and future commercialization of gevokizumab in diabetes and cardiovascular related diseases, as well as the first $50.0 million of future gevokizumab global clinical development and chemistry and manufacturing controls expenses and 50% of further expenses for the Behcet's uveitis indication. For the three and nine months ended September 30, 2011, the Company recorded revenue of $9.8 million and $27.5 million, respectively, under this agreement, which included the revenue relating to the upfront payment.

In November of 2011, the Company announced plans for expanded gevokizumab clinical development. The plan includes a global Phase 3 trial in non-infectious uveitis involving the intermediate and/or posterior segments of the eye, including Behçet's uveitis ("NIU") and a Phase 3 trial outside the U.S. in Behçet's uveitis. Based on the timing of anticipated regulatory interactions to discuss the planned Phase 3 program, the Company anticipates initiating the NIU Phase 3 trial in the second quarter of 2012. Servier has agreed to provide funding for the NIU Phase 3 trial under the terms of the collaboration agreement discussed above for the Behçet's uveitis indication so long as input from the European Medicines Agency enables the results to be useful for the European commercialization of gevokizumab. In addition, the Company announced a proof-of-concept clinical program to identify additional conditions that may respond to treatment with gevokizumab.

Merck/Schering-Plough

In May of 2006, the Company entered into a fully funded collaboration agreement with Schering-Plough Research Institute, a division of Schering Corporation, now a subsidiary of Merck ("Merck/Schering-Plough") for therapeutic monoclonal antibody discovery and development. Under the agreement, Merck/Schering-Plough made up-front, annual maintenance and milestone payments to the Company, funded its research and development activities related to the agreement and would have paid royalties on sales of products resulting from the collaboration. During the collaboration, the Company discovered therapeutic antibodies against multiple targets selected by Merck/Schering-Plough using multiple human antibody phage display libraries, optimized antibodies through affinity maturation or other protein engineering, used the Company's proprietary HE™ technology to humanize antibody candidates generated by hybridoma techniques, performed preclinical studies to support regulatory filings, developed cell lines and production processes and produced antibodies for initial clinical trials. Merck/Schering-Plough selected the first target at the inception of the agreement and, in December of 2006, exercised its right to initiate the additional discovery and development programs. In January of 2011, the Company successfully completed the contract services it had agreed to perform under the collaboration agreement with Merck/Schering-Plough.

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6. Long-Term Debt and Other Financings

Long-Term Debt

Novartis Note

In May of 2005, the Company executed a secured note agreement with Novartis (then Chiron Corporation), which is due and payable in full in June of 2015. Under this note agreement, the Company borrowed semi-annually to fund up to 75% of the Company's research and development and commercialization costs under its collaboration arrangement with Novartis, not to exceed $50.0 million in aggregate principal amount. Interest on the principal amount of the loan accrues at six-month LIBOR plus 2%, which was equal to 2.39% at September 30, 2011, and is payable semi-annually in June and December of each year. At the Company's election, the semi-annual interest payments can be added to the outstanding principal amount, in lieu of a cash payment, as long as the aggregate principal amount does not exceed $50.0 million. The Company has made this election for all interest payments thus far. Loans under the note agreement are secured by the Company's interest in the collaboration with Novartis, including any payments owed to it thereunder.

At September 30, 2011 and December 31, 2010, the outstanding principal balance under this note agreement was $13.9 million and $13.7 million, respectively. Pursuant to the terms of the arrangement as restructured in November of 2008, the Company will not make any additional borrowings under the Novartis note. Due to the structure of the secured note agreement with Novartis and since there is no liquid market for this obligation, there is no practical method to estimate fair value of this long-term debt.

Servier Loan

In December of 2010, in connection with the license and collaboration agreement entered into with Servier (see footnote 5), the Company executed a loan agreement with Servier, which provided for an advance of up to €15.0 million. The loan was fully funded in January of 2011, with the proceeds converting to approximately $19.5 million. The loan is secured by an interest in XOMA's intellectual property rights to all gevokizumab indications worldwide, excluding certain rights in the U.S. and Japan. Interest is calculated at a floating rate based on a Euro Inter-Bank Offered Rate ("EURIBOR") and subject to a cap. The interest rate is reset semi-annually in January and July of each year. The interest rate for the initial interest period was 3.22%. The interest rate has been reset to 3.83% for the six-month period from July 2011 through January 2012. Interest is payable semi-annually; however, the loan agreement provides for a deferral of interest payments over a period specified in the agreement. During the deferral period, accrued interest will be added to the outstanding principal amount for the purpose of interest calculation for the next six-month interest period. On the repayment commencement date, all unpaid and accrued interest shall be paid to Servier and thereafter, all accrued and unpaid interest shall be due and payable at the end of each six-month period. The loan matures in 2016; however, after a specified period prior to final maturity, the loan is to be repaid (i) at Servier's option, by applying up to a significant percentage of any milestone or royalty payments owed by Servier under the Company's collaboration agreement and (ii) using a significant percentage of any upfront, milestone or royalty payments the Company receives from any third party collaboration or development partner for rights to gevokizumab in the U.S. and/or Japan. In addition, the loan becomes immediately due and payable upon certain customary events of default. At September 30, 2011, the outstanding principal balance under this loan was $20.4 million. For the three and nine months ended September 30, 2011, the Company recorded an unrealized foreign exchange gain of $1.2 million and an unrealized foreign exchange loss of $0.9 million, respectively, related to the re-measurement of the loan as of September 30, 2011.

The loan has a stated interest rate lower than the market rate based on comparable loans held by similar companies, which represents additional value to the Company. The Company recorded this additional value as a discount to the face value of the loan amount, at its fair value of $8.9 million. The fair value of this discount, which was determined using a discounted cash flow model, represents the differential between the stated terms and rates of the loan, and market rates. Based on the association of the loan with the collaboration arrangement, the Company recorded the offset to this discount as deferred revenue.

The loan discount is amortized under the effective interest method over the expected five-year life of the loan. The Company recorded non-cash interest expense of $0.3 million and $1.0 million during the three and nine months ended September 30, 2011, respectively, resulting from the amortization of the loan discount. At September 30, 2011, the net carrying value of the loan was $12.7 million. For the three and nine months ended September 30, 2011, the Company recorded unrealized foreign exchange losses of $0.2 million and $0.4 million, respectively, related to the re-measurement of the loan discount as of September 30, 2011.

The Company believes that realization of the benefit and the associated deferred revenue is contingent on the loan remaining outstanding over the five-year contractual term of the loan. If the Company were to stop providing service under the collaboration arrangement and the arrangement is terminated, the maturity date of the loan would be accelerated and a portion of measured benefit would not be realized. As the realization of the benefit is contingent, in part, on the provision of future services, the Company is recognizing the deferred revenue over the expected five-year life of the loan. The deferred revenue is amortized under the effective interest method, and the Company recorded $0.3 million and $1.0 million of related non-cash revenue during the three and nine months ended September 30, 2011, respectively.

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Interest Expense

Interest expense for the Novartis note and Servier loan are shown below (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Interest expense				
Novartis note	$ 85	$ 95	$ 254	$ 260
Servier loan	564	-	1,544	-
Other	3	9	20	21
Total interest expense	$ 652	$ 104	$ 1,818	$ 281

Other Financings

ATM Agreements

In the third quarter of 2010, the Company entered into an At Market Issuance Sales Agreement (the “2010 ATM Agreement”), with Wm Smith & Co. and McNicoll, Lewis & Vlak LLC (the “Agents”), under which the Company could sell common shares from time to time through the Agents, as its agents for the offer and sale of the common shares, in an aggregate amount not to exceed the amount that could be sold under its registration statement on Form S-3 (File No. 333-148342) filed with the SEC on December 26, 2007. The Agents could sell the common shares by any method permitted by law deemed to be an “at the market” offering as defined in Rule 415 of the Securities Act of 1933, as amended (the “Securities Act”), including without limitation sales made directly on The NASDAQ Global Market, on any other existing trading market for the common shares or to or through a market maker. The Agents could also sell the common shares in privately negotiated transactions, subject to the Company’s prior approval. The Company paid the Agents, collectively, a commission equal to 3% of the gross proceeds of the sales price of all common shares sold through them as sales agents under the 2010 ATM Agreement. From the inception of the 2010 ATM Agreement through May of 2011, the Company sold a total of 7,560,862 common shares under this agreement for aggregate gross proceeds of $34.0 million, including 821,386 common shares sold in 2011 for aggregate gross proceeds of $4.4 million. Total offering expenses incurred related to sales under the 2010 ATM Agreement from inception to May of 2011 were $1.0 million, including $0.1 million incurred in 2011. In May of 2011, the 2010 ATM Agreement expired by its terms, and there will be no further issuances under this facility.

On February 4, 2011, the Company entered into an At Market Issuance Sales Agreement (the “2011 ATM Agreement”), with McNicoll, Lewis & Vlak LLC (“MLV”), under which the Company may sell common shares from time to time through MLV, as its agent for the offer and sale of the common shares, in an aggregate amount not to exceed the amount that can be sold under the Company’s registration statement on Form S-3 (File No. 333-172197) filed with the SEC on February 11, 2011 and amended on March 10, 2011 and June 3, 2011, which was declared effective by the SEC on June 6, 2011. MLV may sell the common shares by any method permitted by law deemed to be an “at the market” offering as defined in Rule 415 of the Securities Act, including without limitation sales made directly on The NASDAQ Global Market, on any other existing trading market for the common shares or to or through a market maker. MLV may also sell the common shares in privately negotiated transactions, subject to the Company’s prior approval. The Company will pay MLV a commission equal to 3% of the gross proceeds of the sales price of all common shares sold through them as sales agent under the 2011 ATM Agreement. From the inception of the 2011 ATM Agreement through September 30, 2011, the Company sold a total of 3,603,422 common shares under this agreement for aggregate gross proceeds of $8.5 million. Total offering expenses incurred related to sales under the 2011 ATM Agreement from inception to September 30, 2011 were $0.3 million.

7. Income Taxes

Income tax expense was not material for the three and nine months ended September 30, 2011 or the comparable periods in 2010. The Company's effective tax rate will fluctuate from period to period due to several factors inherent in the nature of the Company's operations and business transactions. The factors that most significantly impact this rate include the variability of licensing transactions in foreign jurisdictions.

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8. Share-Based Compensation

In December of 2010, the Board of Directors of the Company approved a company-wide grant of share options under the Company's 2010 Long Term Incentive and Share Award Plan ("LTIP") and, in the first quarter of 2011, the options for 1,430,840 shares became effective. 1,040,220 of these options were granted subject to shareholder approval of an increase in the number of shares available under the LTIP. On May 26, 2011, shareholder approval was obtained at the Company's annual general meeting of shareholders. A cumulative adjustment of $1.3 million was recorded in the second quarter of 2011 to reflect the share-based compensation expense that would have been recorded from the conditional grant date to the shareholder approval date. The adjustment was based on the fair value of these options at the date of shareholder approval and calculated using the closing share price and expected term on that date. The remaining assumptions included in the calculation were the same assumptions used for the second quarter option grants. A portion of the 2011 annual options granted include immediate vesting terms with the remainder of the options vesting monthly over two years for employees and one year for directors.

On August 31, 2011, the Company announced that Steven B. Engle resigned as Chief Executive Officer, President and Chairman of the Board of the Company. In the third quarter of 2011, the Company incurred a share-based compensation charge of approximately $0.7 million, related to Mr. Engle's resignation.

As of September 30, 2011, the Company had approximately 4,598,775 common shares reserved for future issuance under its share option plans and Employee Share Purchase Plan ("ESPP").

The following table shows total share-based compensation expense included in the condensed consolidated statements of operations for the three and nine months ended September 30, 2011 and 2010 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Research and development	$ 458	$ 742	$ 2,404	$ 1,829
Selling, general and administrative	1,084	920	3,194	1,914
Total share-based compensation expense	$ 1,542	$ 1,662	$ 5,598	$ 3,743

The valuation of share-based compensation awards is determined at the date of grant using the Black-Scholes Model. This model requires inputs such as the expected term of the option, expected volatility and risk-free interest rate. Further, the forfeiture rate also affects the amount of aggregate compensation. These inputs are subjective and generally require significant analysis and judgment to develop. While estimates of the expected term, volatility and forfeiture rate are derived primarily from the Company's historical data, the risk-free rate is based on the yield available on United States Treasury zero-coupon issues. The fair value of share-based awards was estimated based on the following weighted average assumptions for the three and nine months ended September 30, 2011 and 2010:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Dividend yield	0 %	0 %	0 %	0 %
Expected volatility	89 %	79 %	87 %	79 %
Risk-free interest rate	0.96 %	1.27 %	1.86 %	1.67 %
Expected term	5.6 years	5.6 years	5.3 years	5.3 years

Share option activity for the nine months ended September 30, 2011 was as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)
Options outstanding at December 31, 2010	2,331,450	$ 25.36	7.71	$ 99
Granted	1,811,840	5.23		
Forfeited, expired or cancelled	(134,204)	37.35		
Options outstanding at September 30, 2011	4,009,086	$ 15.86	7.90	$ -
Options exercisable at September 30, 2011	2,500,259	$ 21.58	7.27	$ -

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9. Share Capital

Series B Preference Shares

In December of 2003, the Company issued 2,959 Series B preference shares to Genentech, Inc. in repayment of $29.6 million of the outstanding balance under a convertible subordinated debt agreement. Pursuant to the rights of the Series B preference shares, the holder of Series B preference shares was not entitled to receive any dividends on the Series B preference shares. The Series B preference shares ranked senior with respect to rights on liquidation, winding-up and dissolution of the Company to all classes of common shares. Upon any voluntary or involuntary liquidation, dissolution or winding-up of the Company, the holder of Series B preference shares would have been entitled to receive $10,000 per Series B preference share (or $29.6 million in the aggregate) before any distribution was made on the common shares. The holder of the Series B preference shares had no voting rights, except as required under Bermuda law.

The holder of Series B preference shares had the right to convert Series B preference shares into common shares at a conversion price equal to $116.25 per common share, subject to adjustment in certain circumstances.

In April of 2011, the 2,959 Series B convertible preference shares were converted by Genentech into 254,560 common shares. The $29.6 million liquidation preference associated with the Series B preference shares was eliminated as a result of this conversion.

10. Legal Proceedings, Commitments and Contingencies

On April 9, 2009, a complaint was filed in the Superior Court of Alameda County, California, in a lawsuit