XOMA LTD /DE/
Form 10-Q
November 08, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2007

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 ¨

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

Large Accelerated Filer ¨ Accelerated Filer x Non-Accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act of 1934). Yes ¨ 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 6, 2007
Common shares US$.0005 par value	**131,857,960**

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PART I - FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

XOMA Ltd.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

	September 30, 2007 (unaudited)	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 41,770	$ 28,002
Short-term investments	5,868	18,381
Restricted cash	1,640	4,330
Receivables	13,417	12,045
Prepaid expenses	1,840	1,061
Debt issuance costs	254	668
Total current assets	64,789	64,487
Property and equipment, net	24,345	22,434
Debt issuance costs long-term	786	2,661
Deposits and other	495	495
Total assets	$ 90,415	$ 90,077
LIABILITIES AND SHAREHOLDERS EQUITY (NET CAPITAL DEFICIENCY)		
Current liabilities:		
Accounts payable	$ 6,008	$ 4,186
Accrued liabilities	6,716	7,086
Accrued interest	427	1,794
Deferred revenue	7,994	8,200
Total current liabilities	21,145	21,266
Deferred revenue long-term	10,770	8,768
Convertible debt long-term		46,823
Interest bearing obligation long-term	49,249	51,393
Total liabilities	81,164	128,250
Commitments and contingencies		
Shareholders equity (net capital deficiency):		
Preference shares, $.05 par value, 1,000,000 shares authorized		
Series A, 210,000 designated, no shares issued and outstanding		
Series B, 8,000 designated, 2,959 shares issued and outstanding; aggregate liquidation preference of $29.6 million	1	1
	66	53

Common shares, $.0005 par value, 210,000,000 shares authorized, 131,847,003 and 105,454,389 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively		
Additional paid-in capital	739,174	689,315
Accumulated comprehensive loss	(8)	(9)
Accumulated deficit	(729,982)	(727,533)
Total shareholders equity (net capital deficiency)	9,251	(38,173)
Total liabilities and shareholders equity (net capital deficiency)	$ 90,415	$ 90,077

See accompanying notes to condensed consolidated financial statements.

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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,	
	2007	2006	2007	2006
Revenues:				
License and collaborative fees	$ 31,311	$ 636	$ 35,859	$ 2,021
Contract and other revenue	7,424	3,813	21,530	11,588
Royalties	4,405	2,906	12,139	6,862
Total revenues	43,140	7,355	69,528	20,471
Operating costs and expenses:				
Research and development (including contract related of $1,637 and $3,331 for the three months ended September 30, 2007 and 2006, respectively, and $10,861 and $7,942, respectively, for the nine months ended September 30, 2007 and 2006)	14,620	12,671	47,864	36,956
General and administrative	5,803	4,189	15,064	13,628
Total operating costs and expenses	20,423	16,860	62,928	50,584
Income (loss) from operations	22,717	(9,505)	6,600	(30,113)
Other income (expense):				
Investment and interest income	337	329	1,316	1,171
Interest expense	(1,240)	(1,655)	(10,358)	(8,400)
Other income (expense)	3	(5)	(7)	(12)
Net income (loss)	$ 21,817	$ (10,836)	$ (2,449)	$ (37,354)
Basic net income (loss) per common share	$ 0.17	$ (0.11)	$ (0.02)	$ (0.40)
Diluted net income (loss) per common share	$ 0.16	$ (0.11)	$ (0.02)	$ (0.40)
Shares used in computing basic net income (loss) per common share	131,766	97,414	126,609	94,041
Shares used in computing diluted net income (loss) per common share	136,219	97,414	126,609	94,041

See accompanying notes to condensed consolidated financial statements.

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XOMA Ltd.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in thousands)

	Nine Months Ended September 30,	
	2007	**2006**
Cash flows from operating activities:		
Net loss	$ (2,449)	$ (37,354)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,581	3,731
Common shares contributed to 401(k) and management incentive plans	1,321	1,088
Share-based compensation expense	2,135	831
Accrued interest on convertible notes and other interest bearing obligations	(754)	(287)
Revaluation of embedded derivative	6,101	4,144
Interest paid on conversion of convertible debt	(5,172)	
Loss on disposal/retirement of property and equipment	14	10
Other non-cash adjustments	513	775
Changes in assets and liabilities:		
Receivables	(1,372)	(788)
Prepaid expenses	(779)	(395)
Accounts payable	1,823	(1,946)
Accrued liabilities	(370)	(94)
Deferred revenue	1,796	1,709
Net cash provided by (used in) operating activities	7,388	(28,576)
Cash flows from investing activities:		
Proceeds from sales/maturities of investments	30,445	29,679
Purchase of investments	(17,925)	(19,891)
Transfer of restricted cash	2,690	
Purchase of property and equipment	(6,505)	(6,829)
Net cash provided by investing activities	8,705	2,959
Cash flows from financing activities:		
Proceeds from issuance of convertible notes		3,003
Proceeds from issuance (principal payments of) long-term debt	(2,756)	11,969
Proceeds from issuance of common shares	431	358
Net cash provided by (used in) financing activities	(2,325)	15,330
Net increase (decrease) in cash and cash equivalents	13,768	(10,287)
Cash and cash equivalents at the beginning of the period	28,002	20,804
Cash and cash equivalents at the end of the period	$ 41,770	$ 10,517

See accompanying notes to condensed consolidated financial statements.

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XOMA Ltd.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

September 30, 2007

1. OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business

XOMA Ltd. (XOMA or the Company), a Bermuda company, is a biopharmaceutical company that discovers and develops antibodies and other genetically-engineered protein products to treat immunological and inflammatory disorders, cancer and infectious diseases. The Company s products are presently in various stages of development and most are subject to regulatory approval before they can be introduced commercially. The Company receives royalties from Genentech, Inc. (Genentech) on two approved products, RAPTIVA®, for the treatment of moderate-to-severe plaque psoriasis, and LUCENTIS®, for the treatment of neovascular (wet) age-related macular degeneration. XOMA s pipeline includes both proprietary products and collaborative programs at various stages of preclinical and clinical development.

Basis of Presentation

The condensed consolidated financial statements include the accounts of XOMA and its subsidiaries. All significant 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 year ended December 31, 2006, filed with the SEC on March 8, 2007.

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, 2007, the consolidated results of the Company s operations for the three and nine months ended September 30, 2007 and 2006, and the Company s cash flows for the nine months then ended. Certain prior period amounts have been reclassified to conform with current period presentation. These reclassifications had no impact on previously reported net earnings, financial position or cash flows. The condensed consolidated balance sheet amounts at December 31, 2006, have been derived from audited consolidated financial statements. The interim results of operations are not necessarily indicative of the results that may occur for the full fiscal year or future periods.

Critical Accounting Policies

There have been no significant changes in critical accounting policies during the nine months ended September 30, 2007, except as noted below, as compared with those previously disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2006, filed with the SEC on March 8, 2007.

Income Taxes

The Company accounts for uncertain tax positions in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), an interpretation of FASB Statement No. 109, Accounting for Income Taxes (FAS 109) The application of income tax law and regulations are inherently complex. Interpretations of and guidance surrounding income tax laws and regulations change over time. As such, changes in the Company s subjective assumptions and judgments can materially affect amounts recognized in the consolidated balance sheets and statements of income.

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 and liabilities and disclosure of contingent assets and liabilities, if any, at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

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In February of 2007, the Company announced that pursuant to the terms of its collaboration agreement with Chiron Corporation, subsequently acquired by Novartis AG (Novartis), entered into in February of 2004, the parties' mutual exclusivity obligation to conduct antibody discovery, development and commercialization work in oncology had ended. The expiration of this mutual obligation has no impact on the existing collaboration projects which have reached the development stage and the parties may continue to collaborate on a non-exclusive basis. The entire remaining unamortized balance of $4.3 million, at December 31, 2006, associated with the upfront collaboration fee of $10.0 million was recognized during the first quarter of 2007 due to the change in estimate from five years to three years.

Recent Accounting Pronouncements

In February of 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. If the use of fair value is elected, any upfront costs and fees related to the item must be recognized in earnings and cannot be deferred, e.g., debt issuance costs. The fair value election is irrevocable and generally made on an instrument by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. At the adoption date, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, and is required to be adopted by XOMA in the first quarter of fiscal 2008. XOMA is currently determining whether fair value accounting is appropriate for any of its eligible items and cannot estimate the impact, if any, which SFAS 159 will have on its financial position or results of operations.

Concentration of Risk

Cash equivalents, short-term investments, restricted cash and receivables are financial instruments, which potentially subject the Company to concentrations of credit risk. The Company maintains money market funds and short-term investments that bear minimal risk. The Company has not experienced any significant credit losses and does not generally require collateral on receivables. For the nine months ended September 30, 2007, four customers represented 43%, 17%, 13% and 10% of total revenues. Three of these customers represented 33%, 27%, and 25% of the $13.2 million billed and unbilled receivables outstanding at September 30, 2007. For the nine months ended September 30, 2006, two customers represented 44% and 33% of total revenues and, as of September 30, 2006, these customers represented 49% and 43% of the $5.8 million billed and unbilled receivables outstanding.

Share-Based Compensation

The Company grants qualified and non-qualified share options, shares and other share related awards under various plans to directors, officers, employees and other individuals. To date, share-based compensation issued under these plans consists of qualified and non-qualified incentive share options and shares. Share options are granted at exercise prices of not less than the fair market value of the Company s common shares on the date of grant. Generally, share options granted to employees fully vest four years from the grant date and expire ten years from the date of the grant or three months from the date of termination of employment (longer in case of death or certain retirements). Certain options granted to directors fully vest on the date of grant and certain options may fully vest upon a change of control of the Company. Additionally, the Company has an Employee Share Purchase Plan (ESPP) that allows employees to purchase Company shares at a purchase price equal to 95% of the closing price on the exercise date. For ESPP periods beginning prior to December 31, 2004, the purchase price per common share was 85% of fair market value at the lower of either the first day of the 24 month offering period or the last day of the period. As of September 30, 2007, the Company had approximately 3.5 million common shares reserved for future grant under its share option plans and ESPP.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), using the modified prospective transition method.

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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, 2007 and 2006 (in thousands).

	Three Months Ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Research and development	$ 178	$ 110	$ 625	$ 380
General and administrative	824	74	1,510	451
Total share-based compensation expense	$ 1,002	$ 184	$ 2,135	$ 831

There was no capitalized share-based compensation cost as of September 30, 2007. There were no recognized tax benefits during the nine months ended September 30, 2007 and 2006.

To estimate the value of an award, the Company uses the Black-Scholes option pricing model. This model requires inputs such as expected life, expected volatility and risk-free interest rate. The forfeiture rate also impacts the amount of aggregate compensation. These inputs are subjective and generally require significant analysis and judgment to develop. While estimates of expected life, volatility and forfeiture rate are derived primarily from the Company s historical data, the risk-free rate is based on the yield available on U.S. Treasury zero-coupon issues.

The fair value of share based awards was estimated using a Black-Scholes model with the following weighted-average assumptions for the three and nine months ended September 30, 2007 and 2006.

	Three Months Ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Dividend yield	0%	0%	0%	0%
Expected volatility	65%	75%	68%	80%
Risk-free interest rate	4.26%	4.56%	4.42%	4.65%
Expected life	5.3 years	5.3 years	5.3 years	5.3 years

Share option activity for the nine months ended September 30, 2007, is as follows:

	Options	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Options outstanding at December 31, 2006	6,229,864	$ 4.22		
Granted	4,491,950			
Exercised	(163,130)			
Forfeited, expired or canceled	(887,649)			
Options outstanding at September 30, 2007	9,671,035	$ 3.64	7.54	$ 7,039
Options exercisable at September 30, 2007	5,176,825	$ 4.70	5.98	$ 2,571

Total intrinsic value of the options exercised for the nine months ended September 30, 2007 was approximately $136,000.

At September 30, 2007, there was $5.0 million of unrecognized share-based compensation expense related to unvested share options with a weighted average remaining recognition period of 3.3 years.

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Comprehensive Income (Loss)

Unrealized gains or losses on the Company s available-for-sale securities are included in accumulated comprehensive income (loss). Comprehensive income (loss) and its components for the three and nine months ended September 30, 2007 and 2006, are as follows (in thousands):

	Three Months Ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Net income (loss)	$ 21,817	$ (10,836)	$ (2,449)	$ (37,354)
Unrealized gain (loss) on securities available-for-sale	(8)	27	1	22
Comprehensive income (loss)	$ 21,809	$ (10,809)	$ (2,448)	$ (37,332)

Net Income (Loss) Per Common Share

Basic net income (loss) per common share is based on the weighted average number of common shares outstanding during the period. Diluted net income (loss) per common share is based on the weighted average number of common shares and other dilutive securities outstanding during the period, provided that including these dilutive securities does not increase the net loss per share.

Potentially dilutive securities are excluded from the calculation of earnings per share if their inclusion is antidilutive. The effect of the warrants was antidilutive for the three and nine months ended September 30, 2007. The following table shows the total outstanding securities considered antidilutive and therefore excluded from the computation of diluted net income (loss) per share (in thousands):

	Three Months Ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Options for common shares	6,361	6,216	9,671	6,216
Warrants for common shares	125	125	125	125
Convertible preference shares, notes and related interest, as if converted		37,322	3,818	37,322

The following is a reconciliation of the numerators and denominators of the basic and diluted net income (loss) per share (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Numerator				
Net income (loss) used for diluted net income (loss) per share	$ 21,817	$ (10,836)	$ (2,449)	$ (37,354)
Denominator				
Weighted average shares outstanding used for basic net income (loss) per share	131,766	97,414	126,609	94,041
Effect of dilutive share options	635			
Effect of convertible preference shares	3,818			
Weighted-average shares outstanding and dilutive securities used for diluted net income (loss) per share	136,219	97,414	126,609	94,041

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Short-Term Investments

Short-term investments include debt securities classified as available-for-sale. Available-for-sale securities are stated at fair value, with unrealized gains and losses, net of tax, if any, reported in other comprehensive income (loss). Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale are also included in investment and other income. The Company has made all investments available to fund current operations, and intends to realize these as cash as required to provide for day-to-day working capital requirements. As of September 30, 2007 and December 31, 2006, short-term investments with maturities less than one year were $4.8 million and $18.4 million, respectively. As of September 30, 2007 and December 31, 2006, short-term investments with maturities of 1 year to 18 months were $1.1 million and $0, respectively. There were no investments held with maturities in excess of 18 months.

Receivables

Receivables consist of the following (in thousands):

	September 30, 2007	December 31, 2006
Trade receivables	$ 12,976	$ 11,458
Unbilled receivables	212	148
Other receivables	229	439
Total	$ 13,417	$ 12,045

Total related parties receivables were $76,000 and $94,000 at September 30, 2007 and December 31, 2006, respectively, of which $38,000 and $56,000 are included in Other receivables at September 30, 2007 and December 31, 2006, respectively.

Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	September 30, 2007	December 31, 2006
Accrued payroll costs	$ 2,365	$ 2,015
Accrued co-development		1,952
Accrued management incentive compensation	3,254	2,053
Accrued professional fees	834	876
Other	263	190
Total	$ 6,716	$ 7,086

2. CONVERTIBLE NOTES AND OTHER ARRANGEMENTS

In February of 2006, the Company completed an exchange offer with holders of its 6.5% convertible senior notes due 2012 in which the Company exchanged $60.0 million aggregate principal amount of its new 6.5% Convertible SNAPs$_{SM}$ due 2012 (the New Notes) for all $60.0 million aggregate principal amount of its then outstanding convertible senior notes due 2012. The Company also issued an additional $12.0 million of New Notes to the public for cash at a public offering price of 104% of principal, or $12.5 million. The New Notes were initially convertible into approximately 38.4 million common shares at a conversion rate of 533.4756 of common shares per $1,000 principal amount of New Notes, which is equivalent to a conversion price of approximately $1.87 per common share. The Company was able to automatically convert some or all of the New Notes on or prior to the maturity date if the closing price of its common shares exceeded 150% of the conversion price then in effect for at least 20 trading days during any consecutive 30 trading day period ending within five trading days prior to the notice of

auto-conversion. If the Company elected to automatically convert, or if holders elected to voluntarily convert, some or all of the New Notes on or prior to February 10, 2010, it was required to pay or provide for additional interest equal to four years worth of interest less any interest paid or provided for (additional interest payment feature), on the principal amount so converted, prior to the date of conversion. Additional interest could be paid in cash or, solely at the Company s option and subject to certain limitations, in its common shares valued at the conversion price then in effect.

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The Company separately accounted for the additional interest payment feature of the New Notes as an embedded derivative instrument, which was measured at fair value and classified on the balance sheet with the convertible debt. Changes in the fair value of the embedded derivative were recognized in earnings as a component of other income (expense). The initial fair value of the derivative was subtracted from the carrying value of the debt, reflected as a debt discount, which was amortized as interest expense using the effective interest method through the date the notes were scheduled to mature, and separately reported as a derivative liability.

The additional New Notes were issued to the initial purchasers for net proceeds of $11.8 million. Debt issuance costs related to the New Notes of approximately $0.7 million were being amortized on a straight-line basis over the original 72 month life of the notes. Additional debt issuance costs of $2.0 million, related to the modification of the existing debt, were expensed as incurred with $1.1 million and $0.9 million expensed during the quarters ended March 31, 2006 and December 31, 2005, respectively.

At the time of note conversion, unamortized discount, premium and debt issuance costs related to the converted notes were charged to shareholders equity.

Convertible debt consisted of the following (in thousands):

	September 30, 2007	December 31, 2006
Convertible debt	$	$ 41,363
Embedded derivative		5,207
Premium		253
Total	$	$ 46,823

During the first quarter of 2007, $42.0 million of New Notes were voluntarily converted by holders through March 7, 2007, at which time the Company announced that it had elected to automatically convert all of the remaining $2.5 million of New Notes outstanding. As a result, during the first quarter of 2007, 25,640,187 shares were issued to effect the conversion of the principal balances. Additionally, the Company issued 1,889,317 shares and $5.2 million in cash to satisfy the remaining additional interest payment feature related to these converted New Notes. The Company recorded a $6.1 million charge to interest expense as a result of the revaluation of the embedded derivative related to the additional interest feature of the convertible notes.

For the three months ended September 30, 2006, $20,000 of New Notes were converted into 13,097 common shares including 2,427 shares related to the additional interest payment feature of the notes. The Company recorded a $176,000 charge to interest expense during the quarter ended September 30, 2006, as a result of an increase in the fair value of the embedded derivative on its convertible debt including $2,000 related to the converted notes.

For the nine months ended September 30, 2006, $15.5 million of New Notes were converted into 10,398,267 shares of common shares including 2,145,398 shares related to the additional interest payment feature of the notes. The Company recorded $4.1 million in interest expense during the nine months ended September 30, 2006, as a result of an increase in the fair value of the embedded derivative on its convertible debt including $2.7 million related to the converted notes.

For the three months ended September 30, 2007 and 2006, the Company incurred $0 and $0.9 million, respectively, in interest expense payable on its convertible debt. For the nine months ended September 30, 2007 and 2006, the Company incurred $0.2 million and $2.8 million, respectively, in interest expense payable on its convertible debt. Interest expense was payable on a semi-annual basis. Additionally, the Company amortized a net of $0 and $0.3 million in debt issuance costs, premium and discount for the three months ended September 30, 2007 and 2006, respectively, and amortized a net of $0.1 million and $0.7 million in debt issuance costs, premium and discount for the nine months ended September 30, 2007 and 2006, respectively.

On November 9, 2006, XOMA (US) LLC entered into a five-year, $35.0 million term loan facility (the facility) with Goldman Sachs Specialty Lending Holdings Inc. (Goldman Sachs) and borrowed the full amount thereunder. The loan is guaranteed by the Company. Indebtedness under the facility will bear interest at an annual rate equal to six-month LIBOR plus 5.25%, which was 10.39% at September 30, 2007, and is secured by all rights to receive payments due XOMA (US) LLC relating to RAPTIVA® , LUCENTIS® and CIMZIA® and other assets of the Company. Payments received by XOMA (US) LLC in respect of these payment

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rights, in addition to a standing reserve of the next semi-annual interest payment, will be held in a custodial account which is classified as restricted cash. This cash account and the interest earned thereon can be used solely for the payment of the semi-annual interest amounts due in March and September of each year and, at that time, amounts in excess of the interest reserve requirement may be used to pay down principal or be distributed back to the Company, at the discretion of the lender. XOMA (US) LLC may prepay indebtedness under the facility at any time, subject to certain prepayment premiums. XOMA (US) LLC is required to comply with a debt covenant determined by the ratio of royalties collected to interest payable. Proceeds from the loan will be used for general corporate purposes.

At September 30, 2007, the outstanding principal amount under this loan totaled $30.3 million and related restricted cash was $1.6 million. Debt issuance costs of $1.5 million are being amortized over the five year life of the loan and are disclosed as current and long-term debt issuance costs on the balance sheet. For the three and nine months ended September 30, 2007, the Company incurred interest expense of $0.8 million and $2.6 million, respectively and amortization of debt issuance costs of $0.1 million and $0.4 million, respectively .

3. COLLABORATIVE AND OTHER ARRANGEMENTS

Pfizer

As of August 27, 2007, XOMA entered into a license agreement with Pfizer, Inc. (Pfizer) for non-exclusive, worldwide rights for XOMA s patented bacterial cell expression (BCE) technology for research (including phage display), development and manufacturing of antibody products. Under the terms of the agreement, XOMA received an initial license fee payment of $30 million and will receive milestone (licensee achievement based), royalty and other fees on future sales of all products subject to this license, including products currently in late-stage clinical development. The Company has no further obligations under the license agreement. As such, the $30.0 million was recorded as license fee revenue in the accompanying statement of operations.

Schering-Plough / AVEO

In April of 2006, XOMA entered into an agreement with AVEO Pharmaceuticals, Inc (AVEO) to utilize XOMA s HE technology to humanize AV-299 under which AVEO paid XOMA an up-front license fee and development milestones. Under this agreement XOMA created four HE versions of the original AV-299, all of which met design goals and from which AVEO selected one as its lead development candidate. In the future, AVEO will pay annual maintenance fees, additional development milestones and royalties.

In September of 2006, as a result of the successful humanization of AV-299, XOMA entered into a second agreement with AVEO to manufacture and supply AV-299, AVEO s novel anti-HGF antibody, in support of early clinical trials. Under the agreement, XOMA will create AV-299 production cell lines and conduct process and assay development as well as Good Manufacturing Practices (cGMP) manufacturing activities in support of AVEO s Investigational New Drug (IND) filing and early clinical trials. As between AVEO and XOMA, AVEO retains all development and commercialization rights to AV-299.

In April of 2007, Schering Corporation, acting through its Schering-Plough Research Institute division (SPRI), entered into a research, development and license agreement with AVEO concerning AV-299 and other anti-HGF molecules. In connection with the aforementioned license agreement, AVEO has assigned its entire right, title and interest in, to and under its manufacturing agreement with XOMA to SPRI.

Other

In July of 2007 the Company reached an agreement with a major collaborator to resolve its liability for material cost charges incurred pursuant to the collaboration arrangement. As a result, the Company reduced its research and development costs by $2.8 million included in the statement of operations for the three months ended September 30, 2007. Additionally, as of September 30, 2007, the Company eliminated an approximate $1.8 million liability carried on the balance sheet since December 31, 2006 and established a collaboration receivable balance of $1.0 million for the remaining balance related to the material cost charges liability resolution.

As of August 13, 2007, XOMA signed a restated and amended license agreement with an existing technology partner for non-exclusive, worldwide rights for XOMA s patented BCE technology for research (including phage display), development and manufacturing of antibody products. Under the terms of the agreement, XOMA received an initial license fee payment of $1.3 million and will receive milestone (licensee achievement based), royalty and other fees on future sales of all products subject to this license.

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The Company has no further obligations under the license agreement. As such, the $1.3 million was recorded as license fee revenue in the accompanying statement of operations.

4. CEO TRANSITION

On August 6, 2007, the Company announced that its Board of Directors had appointed Steven B. Engle as Chief Executive Officer and President and a member of the board of directors. Mr. Engle was also appointed Chairman of the Company s Board of Directors effective October 5, 2007. Mr. Engle most recently served as chairman and CEO of La Jolla Pharmaceutical Company. Mr. Engle succeeds Jack Castello, the company s former president and chief executive officer, who announced his intention to retire earlier this year. In the third quarter of 2007, the Company incurred a charge of approximately $0.9 million, or $0.01 per diluted share, primarily related to share-based compensation for the transition of the CEO position from Mr. Castello to Mr. Engle. This charge was recorded as general and administrative expense in the accompanying statement of operations.

5. INCOME TAXES

On January 1, 2007, the Company adopted FIN 48 which clarifies the accounting for uncertainty in income taxes recognized in the Company s financial statements in accordance with FAS 109 and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 did not have a material effect on the Company.

The Company files income tax returns in the U.S. federal jurisdiction, state of California and Ireland. The Company s federal income tax returns for tax years 2003 and beyond remain subject to examination by the Internal Revenue Service. The Company s California and Irish income tax returns for tax years 2002 and beyond remain subject to examination by the Franchise Tax Board and Irish Revenue. In connection with the adoption of FIN 48, the Company will recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense.

The Company anticipates losses for the year and as such no income tax provision for the current quarter or year has been provided. In addition, the Company continues to have substantial net operating loss carry forwards available to offset future taxable income for federal and state income tax purposes. The Company's ability to utilize its net operating losses may be limited due to changes in the Company's ownership as defined by Section 382 of the Internal Revenue Code.

6. LEGAL PROCEEDINGS, COMMITMENTS AND CONTINGENCIES

There were no developments material to XOMA in the United States Bankruptcy Court proceedings involving Aphton Corporation (described in XOMA s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2007) during the quarter ended September 30, 2007.

7. SUBSEQUENT EVENTS

On October 31, 2007, the Board of Directors of the Company (the Board), on the recommendation of its compensation committee, approved a company-wide grant to employees of additional options to purchase common shares. The purpose of the grant was to improve the level of employee ownership in the business by using existing share based option plans to bring the Company in line with competitive industry levels. All of these options have an exercise price of $3.67, a 10-year term and will become exercisable ratably over a four year period. Of the total of 6,635,000 options granted, 5,185,000 options were made subject to shareholder approval of a commensurate increase in the number of shares available for the grant of options under the Company s existing share option plans.

On October 31, 2007, the Board also approved, on the recommendation of its compensation committee, amendments to the Company s Management Incentive Compensation Plan (MICP), CEO Incentive Compensation Plan and Bonus Compensation Plan (collectively the Incentive Plans) to eliminate the provisions requiring payments to be made partly in common shares. Beginning with any awards for 2007, bonuses awarded under the Incentive Plans will be paid entirely in cash. The Board also approved a retroactive increase in the targets under the targets set forth in the MICP. As a result, the Company recorded an additional $0.4 million increase in accrued liabilities on the balance sheet as of September 30, 2007 and a related increase in compensation expense in the results of operations for the third quarter.

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

The accompanying discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements and the related disclosures, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates, assumptions and judgments that affect the reported amounts in our consolidated financial statements and accompanying notes. On an on-going basis, we evaluate our estimates, including those related to terms of research collaborations, investments, share compensation, impairment issues and the estimated useful life of assets and contingencies. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Results of Operations

Revenues

Total revenues were $43.1 million and $69.5 million for the three and nine months ended September 30, 2007, respectively, compared with $7.4 million and $20.5 million, for the same periods of 2006.

License and collaborative fees were $31.3 million and $35.9 million for the three and nine months ended September 30, 2007, respectively, compared with $0.6 million and $2.0 million for the same periods of 2006, respectively. These revenues include upfront payments related to the outlicensing of our products and technologies and other collaborative arrangements. The $33.9 million increase for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006 resulted primarily from the recognition of $30.0 million in license fees from Pfizer, Inc. (Pfizer) and $1.3 million in license fees from an existing technology partner in the third quarter of 2007 which represent initial license fee payments for which no remaining obligation of the Company exists. The contracts provide for milestone (licensee achievement based), royalty and other fees on future sales of all products subject to the agreements, including products currently in late-stage clinical development, the amounts and timing of which cannot currently be estimated.

An additional $4.3 million in revenue was recognized during the first quarter of 2007 from the $10.0 million upfront collaboration fee received in connection with our collaboration with Novartis AG (Novartis) in February of 2004. In February of 2007, we announced that pursuant to the terms of our collaboration agreement with Novartis, the mutual exclusivity obligation to conduct antibody discovery, development and commercialization work in oncology had ended. The expiration of this mutual obligation has no impact on the existing collaboration projects which have reached the development stage and the parties may continue to collaborate on a non-exclusive basis. Prior to the expiration of the exclusivity period, the upfront fee was being amortized over the expected five-year term of the exclusivity provision, or at a rate of $0.5 million a quarter.

Contract revenues were $7.4 million and $21.5 million for the three and nine months ended September 30, 2007, respectively, compared with $3.8 million and $11.6 million for the same periods of 2006, respectively. The increase of $3.6 million and $9.9 million, respectively, for the three and nine months ended September 30, 2007, resulted primarily from increased activities in our contracts with AVEO Pharmaceuticals, Inc. (AVEO), Schering Plough Research Institute (SPRI), Takeda Pharmaceutical Company Limited (Takeda) and our July 2006 contract with the National Institute of Allergy and Infectious Diseases (NIAID), a part of the National Institutes of Health, Department of Health and Human Services which is being funded with federal funds under Contract No. HHSN26620060008C/N01-A1-60008. This increase was partially offset by the completion of our contract, in October of 2006, with NIAID. The contract was entered into in March of 2005 and was 100% funded with federal funds from NIAID under Contract No. HHSN26620050004C.

Royalties were $4.4 million and $12.1 million for the three and nine months ended September 30, 2007, respectively, compared with $2.9 million and $6.9 million, for the same periods of 2006, respectively. The increase of $1.5 million and $5.2 million, respectively, for the three and nine months ended September 30, 2007, resulted primarily from LUCENTIS® royalties which began in June of 2006 and, to a lesser extent, increases in RAPTIVA® royalties earned under our royalty arrangements with Genentech.

Operating Costs and Expenses

Research and development expenses consist of direct and research-related allocated overhead costs such as salaries and related personnel costs, patents, materials and supplies in addition to costs related to clinical trials to validate our testing processes and

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procedures and related overhead expenses. Research and development expenses include independent research and development and costs associated with collaborative research and development as well as contract research and development arrangements. Research and development expenses were $14.6 million and $47.9 million for the three and nine months ended September 30, 2007, respectively, compared with $12.7 million and $37.0 million, for the same periods of 2006, respectively. The increase of $1.9 million and $10.9 million for the three and nine months ended September 30, 2007, respectively, primarily reflects an increase in spending for the development of XOMA 052, our collaborations with SPRI and Takeda, our July 2006 contract with NIAID and our contracts with AVEO and Taligen Therapeutics, Inc. (Taligen), partially offset by decreased spending on our March 2005 NIAID contract and our collaboration agreement with Novartis.

In July of 2007, we reached an agreement with a major collaborator regarding material cost charges previously recorded under the collaboration agreement of $2.8 million. The impact of the resolution caused a reduction in research and development costs in our results of operations for the three months ending September 30, 2007.

Our research and development activities can be divided into earlier stage programs, which include molecular biology, process development, pilot-scale production and preclinical testing, and later stage programs, which include clinical testing, regulatory affairs and manufacturing clinical supplies. The costs associated with these programs approximate the following (in thousands):

	Three Months Ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Earlier stage programs	$ 10,490	$ 11,211	$ 39,408	$ 30,255
Later stage programs	4,130	1,460	8,456	6,701
Total	$ 14,620	$ 12,671	$ 47,864	$ 36,956

Our research and development activities can also be divided into those related to our internal projects and those projects related to collaborative and contract arrangements. The costs related to internal projects versus collaborative and contract arrangements approximate the following (in thousands):

	Three Months Ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Internal projects	$ 12,090	$ 7,977	$ 33,867	$ 23,161
Collaborative and contract arrangements	2,530	4,694	13,997	13,795
Total	$ 14,620	$ 12,671	$ 47,864	$ 36,956

For the three months ended September 30, 2007, two development programs (AVEO and XOMA 052) accounted for more than 10% but less than 20%, and no development program accounted for more than 20% of our total research and development expenses. For the nine months ended September 30, 2007, two development programs (XOMA 052 and NIAID) accounted for more than 10% but less than 20% of our total research and development expenses, and no development program accounted for more than 20% of our total research and development expenses. For the three months ended September 30, 2006, two development programs (our Novartis collaboration and NIAID) accounted for more than 10% but less than 20% of our total research and development expenses, one development program (XOMA 052) accounted for more than 20% but less than 30% and no development program accounted for more than 30% of our total research and development expenses. For the nine months ended September 30, 2006, three development programs (our Novartis collaboration, NIAID, and XOMA 052) accounted for more than 10% but less than 20% of our total research and development expenses and no development program accounted for more than 20% of our total research and development expenses.

We currently anticipate that research and development expenses will continue to increase in 2007 as compared with 2006. We expect our spending on our oncology collaboration with Novartis and Lexicon Pharmaceuticals, Inc. (Lexicon) to continue at a level consistent with prior

periods as well as increases in spending on our collaborations with SPRI and Takeda, our contracts with NIAID, our development of XOMA 052, NEUPREX® and XOMA 629 and other new projects. Future research and development spending may also be impacted by potential new licensing or collaboration arrangements, as well as the termination of existing agreements. Beyond this, the scope and magnitude of future research and development expenses are difficult to predict at this time.

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General and administrative expenses include salaries and related personnel costs, facilities costs and professional fees. General and administrative expenses were $5.8 million and $15.1 million for the three and nine months ended September 30, 2007, respectively, compared with $4.2 million and $13.6 million for the same periods of 2006, respectively. The $1.5 million increase for the nine months ended September 30, 2007 primarily resulted from an increase in share-based expenses related to our CEO transition. Additionally, on October 31, 2007, the Board of Directors approved certain amendments to our Management Incentive Compensation Plan, CEO Incentive Compensation Plan and Bonus Compensation Plan (collectively Incentive Plans"). We expect this change to result in higher bonus related expenses in the fourth quarter.

Other Income (Expense)

Investment and interest income was $0.3 million and $1.3 million for the three and nine months ended September 30, 2007, respectively, compared with $0.3 million and $1.2 million for the same periods in 2006, respectively. Investment and interest income consists primarily of interest earned on our cash and investment balances.

Interest expense was $1.2 million and $10.4 million for the three and nine months ended September 30, 2007, respectively, compared with $1.7 million and $8.4 million, for the same periods in 2006, respectively. Interest expense for the three months ended September 30, 2007, consists of $0.8 million of interest expense on our Goldman Sachs Specialty Lending Holding Inc. (Goldman Sachs) loan, $0.1 million in amortization of debt issuance costs on Goldman Sachs loan and $0.4 million of interest expense on our note with Novartis. Interest expense for the nine months ended September 30, 2007, consists of $6.1 million from the revaluation of the embedded derivative related to the additional interest feature of our convertible debt, of which $5.2 million was paid in cash as a result of the limitation on shares available and the remainder in shares, $0.2 million of interest expense on our convertible debt, $0.4 million in net amortization of debt issuance costs, discount and premium on our convertible debt, $2.6 million of interest payable on our Goldman Sachs loan, $0.4 million in amortization of debt issuance costs on Goldman Sachs loan and $1.0 million of interest expense on our note with Novartis.

Interest expense for the three months ended September 30, 2006, consists of $0.2 million from the revaluation of the embedded derivative from our convertible debt, $0.9 million of interest expense on our convertible debt, $0.3 million in net amortization of debt issuance costs, discount and premium on our convertible debt and $0.3 million of interest expense on our note with Novartis. Interest expense for the nine months ended September 30, 2006, consists of $4.1 million from the revaluation of the embedded derivative from our convertible debt, $2.8 million of interest expense on our convertible debt, $0.8 million in net amortization of debt issuance costs, discount and premium on our convertible debt and $0.7 million of interest expense on our note with Novartis.

Accounting for Share-Based Compensation

Effective January 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123R), using the modified prospective transition method

During the three and nine months ended September 30, 2007, we recognized $1.0 million and $2.1 million, respectively, in share-based compensation expense, as compared to $0.2 million and $0.8 million, respectively, for the same period in 2006. At September 30, 2007, there was $5.0 million of unrecognized share-based compensation expense related to unvested shares with a weighted average remaining recognition period of 3.3 years.

Income Taxes

On January 1, 2007, we adopted Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), an interpretation of FASB Statement No. 109, Accounting for Income Taxes (FAS 109), which clarifies the accounting for uncertainty in income taxes recognized in our financial statements in accordance with FAS 109 and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 did not have a material effect on us.

We file income tax returns in the U.S. federal jurisdiction, state of California and Ireland. Our federal income tax returns for tax years 2003 and beyond remain subject to examination by the Internal Revenue Service. Our California and Irish income tax returns for tax years 2002 and beyond remain subject to examination by the Franchise Tax Board and Irish Revenue. In connection with the adoption of FIN 48, we will recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense.

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We anticipate losses for the year and as such no income tax provision for the current quarter or year has been provided. In addition, we continue to have substantial net operating loss carry forwards available to offset future taxable income for federal and state income tax purposes. Our ability to utilize net operating losses may be limited due to changes in ownership as defined by Section 382 of the Internal Revenue Code.

Liquidity and Capital Resources

Cash, cash equivalents and short-term investments at September 30, 2007, was $47.6 million compared with $46.4 million at December 31, 2006. The $1.2 million increase includes cash provided by operating activities of $7.4 million, the transfer of $2.7 million from restricted cash and a draw on the Novartis loan of $2.0 million offset by cash used for $4.7 million in principal payments on our Goldman Sachs term loan and cash used in the purchase of fixed assets of $6.5 million.

Net cash provided by operating activities was $7.4 million for the nine months ended September 30, 2007, compared with net cash used by operations of $28.6 million for the same period in 2006.

Cash provided by operations for the nine months ended September 30, 2007, consisted of a net loss of $2.4 million with non-cash addbacks for the revaluation of our embedded derivative of $6.1 million, depreciation and amortization of $4.6 million, equity share-based compensation of $1.3 million, and an increase in the amortization of debt issuance costs and the premium or discount on convertible notes of $0.5 million, as well as a net increase in liabilities of $3.2 million, a net decrease in assets of $2.2 million which was partially offset by cash payments for the additional interest feature of our convertible debt of $5.2 million and $0.8 million of accrued interest on convertible debt and other interest bearing obligations. During the nine months ended September 30, 2007, we made payments of $6.6 million for interest on our convertible debt, $2.9 million for interest on our Goldman Sachs term loan, $1.0 million for interest on our note with Novartis and $1.0 million for our Management Incentive Compensation Plan (MICP), which is paid in March of each year.

Cash used in operations for the nine months ended September 30, 2006, consisted of a net loss of $37.4 million with non-cash addbacks for the revaluation of our embedded derivative of $4.1 million, depreciation and amortization of $4.5 million, equity related compensation of $1.9 million partially offset by a decrease in accrued interest of $0.3 million and an increase in assets of $1.6 million. During the nine months ended September 30, 2006, we made payments of $2.7 million for debt issuance costs on our convertible debt of which $2.0 million affected cash from operations, $3.7 million for interest on our convertible debt and $1.1 million for our MICP, which is paid in March of each year.

Net cash provided by investing activities for the nine months ended September 30, 2007, was $8.7 million compared with $3.0 million provided by investing activities for the nine months ended September 30, 2006. The $5.7 million increase in cash flows for 2007 compared with 2006 reflected an increase in sales, net of purchases, of investments of $2.7 million, a $0.3 million reduction in purchases of property and equipment and a transfer from restricted cash of $2.7 million.

Net cash used in financing activities for the nine months ended September 30, 2007, was $2.3 million compared with net cash provided by financing activities of $15.3 million for the nine months ended September 30, 2006. Cash activity in 2007 included $4.7 million in principal pay down of the Goldman Sachs term loan in 2007 offset by $2.0 million of additional draw on the Novartis note and $0.4 million in proceeds from the issuance of common shares. Financing activities for the nine months ended September 30, 2006, consisted of $12.5 million in proceeds from the issuance of convertible notes and long-term debt, offset by $0.5 million in debt issuance costs, a $3.0 million advance on our line of credit with Novartis and $0.4 million in proceeds from the issuance of common shares. The $17.7 million decrease in cash is primarily related to the issuance of convertible notes in 2006.

On November 9, 2006, we entered into a five-year, $35.0 million term loan facility (the facility) with Goldman Sachs and borrowed the full amount thereunder. The loan was made to XOMA (US) LLC and is guaranteed by XOMA. Indebtedness under the facility bears interest at an annual rate equal to six-month LIBOR plus 5.25%, which was 10.39% at September 30, 2007, and is secured by all rights to receive payments due XOMA (US) LLC relating to RAPTIVA®, LUCENTIS® and CIMZIA® and other assets. Payments received by XOMA (US) LLC in respect of these payment rights, in addition to a standing reserve of the next semi-annual interest payment, will be held in a custodial account which is classified as restricted cash. This cash account and the interest earned thereon can be used solely for the payment of the interest amounts in March and September of each year and, at that time, amounts in excess of the interest reserve requirement may be used to pay down principal or be distributed back to us, at the discretion of the lender. XOMA (US) LLC may prepay indebtedness under the facility at any time, subject to certain prepayment premiums. XOMA (US) LLC is required to comply with a debt covenant determined by the ratio of royalties collected to interest payable. Proceeds from the loan will be used for general corporate purposes.

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At September 30, 2007, the outstanding principal amount under this loan totaled $30.3 million and the balance in restricted cash was $1.6 million. Debt issuance costs of $1.5 million are being amortized on a straight-line basis over the five year life of the loan and are disclosed as current and long-term debt issuance costs on the balance sheet. For the nine months ended September 30, 2007, the lender took down $4.7 million in principal and we incurred interest expense payable of $2.6 million and amortization of debt issuance costs of $0.4 million.

In February of 2006, we completed an exchange offer with holders of our 6.5% convertible senior notes due 2012 in which we exchanged $60.0 million aggregate principal amount of our new 6.5% Convertible SNAPs$_{SM}$ due 2012 (the New Notes) for all $60.0 million aggregate principal amount of our then outstanding convertible senior notes due 2012. We also issued an additional $12.0 million of New Notes to the public for cash at a public offering price of 104% of principal, or $12.5 million. The New Notes were initially convertible into approximately 38.4 million common shares at a conversion rate of 533.4756 of common shares per $1,000 principal amount of New Notes, which is equivalent to a conversion price of approximately $1.87 per common share. In addition, we were able to automatically convert some or all of the New Notes on or prior to the maturity date if the closing price of our common shares has exceeded 150% of the conversion price then in effect for at least 20 trading days during any consecutive 30 trading day period ending within five trading days prior to the notice of auto-conversion. If we elected to automatically convert, or if holders elected to voluntarily convert, some or all of the New Notes on or prior to February 10, 2010, we were required to pay or provide for additional interest equal to four years worth of interest less any interest paid or provided for, on the principal amount so converted, prior to the date of conversion. Additional interest could be paid in cash or, solely at our option and subject to certain limitations, in our common shares valued at the conversion price then in effect.

We separately accounted for the additional interest payment feature of the New Notes as an embedded derivative instrument, which was measured at fair value and classified on the balance sheet with the convertible debt. Changes in the fair value of the embedded derivative were recognized in earnings as a component of other income (expense). The initial fair value of the derivative was subtracted from the carrying value of the debt, reflected as a debt discount, which was amortized as interest expense using the effective interest method through the date the notes were scheduled to mature, and separately reported as a derivative liability.

The additional New Notes were issued to the initial purchasers for net proceeds of $11.8 million. Debt issuance costs related to the New Notes of approximately $0.7 million were being amortized on a straight-line basis over the original 72 month life of the notes. Additional debt issuance costs of $2.0 million, related to the modification of the existing debt, were expensed as incurred with $1.1 million and $0.9 million expensed during the quarters ended March 31, 2006 and December 31, 2005, respectively.

At the time of note conversion, unamortized discount, premium and debt issuance costs related to the converted notes was charged to shareholder s equity.

During the first quarter of 2007, $42.0 million of New Notes were voluntarily converted by holders through March 7, 2007, at which time we announced that we had elected to automatically convert 100% of the remaining $2.5 million of New Notes outstanding. As a result, during the quarter 25,640,187 shares were issued to effect the conversion of the principal balances. Additionally, we issued 1,889,317 shares and $5.2 million in cash to satisfy the remaining additional interest payment feature related to these converted New Notes. We recorded a $6.1 million charge to interest expense during the quarter ended March 31, 2007 as a result of the revaluation of the embedded derivative related to the additional interest feature of the convertible notes.

For the three months ended September 30, 2006, $20,000 of New Notes were converted into 13,097 common shares including 2,427 shares related to the additional interest payment feature of the notes. We recorded a $176,000 charge to interest expense during the quarter ended September 30, 2006, as a result of an increase in the fair value of the embedded derivative on our convertible debt including $2,000 related to converted notes.

For the nine months ended September 30, 2006, $15.5 million of New Notes were converted into 10,398,267 shares of common shares including 2,145,398 shares related to the additional interest payment feature of the notes. We recorded $4.1 million in interest expense during the nine months ended September 30, 2006, as a result of an increase in the fair value of the embedded derivative on our convertible debt including $2.7 million related to the converted notes.

For the three months ended September 30, 2007 and 2006, we incurred $0 and $0.9 million, respectively, in interest expense payable on our convertible debt. For the nine months ended September 30, 2007 and 2006, we incurred $0.2 million and $2.8 million, respectively, in interest expense payable on our convertible debt. Interest expense was payable on a semi-annual basis. Additionally, we amortized a net of nil and $0.3 million, respectively, in debt issuance costs, premium and discount for the three and nine months ended September 30, 2007, and amortized $0.3 million and $0.7 million, respectively, in debt issuance costs, premium and discount for the same periods in 2006.

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We expect our cash, cash equivalents and short-term investments to decrease during 2007 as a result of the use of cash to fund ongoing operations and capital investments. Additional licensing, antibody discovery collaboration agreements and debt financing arrangements may positively impact our cash balances.

Based on current spending levels, anticipated revenues, collaborator funding, proceeds from our November 2006 term loan and other sources of funding we believe to be available, we estimate that we have sufficient cash resources to meet our anticipated net cash needs through at least 2008. Any significant revenue shortfalls, increases in planned spending on development programs or more rapid progress of development programs than anticipated, as well as the unavailability of anticipated sources of funding, could shorten this period. Progress or setbacks by potentially competing products may also affect our ability to raise new funding on acceptable terms. For a further discussion of the risks related to our business and their effects on our cash flow and ability to raise new funding on acceptable terms, see Risk Factors included in Item 1A.

Critical Accounting Policies

Critical accounting policies are those that require significant judgment and/or estimates by management at the time that the financial statements are prepared such that materially different results might have been reported if other assumptions had been made. We consider certain accounting policies related to revenue recognition and recognition of research and development expenses to be critical policies. There have been no significant changes in our critical accounting policies during the nine months ended September 30, 2007, except as noted below, as compared with those previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2006, filed with the SEC on March 8, 2007.

Income Taxes

We account for uncertain tax positions in accordance with FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), an interpretation of FASB Statement No. 109, Accounting for Income Taxes (FAS 109). The application of income tax law and regulations are inherently complex. Interpretations of and guidance surrounding income tax laws and regulations change over time. As such, changes in our subjective assumptions and judgments can materially affect amounts recognized in the consolidated balance sheets and statements of income.

Recent Accounting Pronouncements

In February of 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. If the use of fair value is elected, any upfront costs and fees related to the item must be recognized in earnings and cannot be deferred, e.g., debt issuance costs. The fair value election is irrevocable and generally made on an instrument by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. At the adoption date, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, and is required to be adopted by us in the first quarter of fiscal 2008. We are currently determining whether fair value accounting is appropriate for any of its eligible items and cannot estimate the impact, if any, which SFAS 159 will have on our consolidated results of operations and financial condition.

Subsequent Events

On October 31, 2007, our Board of Directors of the Company (the Board), on the recommendation of its compensation committee, approved a company-wide grant to employees of additional options to purchase common shares. The purpose of the grant was to improve the level of employee ownership in the business by using our existing share based option plans to bring us in line with competitive industry levels. All of these options have an exercise price of $3.67, a 10-year term and will become exercisable ratably over a four-year period. Of the total 6,635,000 options granted, 5,185,000 options were made subject to shareholder approval of a commensurate increase in the number of shares available for the grant of options under our existing share option plans.

On October 31, 2007, the Board also approved, on the recommendation of its compensation committee, amendments to our Incentive Plans to eliminate the provisions requiring payments to be made partly in common shares. Beginning with any awards for 2007, bonuses awarded under the Incentive Plans will be paid entirely in cash. The Board also approved a retroactive increase in the targets set forth in the MICP. As a result, we recorded an additional $0.4 million increase in accrued liabilities on the balance sheet as of September 30, 2007 and a related increase in compensation expense in the results of operations for the third quarter.

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Forward-Looking Information and Cautionary Factors That May Affect Future Results

Certain statements contained herein related to the sufficiency of our cash resources, levels of future revenues, losses, expenses and cash, future sales of approved products, as well as other statements related to current plans for product development and existing and potential collaborative and licensing relationships, or that otherwise relate to future periods, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements are based on assumptions that may not prove accurate. Actual results could differ materially from those anticipated due to certain risks inherent in the biotechnology industry and for companies engaged in the development of new products in a regulated market. Among other things, the period for which our cash resources are sufficient could be shortened if expenditures are made earlier or in larger amounts than anticipated or are unanticipated, if anticipated revenues or cost sharing arrangements do not materialize, if funds are not otherwise available on acceptable terms; revenue levels may be other than as expected if sales of approved products are lower than expected; losses may be other than as expected for any of the reasons affecting revenues and expenses; expense levels and cash utilization may be other than as expected due to unanticipated changes in our research and development programs; and the sales efforts for approved products may not be successful if the parties responsible for marketing and sales fail to meet their commercialization goals, due to the strength of the competition, if physicians do not adopt the product as treatment for their patients or if remaining regulatory approvals are not obtained. These and other risks, including those related to the results of pre-clinical testing; the timing or results of pending and future clinical trials (including the design and progress of clinical trials; safety and efficacy of the products being tested; action, inaction or delay by the United States Food and Drug Administration (FDA), European or other regulators or their advisory bodies; and analysis or interpretation by, or submission to, these entities or others of scientific data); changes in the status of existing collaborative relationships; the ability of collaborators and other partners to meet their obligations; our ability to meet the demand of the United States government agency with which we have entered our first government contract; competition; market demands for products; scale-up and marketing capabilities; availability of additional licensing or collaboration opportunities; international operations; share price volatility; our financing needs and opportunities; uncertainties regarding the status of biotechnology patents; uncertainties as to the costs of protecting intellectual property; and risks associated with our status as a Bermuda company, are described in more detail in Item 1A Risk Factors .

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio and our loan facilities. By policy, we make our investments in high quality debt securities, limit the amount of credit exposure to any one issuer, limit duration by restricting the term of the instrument and typically hold investments to maturity. We do not invest in derivative financial instruments.

In November of 2006, we entered into a five-year senior term loan facility in the aggregate amount of $35.0 million with the principal due at maturity. As of September 30, 2007, $30.3 million was outstanding under this facility. Interest on the facility will be at a rate of USD six month LIBOR plus 5.25%, which was 10.39% at September 30, 2007.

In February of 2005, we issued $60.0 million of 6.5% convertible senior notes due 2012. In February of 2006, we completed an exchange offer for all $60.0 million of our 6.5% convertible senior notes due 2012 for $60.0 million of 6.5% convertible $SNAPs_{SM}$ due 2012 (the New Notes) and issued an additional $12.0 million of New Notes to the public for cash. The interest rate and amount of principal of the previously outstanding notes and the New Notes were fixed. The New Notes included an additional interest feature which was accounted for as an embedded derivative which was measured at fair value. Changes in the fair value of the embedded derivative were recognized in earnings as interest expense. As of September 30, 2007, all of these notes had been converted into common shares.

As of September 30, 2007, we have drawn down $18.9 million against the Novartis $50.0 million loan facility that is due in 2015 at an interest rate of USD six month LIBOR plus 2% which was 7.39% at September 30, 2007.

We estimate that a hypothetical 100 basis point change in interest rates could increase or decrease our interest expense by approximately $499,000 on an annualized basis.

We hold interest-bearing instruments that are classified as cash, cash equivalents and short-term investments. Fluctuations in interest rates can affect the principal values and yields of fixed income investments. If interest rates in the general economy were to

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rise rapidly in a short period of time, our fixed income investments could lose value. The following table presents the amounts and related weighted interest rates of our cash and investments at September 30, 2007 and December 31, 2006, (in thousands, except interest rate):

	Maturity	Carrying Amount (in thousands)	Fair Value (in thousands)	Average Interest Rate
September 30, 2007				
Cash and cash equivalents	Daily to 90 days	$ 41,770	$ 41,770	4.75%
Short-term investments	91 days to less than 18 months	5,868	5,868	5.24%
December 31, 2006				
Cash and cash equivalents	Daily to 90 days	$ 28,002	$ 28,002	4.91%
Short-term investments	91 days to less than 1 year	18,392	18,381	4.30%

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Controls and Procedures

Under the supervision and with the participation of our management, including our Chairman of the Board, President and Chief Executive Officer and our Vice President, Finance and Chief Financial Officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based on this evaluation, our Chairman of the Board and Chief Executive Officer and our Vice President, Finance and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of the end of the period covered by this report in timely alerting them to material information relating to us and our consolidated subsidiaries required to be included in our periodic SEC filings.

Changes in Internal Control

There have been no changes in our internal controls over financial reporting during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

There were no developments material to XOMA in the United States Bankruptcy Court proceedings involving Aphton Corporation (described in XOMA s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2007) during the quarter ended September 30, 2007.

ITEM 1a. RISK FACTORS

The following risk factors and other information included in this quarterly report should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us also may impair our business operations. If any of the following risks occur, our business, financial condition, operating results and cash flows could be materially adversely affected.

Our present and future revenues rely significantly on sales of products marketed and sold by others.

Currently, our revenues rely significantly upon sales of RAPTIVA® and LUCENTIS®, in which we have only royalty interests. RAPTIVA® was approved by the FDA on October 27, 2003, for the treatment of chronic moderate-to-severe plaque psoriasis in adults who are candidates for systemic therapy or phototherapy. Genentech and Merck Serono S.A. (previously Serono, S.A.) (Serono), Genentech s international marketing partner for RAPTIVA®, are responsible for the marketing and sales effort in support of this

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product. In September of 2004, Serono announced that RAPTIVA® had received approval for use in the European Union and the product was launched in several European Union countries in the fourth quarter of 2004. LUCENTIS® was approved by the FDA on June 30, 2006, and in the European Union in January of 2007, for the treatment of age-related macular degeneration. Genentech and Novartis, Genentech s international marketing partner for LUCENTIS®, are responsible for the marketing and sales effort in support of this product. We have no role in marketing and sales efforts, and Genentech, Serono and Novartis do not have an express contractual obligation to us regarding the marketing or sales of RAPTIVA® or LUCENTIS®.

Under our current arrangements with Genentech, we are entitled to receive royalties on worldwide sales of RAPTIVA® and LUCENTIS®. Successful commercialization of these products is subject to a number of risks, including, but not limited to:

- Genentech s, Serono s and Novartis willingness and ability to implement their marketing and sales effort and achieve sales;
- the strength of competition from other products being marketed or developed to treat psoriasis and age-related macular degeneration;
- the occurrence of adverse events which may give rise to safety concerns;
- physicians and patients acceptance of RAPTIVA® as a treatment for psoriasis and LUCENTIS® as a treatment for age-related macular degeneration;
- Genentech s ability to provide manufacturing capacity to meet demand for the products; and
- pricing and reimbursement issues.

According to Genentech, United States sales of RAPTIVA® for the first nine months of 2007 were $80 million, compared with $66 million for the first nine months of 2006. According to Merck Serono, sales of RAPTIVA® outside of the United States for the first nine months of 2007 were $78 million, compared with $49 million for the first nine months of 2006. According to Genentech, United States sales of LUCENTIS® were $618 million for the first nine months of 2007, compared with $163 million for the first nine months of 2006. According to Novartis, sales of LUCENTIS® outside of the United States for the first nine months of 2007 were $222 million, compared with $6 million for the first nine months of 2006. LUCENTIS® sales began on June 30, 2006, upon its approval by regulatory agencies. Given our current reliance on RAPTIVA® and LUCENTIS® as principal sources of our revenues, any material adverse developments with respect to the commercialization of RAPTIVA® or LUCENTIS® may cause our revenues to decrease and may cause us to incur losses in the future.

Because our products are still being developed, we will require substantial funds to continue; we cannot be certain that funds will be available and, if they are not available, we may have to take actions which could adversely affect your investment.

If adequate funds are not available, we may have to raise additional funds in a manner that may dilute or otherwise adversely affect the rights of existing shareholders, curtail or cease operations, or file for bankruptcy protection in extreme circumstances. We have spent, and we expect to continue to spend, substantial funds in connection with:

- research and development relating to our products and production technologies,
- enhancement of our production capabilities,

various human clinical trials, and

protection of our intellectual property.

Based on current spending levels, anticipated revenues, collaborator funding, proceeds from our convertible note offerings in February of 2005 and February of 2006, proceeds from our November 2006 term loan and other sources of funding we believe to be available, we estimate that we have sufficient cash resources to meet our anticipated net cash needs through at least 2008. Any significant revenue shortfalls, increases in planned spending on development programs or more rapid progress of development programs than anticipated, as well as the unavailability of anticipated sources of funding, could shorten this period. Progress or setbacks by potentially competing products may also affect our ability to raise new funding on acceptable terms. As a result, we do not know when or whether:

operations will generate meaningful funds,

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additional agreements for product development funding can be reached,

strategic alliances can be negotiated, or

adequate additional financing will be available for us to finance our own development on acceptable terms, or at all.

Cash balances and operating cash flow are influenced primarily by the timing and level of payments by our licensees and development partners, as well as by our operating costs.

Our level of leverage and debt service obligations could adversely affect our financial condition.

As of September 30, 2007, we (including our subsidiaries) had approximately $49.2 million of indebtedness outstanding. We may not be able to generate cash sufficient to pay the principal of, interest on and other amounts due in respect of our indebtedness when due. We and our subsidiaries may also incur additional debt that may be secured. In connection with our collaboration with Novartis, Novartis has extended a line of credit to us (through our U.S. subsidiary) for $50.0 million to fund up to 75% of our expenses thereunder, of which $18.9 million was drawn as of September 30, 2007. This line of credit is secured by a pledge of our interest in the collaboration. On November 9, 2006, XOMA (US) LLC entered into a five-year, $35.0 million term loan facility with Goldman Sachs and borrowed the full amount thereunder. As of September 30, 2007, $30.3 million was outstanding under this facility. The loan is guaranteed by XOMA and is secured by the payment rights due to XOMA (US) LLC relating to RAPTIVA®, LUCENTIS® and CIMZIA®. As a result, these assets will not be available to XOMA or any other lender to secure future indebtedness.

Our level of debt and debt service obligations could have important effects on us and our investors. These effects may include:

making it more difficult for us to satisfy our obligations with respect to our debt;

limiting our ability to obtain additional financing or renew existing financing at maturity on satisfactory terms to fund our working capital requirements, capital expenditures, acquisitions, investments, debt service requirements and other general corporate requirements;

increasing our vulnerability to general economic downturns, competition and industry conditions, which could place us at a competitive disadvantage compared with our competitors that are less leveraged;

increasing our exposure to rising interest rates to the extent any of our borrowings are at variable interest rates;

reducing the availability of our cash flow to fund our working capital requirements, capital expenditures, acquisitions, investments and other general corporate requirements because we will be required to use a substantial portion of our cash flow to service debt obligations; and

limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate.

Our ability to satisfy our debt obligations will depend upon our future operating performance and the availability of refinancing debt. If we are unable to service our debt and fund our business, we may be forced to reduce or delay capital expenditures, seek additional debt financing or equity capital, restructure or refinance our debt or sell assets. We cannot assure you that we would be able to obtain additional financing, refinance existing debt or sell assets on satisfactory terms or at all.

Most of our therapeutic products have not received regulatory approval. If these products do not receive regulatory approval, neither our third party collaborators nor we will be able to manufacture and market them.

Our products cannot be manufactured and marketed in the United States and other countries without required regulatory approvals. The United States government and governments of other countries extensively regulate many aspects of our products, including:

- testing,

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manufacturing,

promotion and marketing, and

exporting.

In the United States, the FDA regulates pharmaceutical products under the Federal Food, Drug, and Cosmetic Act and other laws, including, in the case of biologics, the Public Health Service Act. At the present time, we believe that most of our products will be regulated by the FDA as therapeutic biologics. Initiation of clinical trials requires approval by health authorities. Clinical trials involve the administration of the investigational new drug to healthy volunteers or to patients under the supervision of a qualified principal investigator. Clinical trials must be conducted in accordance with FDA and International Conference on Harmonisation of Technical Requirements for Registration of Pharmaceuticals for Human Use (ICH) Good Clinical Practices and the European Clinical Trials Directive under protocols that detail the objectives of the study, the parameters to be used to monitor safety and the efficacy criteria to be evaluated. Other national, foreign and local regulations may also apply. The developer of the drug must provide information relating to the characterization and controls of the product before administration to the patients participating in the clinical trials. This requires developing approved assays of the product to test before administration to the patient and during the conduct of the trial. In addition, developers of pharmaceutical products must provide periodic data regarding clinical trials to the FDA and other health authorities, and these health authorities may issue a clinical hold upon a trial if they do not believe, or cannot confirm, that the trial can be conducted without unreasonable risk to the trial participants. We cannot assure you that U.S. and foreign health authorities will not issue a clinical hold with respect to any of our clinical trials in the future.

The results of the preclinical studies and clinical testing, together with chemistry, manufacturing and controls information, are submitted to the FDA and other health authorities in the form of a new drug application for a pharmaceutical product, and in the form of a biologics license application for a biological product, requesting approval to commence commercial sales. In responding to a new drug application or an antibody license application, the FDA or foreign health authorities may grant marketing approvals, request additional information or further research, or deny the application if it determines that the application does not satisfy its regulatory approval criteria. Regulatory approval of a new drug application, biologics license application, or supplement is never guaranteed, and the approval process can take several years and is extremely expensive. The FDA and foreign health authorities have substantial discretion in the drug and biologics approval processes. Despite the time and expense incurred, failure can occur at any stage, and we could encounter problems that cause us to abandon clinical trials or to repeat or perform additional preclinical, clinical or manufacturing-related studies.

Changes in the regulatory approval policy during the development period, changes in, or the enactment of additional regulations or statutes, or changes in regulatory review for each submitted product application may cause delays in the approval or rejection of an application. Even if the FDA or other regulatory agency approves a product candidate, the approval may impose significant restrictions on the indicated uses, conditions for use, labeling, advertising, promotion, marketing and/or production of such product. Even for approved products such as RAPTIVA® and LUCENTIS®, the FDA may impose ongoing requirements for post-approval studies, including additional research and development and clinical trials, and may subsequently withdraw approval based on these additional trials. The FDA and other agencies also may impose various civil or criminal sanctions for failure to comply with regulatory requirements, including withdrawal of product approval. State regulations may also affect our proposed products. The FDA has substantial discretion in both the product approval process and manufacturing facility approval process and, as a result of this discretion and uncertainties about outcomes of testing, we cannot predict at what point, or whether, the FDA will be satisfied with our or our collaborators submissions or whether the FDA will raise questions which may be material and delay or preclude product approval or manufacturing facility approval. As we accumulate additional clinical data, we will submit it to the FDA, which may have a material impact on the FDA product approval process.

We face uncertain results of clinical trials of our potential products.

Our potential products will require significant additional research and development, extensive preclinical studies and clinical trials and regulatory approval prior to any commercial sales. This process is lengthy and expensive, often taking a number of years. As clinical results are frequently susceptible to varying interpretations that may delay, limit or prevent regulatory approvals, the length of time necessary to complete clinical trials and to submit an application for marketing approval for a final decision by a regulatory authority varies significantly. As a result, it is uncertain whether:

our future filings will be delayed,

our preclinical and clinical studies will be successful,

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we will be successful in generating viable product candidates to targets,

we will be able to provide necessary additional data,

results of future clinical trials will justify further development, or

we will ultimately achieve regulatory approval for any of these products.

For example,

In 1996, in conjunction with Genentech, we began testing RAPTIVA® in patients with moderate-to-severe plaque psoriasis. In April of 2002, we announced with Genentech that a pharmacokinetic study conducted on RAPTIVA® comparing XOMA-produced material and Genentech-produced material did not achieve the pre-defined statistical definition of comparability, and the FDA requested that another Phase III study be completed before the filing of a Biologics License Application for RAPTIVA®, delaying the filing beyond the previously-planned time frame of the summer of 2002. In March of 2003, we announced completion of enrollment in a Phase II study of RAPTIVA® in patients suffering from rheumatoid arthritis. In May of 2003, Genentech and we announced our decision to terminate Phase II testing of RAPTIVA® in patients suffering from rheumatoid arthritis based on an evaluation by an independent Data Safety Monitoring Board that suggested no overall net clinical benefit in patients receiving the study drug. We also completed enrollment in a Phase II study of RAPTIVA® as a possible treatment for patients with psoriatic arthritis. In March of 2004, we announced that the study did not reach statistical significance.

In December of 1992, we began human testing of our NEUPREX® product, a genetically engineered fragment of a particular human protein, and licensed certain worldwide rights to Baxter Healthcare Corporation (Baxter) in January of 2000. In April of 2000, members of the FDA and representatives of XOMA and Baxter discussed results from the Phase III trial that tested NEUPREX® in pediatric patients with a potentially deadly bacterial infection called meningococcemia, and senior representatives of the FDA indicated that the data presented were not sufficient to support the filing of an application for marketing approval at that time.

In 2003, we completed two Phase I trials of XMP.629, a BPI-derived topical peptide compound targeting acne, evaluating the safety, skin irritation and pharmacokinetics. In January of 2004, we announced the initiation of Phase II clinical testing in patients with mild-to-moderate acne. In August of 2004, we announced the results of a Phase II trial with XMP.629 gel. The results were inconclusive in terms of clinical benefit of XMP.629 compared with vehicle gel.

The timing of the commencement, continuation and completion of clinical trials may be subject to significant delays relating to various causes, including scheduling conflicts with participating clinicians and clinical institutions, difficulties in identifying and enrolling patients who meet trial eligibility criteria, and shortages of available drug supply. Patient enrollment is a function of many factors, including the size of the patient population, the proximity of patients to clinical sites, the eligibility criteria for the trial, the existence of competing clinical trials and the availability of alternative or new treatments. In addition, we will conduct clinical trials in foreign countries in the future which may subject us to further delays and expenses as a result of increased drug shipment costs, additional regulatory requirements and the engagement of foreign clinical research organizations, as well as expose us to risks associated with foreign currency transactions insofar as we might desire to use U.S. dollars to make contract payments denominated in the foreign currency where the trial is being conducted.

All of our products are prone to the risks of failure inherent in drug development. Preclinical studies may not yield results that would satisfactorily support the filing of an IND (or a foreign equivalent) with respect to our potential products. Even if these applications would be or have been filed with respect to our products, the results of preclinical studies do not necessarily predict the results of clinical trials. Similarly, early-stage clinical trials in healthy volunteers do not predict the results of later-stage clinical trials, including the safety and efficacy profiles of any particular products. In addition, there can be no assurance that the design of our clinical trials is focused on appropriate indications, patient populations, dosing regimens or other variables which will result in obtaining the desired efficacy data to support regulatory approval to commercialize the drug. Preclinical and clinical data can be interpreted in different ways. Accordingly, FDA officials or officials from foreign regulatory authorities could interpret the data in different ways than we or our partners do, which could delay, limit or prevent regulatory approval.

Administering any of our products or potential products may produce undesirable side effects, also known as adverse effects. Toxicities and adverse effects that we have observed in preclinical studies for some compounds in a particular research and development program may occur in preclinical studies or clinical trials of other compounds from the same program. Such toxicities or adverse effects could delay or prevent the filing of an IND (or a foreign equivalent) with respect to such products or potential products

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or cause us to cease clinical trials with respect to any drug candidate. In clinical trials, administering any of our products to humans may produce adverse effects. These adverse effects could interrupt, delay or halt clinical trials of our products and could result in the FDA or other regulatory authorities denying approval of our products for any or all targeted indications. The FDA, other regulatory authorities, our partners or we may suspend or terminate clinical trials at any time. Even if one or more of our products were approved for sale, the occurrence of even a limited number of toxicities or adverse effects when used in large populations may cause the FDA to impose restrictions on, or stop, the further marketing of such drugs. Indications of potential adverse effects or toxicities which may occur in clinical trials and which we believe are not significant during the course of such clinical trials may later turn out to actually constitute serious adverse effects or toxicities when a drug has been used in large populations or for extended periods of time. Any failure or significant delay in completing preclinical studies or clinical trials for our products, or in receiving and maintaining regulatory approval for the sale of any drugs resulting from our products, may severely harm our reputation and business.

Given that regulatory review is an interactive and continuous process, we maintain a policy of limiting announcements and comments upon the specific details of regulatory review of our products, subject to our obligations under the securities laws, until definitive action is taken.

Because all of our products are still being developed, we have sustained losses in the past and we expect to sustain losses in the future.

We have experienced significant losses and, as of September 30, 2007, we had an accumulated deficit of $730.0 million.

For the nine months ended September 30, 2007, we had a net loss of approximately $2.4 million or $0.02 per common share (basic and diluted). For the year ended December 31, 2006, we had net loss of approximately $51.8 million or $0.54 per common share (basic and diluted).

Our ability to achieve profitability is dependent in large part on the success of our development programs, obtaining regulatory approval for our products and entering into new agreements for product development, manufacturing and commercialization, all of which are uncertain. Our ability to fund our ongoing operations is dependent on the foregoing factors and on our ability to secure additional funds. Because our products are still being developed, we do not know whether we will ever achieve sustained profitability or whether cash flow from future operations will be sufficient to meet our needs.

Our agreements with third parties, many of which are significant to our business, expose us to numerous risks.

Our financial resources and our marketing experience and expertise are limited. Consequently, our ability to successfully develop products depends, to a large extent, upon securing the financial resources and/or marketing capabilities of third parties.

In April of 1996, we entered into an agreement with Genentech whereby we agreed to co-develop Genentech s humanized monoclonal antibody product RAPTIVA®. In April of 1999, March of 2003, and January of 2005, the companies amended the agreement. In October of 2003, RAPTIVA® was approved by the FDA for the treatment of adults with chronic moderate-to-severe plaque psoriasis who are candidates for systemic therapy or phototherapy and, in September of 2004, Serono announced the product s approval in the European Union. In January of 2005, we entered into a restructuring of our collaboration agreement with Genentech which ended our existing cost and profit sharing arrangement related to RAPTIVA® in the United States and entitles us to a royalty interest on worldwide net sales.

In November of 2001, we entered into collaboration with Millennium to develop two of Millennium s products for certain vascular inflammation indications. In October of 2003, we announced that we had discontinued one of these products, MLN2201. In December of 2003, we announced the initiation of Phase I testing on the other product, MLN2222. As of May 2006, we completed the transfer of the data from the Phase I study to Millennium as per our amended agreement.

In March of 2004, we announced we had agreed to collaborate with Chiron Corporation (now Novartis) for the development and commercialization of antibody products for the treatment of cancer. Under the terms of the agreement, the companies will jointly research, develop, and commercialize multiple antibody product candidates. In April of 2005, we announced the initiation of clinical testing of the first product candidate out of the collaboration, HCD122, an anti-CD40 antibody, in patients with advanced CLL. In October of 2005, we announced the initiation of the second clinical trial of HCD122 in patients with multiple myeloma.

In October of 2004, we announced the licensing of our ING-1 product to Triton for use with their TNT System.

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In March of 2005, we entered into a contract with NIAID to produce three monoclonal antibodies designed to protect United States citizens against the harmful effects of botulinum neurotoxin potentially used in bioterrorism. In July of 2006, we entered into an additional contract with NIAID for additional production and development of an appropriate formulation for human administration of these three antibodies in a single injection.

In June of 2005, we announced the formation of a collaboration to jointly develop and commercialize antibody drugs for certain targets discovered by Lexicon.

In May of 2006, we entered into a collaboration agreement with the SPRI division of Schering Corporation for therapeutic monoclonal antibody discovery and development. SPRI 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 November of 2006, we entered into a collaboration agreement with Takeda for therapeutic monoclonal antibody discovery and development. In February of 2007, Takeda and we announced that we amended our existing agreement to increase the number of potential therapeutic antibody programs under the collaboration initiated in November of 2006.

We have licensed our BCE technology, an enabling technology used to discover and screen, as well as develop and manufacture, recombinant antibodies and other proteins for commercial purposes, to over 45 companies. As of September 30, 2007, we were aware of one antibody product manufactured using this technology that has received FDA approval, Genentech s LUCENTIS® (ranibizumab injection) for treatment of neovascular (wet) age-related macular degeneration, and one antibody product manufactured using this technology that is in late-stage clinical testing, UCB s CIMZIA® (certolizumab pegol, CDP870) an anti-TNF alpha antibody fragment for rheumatoid arthritis and Crohn s disease.

Because our collaborators and licensees are independent third parties, they may be subject to different risks than we are and have significant discretion in determining the efforts and resources they will apply. If these collaborators and licensees do not successfully develop and market these products, we may not have the capabilities, resources or rights to do so on our own. We do not know whether our collaborators or licensees will successfully develop and market any of the products that are or may become the subject of one of our collaboration or licensing arrangements. In particular, each of these arrangements provides for either sharing of collaboration expenses, which means that not only we but our collaborators must have sufficient available funds for the collaborations to continue, or funding solely by our collaborators or licensees. In addition, our collaboration with Novartis provides for funding by it in the form of a line of credit to us, and we cannot be certain that Novartis will provide the necessary funds available when we attempt to draw on the line of credit. Furthermore, our contracts with NIAID contain numerous standard terms and conditions provided for in the applicable federal acquisition regulations and customary in many government contracts. Uncertainty exists as to whether we will be able to comply with these terms and conditions in a timely manner, if at all. In addition, given our relative lack of experience in programs under contract with government agencies, we are uncertain as to the extent of NIAID s demands and the flexibility that will be granted to us in meeting those demands. Lastly, CIMZIA® (certolizumab pegol, CDP870) has been approved in Switzerland, but has not received marketing approval from the FDA or any other foreign governmental agency, and therefore we cannot assure you that it will prove to be safe and effective, will be otherwise approved for marketing or will be successfully commercialized.

Even when we have a collaborative relationship, other circumstances may prevent it from resulting in successful development of marketable products.

In December of 2003, we agreed to collaborate with Alexion Pharmaceuticals, Inc. (Alexion) for the development and commercialization of an antibody to treat chemotherapy-induced thrombocytopenia. The TPO mimetic antibody was designed to mimic the activity of human thrombopoietin, a naturally occurring protein responsible for platelet production. In November of 2004, in conjunction with Alexion, we determined that the lead molecule in our TPO mimetic collaboration did not meet the criteria established in the program for continued development. In the first quarter of 2005, the companies determined not to continue with this development program and in the second quarter of 2005, the collaboration was terminated.

In November of 2004, we announced the licensing of our BPI product platform, including our NEUPREX® product, to Zephyr Sciences, Inc. In July of 2005, we announced our decision to terminate the license agreement with Zephyr due to Zephyr not meeting the financing requirements of the license agreement.

In September of 2004, we entered into collaboration with Aphton for the treatment of gastrointestinal and other gastrin-sensitive cancers using anti-gastrin monoclonal antibodies. In January of 2006, Aphton announced that its common stock had been delisted from Nasdaq. In May of 2006, Aphton filed for bankruptcy protection under Chapter 11, Title 11 of the United States Bankruptcy Code.

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In September of 2005, we signed a letter agreement with Cubist to develop production processes and to manufacture a novel two-antibody biologic in quantities sufficient to conduct Phase III clinical trials. In July of 2006, Cubist announced that it had decided to cease investment in this product because of stringent FDA requirements for regulatory approval, and as a result we have terminated our letter agreement with Cubist.

In September of 2006, we entered into an agreement with Taligen which formalized an earlier letter agreement, which was signed in May of 2006, for the development and Good Manufacturing Practices (cGMP) manufacture of a novel antibody fragment for the potential treatment of inflammatory diseases. In May of 2007, we and Taligen entered into a letter agreement (the letter agreement) which provides that we will not produce a cGMP batch at clinical scale pursuant to the terms of the agreement entered into in September of 2006. In addition, the letter agreement provides that we will conduct and complete the technical transfer of the process to Avecia Biologics Limited or its designated affiliate (Avecia). The letter agreement also provides that, subject to payment by Taligen of approximately $1.7 million, we will grant to Avecia a non-exclusive, worldwide, paid-up, non-transferable, non-sublicensable, perpetual license under our-owned project innovations. We have received $0.6 million as the first installment under the payment terms of the letter agreement and are entitled to receive two additional payments totaling approximately $1.1 million upon fulfillment of certain obligations, and the parties are in discussion regarding whether those obligations have been fulfilled. We have not received any further payments from Taligen and do not know whether we will receive the remaining $1.1 million. This amount has not been recognized as revenue and is not included as an accounts receivable asset as of September 30, 2007

Although we continue to evaluate additional strategic alliances and potential partnerships, we do not know whether or when any such alliances or partnerships will be entered into.

Certain of our technologies are relatively new and are in-licensed from third parties, so our capabilities using them are unproven and subject to additional risks.

We license technologies from third parties. These technologies include but are not limited to phage display technologies licensed to us in connection with our BCE technology licensing program. However, our experience with some of these technologies remains relatively limited and, to varying degrees, we are still dependent on the licensing parties for training and technical support for these technologies. In addition, our use of these technologies is limited by certain contractual provisions in the licenses relating to them and, although we have obtained numerous licenses, intellectual property rights in the area of phage display are particularly complex. If the owners of the patent rights underlying the technologies we license do not properly maintain or enforce those patents, our competitive position and business prospects could be harmed. Our success will depend in part on the ability of our licensors to obtain, maintain and enforce our licensed intellectual property. Our licensors may not successfully prosecute the patent applications to which we have licenses, or our licensors may fail to maintain existing patents. They may determine not to pursue litigation against other companies that are infringing these patents, or they may pursue such litigation less aggressively than we would. Our licensors may also seek to terminate our license, which could cause us to lose the right to use the licensed intellectual property and adversely affect our ability to commercialize our technologies, products or services.

Our share price may be volatile and there may not be an active trading market for our common shares.

There can be no assurance that the market price of our common shares will not decline below its present market price or that there will be an active trading market for our common shares. The market prices of biotechnology companies have been and are likely to continue to be highly volatile. Fluctuations in our operating results and general market conditions for biotechnology stocks could have a significant impact on the volatility of our common share price. We have experienced significant volatility in the price of our common shares. From January 1, 2006 through November 6, 2007, our share price has ranged from a high of $4.39 to a low of $1.96. On November 6, 2007, the closing price of the common shares as reported on the Nasdaq National Market was $3.28 per share. Factors contributing to such volatility include, but are not limited to:

sales and estimated or forecasted sales of products,

results of preclinical studies and clinical trials,

information relating to the safety or efficacy of products,

developments regarding regulatory filings,

announcements of new collaborations,

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failure to enter into collaborations,

developments in existing collaborations,

our funding requirements and the terms of our financing arrangements,

technological innovations or new indications for our therapeutic products,

introduction of new products or technologies by us or our competitors,

government regulations,

developments in patent or other proprietary rights,

the number of shares issued and outstanding,

the number of shares trading on an average trading day,

announcements regarding other participants in the biotechnology and pharmaceutical industries, and

market speculation regarding any of the foregoing.

We or our third party collaborators or licensees may not have adequate manufacturing capacity sufficient to meet market demand.

Genentech is responsible for manufacturing or arranging for the manufacturing of commercial quantities of RAPTIVA® and LUCENTIS®. Should Genentech have difficulty in providing manufacturing capacity to produce these products in sufficient quantities, we do not know whether they will be able to meet market demand. If not, we will not realize revenues from the sales of these products. If any of our other products are approved, because we have never commercially introduced any pharmaceutical products, we do not know whether the capacity of our existing manufacturing facilities can be increased to produce sufficient quantities of our products to meet market demand. Also, if we or our third party collaborators or licensees need additional manufacturing facilities to meet market demand, we cannot predict that we will successfully obtain those facilities because we do not know whether they will be available on acceptable terms. In addition, any manufacturing facilities acquired or used to meet market demand must meet the FDA s quality assurance guidelines.

We do not know whether there will be, or will continue to be, a viable market for the products in which we have an ownership or royalty interest.

Although RAPTIVA® was approved in the United States in October of 2003 and in the European Union in 2004 and LUCENTIS® was approved in June of 2006 and in the European Union in January of 2007, their acceptance in the marketplace may not continue. Furthermore, even if other products in which we have an interest receive approval in the future, they may not be accepted in the marketplace. In addition, we or our collaborators or licensees may experience difficulties in launching new products, many of which are novel and based on technologies that are unfamiliar to the healthcare community. We have no assurance that healthcare providers and patients will accept such products, if developed. For example, physicians and/or patients may not accept a product for a particular indication because it has been biologically derived (and not discovered and developed by more traditional means) or if no biologically derived products are currently in widespread use in that indication. Similarly, physicians may not accept a product, such as RAPTIVA® or LUCENTIS®, if they believe other products to be more effective or are

more comfortable prescribing other products. Safety concerns may also arise in the course of on-going clinical trials or patient treatment as a result of adverse events or reactions.

Furthermore, government agencies, as well as private organizations involved in healthcare, from time to time publish guidelines or recommendations to healthcare providers and patients. Such guidelines or recommendations can be very influential and may adversely affect the usage of any products we may develop directly (for example, by recommending a decreased dosage of a product in conjunction with a concomitant therapy) or indirectly (for example, by recommending a competitive product over our product). Consequently, we do not know if physicians or patients will adopt or use our products for their approved indications.

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Products and technologies of other companies may render some or all of our products noncompetitive or obsolete.

Developments by others may render our products or technologies obsolete or uncompetitive. Technologies developed and utilized by the biotechnology and pharmaceutical industries are continuously and substantially changing. Competition in the areas of genetically engineered DNA-based and antibody-based technologies is intense and expected to increase in the future as a number of established biotechnology firms and large chemical and pharmaceutical companies advance in these fields. Many of these competitors may be able to develop products and processes competitive with or superior to our own for many reasons, including that they may have:

- significantly greater financial resources,
- larger research and development and marketing staffs,
- larger production facilities,
- entered into arrangements with, or acquired, biotechnology companies to enhance their capabilities, or
- extensive experience in preclinical testing and human clinical trials.

These factors may enable others to develop products and processes competitive with or superior to our own or those of our collaborators. In addition, a significant amount of research in biotechnology is being carried out in universities and other non-profit research organizations. These entities are becoming increasingly interested in the commercial value of their work and may become more aggressive in seeking patent protection and licensing arrangements. Furthermore, positive or negative developments in connection with a potentially competing product may have an adverse impact on our ability to raise additional funding on acceptable terms. For example, if another product is perceived to have a competitive advantage, or another product s failure is perceived to increase the likelihood that our product will fail, then investors may choose not to invest in us on terms we would accept or at all.

Without limiting the foregoing, we are aware that:

- in April of 2004, Amgen Inc. and its partner Wyeth Pharmaceuticals, a division of Wyeth, announced that their rheumatoid arthritis and psoriatic arthritis drug, Enbrel®, had been approved by the FDA for the same psoriasis indication as RAPTIVA® and, in September of 2004, they announced that the product received approval in the European Union in this same indication;
- in April of 2007, Abbott Laboratories announced that it has simultaneously submitted applications to the FDA and the European Medicines Agency seeking approval to market its rheumatoid arthritis and psoriatic arthritis drug Humira as a treatment for the same psoriasis indication as RAPTIVA®;
- in September of 2006, Centocor, Inc. (Centocor) announced that its rheumatoid arthritis and Crohn s disease drug, Remicade® (infliximab), has been approved by the FDA for the treatment of adult patients with chronic severe (i.e. extensive and/or disabling) plaque psoriasis who are candidates for systemic therapy and when other systemic therapies are medically less appropriate. This drug had already been approved to treat plaque psoriasis in the European Union and psoriatic arthritis in the United States and, in combination with methotrexate, in the European Union;

Biogen Idec Inc. (Biogen) sold its worldwide rights to Amevive®, which has been approved in the United States and Canada to treat the same psoriasis indication as RAPTIVA®, to Astellas Pharma US, Inc., in April of 2006;

Biogen and Fumapharm AG (Fumapharm) have taken their psoriasis-treating pill, BG-12 (dimethyl fumarate), through a Phase III trial in Germany in which, according to the companies, the product significantly reduced psoriasis symptoms in patients, and Biogen acquired Fumapharm in June of 2006;

Isotechnika, Inc. has completed a Canadian Phase III trial of ISA247, a trans-isomer of a cyclosporine analog, in 450 patients with moderate to severe psoriasis, achieving all efficacy endpoints, as well as a Phase III extension trial, and, in January of 2007, announced that it has initiated enrollment in a 500-patient second Canadian/European phase III trial;

UCB has announced that it has completed a Phase II clinical trial of CIMZIA® in psoriasis with positive results;

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in October of 2007, Johnson & Johnson announced positive results from a Phase III clinical trial in moderate to severe plaque psoriasis of ustekinumab (CNTO 1275), a fully human monoclonal antibody that targets the cytokines interleukin-12 (IL-12) and interleukin-23 (IL-23) and that they plan to submit marketing applications in the European Union and U.S. in the fourth quarter of 2007; and

other companies are developing monoclonal antibody or other products for treatment of inflammatory skin disorders.

In addition to LUCENTIS®, there are two other FDA-approved therapies to treat macular degeneration: Pfizer, Inc. s and OSI Pharmaceuticals, Inc. s Macugen® and Novartis and QLT Inc. s Visudyne®. It is also possible that LUCENTIS® will compete with Genentech s cancer drug Avastin®.

There are several companies developing topical peptide treatments which may compete with XOMA 629 in acne and superficial skin infections. Migenix Inc. and its partner Cutanea Life Sciences, Inc. are developing CLS001 (formerly MBI 594AN) for rosacea, a topical peptide that has completed two Phase II trials for the treatment of acne. Helix Biomedix, Inc. is developing several peptide compounds. Medicis Pharmaceutical Corp. has rights to human derived antimicrobial peptides that may be developed for acne.

In collaboration with Novartis, we are co-developing a humanized antibody to the target CD40, and, at the current time, there are several CD40-related programs under development, mostly focused on the development of CD40 ligand products. For example, SGN-40 is a humanized monoclonal antibody under development by Seattle Genetics, Inc. (Seattle Genetics) and Genentech which targets CD40 antigen. Seattle Genetics is currently conducting a phase II clinical trial for patients with diffuse large B-cell lymphoma, the most common type of aggressive non-Hodgkin's lymphoma, and phase I trials for patients with multiple myeloma or chronic lymphocytic leukemia. In January of 2007, Seattle Genetics entered into an exclusive worldwide license agreement with Genentech to develop and commercialize SGN-40. Under the agreement, Genentech will fund future research, development, manufacturing and commercialization costs. In January of 2007, Kirin Brewery Company, Limited and Astellas Pharma Inc. announced that they have entered into a license and collaborative research and development agreement under which they will exclusively collaborate in developing and marketing a fully human anti-CD40 antagonistic monoclonal antibody worldwide with a first target indication of prophylaxis of organ rejection associated with organ transplantation.

It is possible that other companies may be developing other products based on the same human protein as our NEUPREX® product, and these products may prove to be more effective than NEUPREX®.

In April of 2007, XOMA announced plans to initiate clinical testing of XOMA 052, a potent anti-inflammatory monoclonal antibody targeting Interleukin 1-beta (IL-1beta), in Type 2 diabetes patients. It is possible that other companies may be developing other products based on the same therapeutic target as XOMA 052 and that these products may prove more effective than XOMA 052. As of May of 2007, we are aware that:

Amgen has been developing AMG 108, a fully human monoclonal antibody that targets inhibition of the action of IL-1, and they announced the initiation of a Phase II safety trial in rheumatoid arthritis patients in September 2006;

Regeneron Pharmaceuticals, Inc. (Regeneron) has been developing rilonacept or IL-1 Trap, a long-acting IL-1 inhibitor, which showed positive phase III clinical data in Cryopyrin-Associated Periodic Syndromes (CAPS). They also reported that the FDA had accepted their Biologics License Application (BLA) filing, and granted Priority Review, Orphan Drug status and Fast Track designation to the IL-1 Trap for the treatment of CAPS. On November 1, 2007, Regeneron announced that the action date for FDA s priority review of the BLA for rilonacept for the long-term treatment of CAPS has been extended to February 29, 2008. In September 2007, Regeneron also announced that treatment with rilonacept demonstrated a statistically significant reduction in patient pain scores in a single-blind, placebo run-in-controlled study of 10 patients with chronic active gout.

Novartis has been developing ACZ885, a fully human anti-IL-1beta monoclonal antibody, and that they reported positive results in phase I proof of concept clinical trials in rheumatoid arthritis and in Muckle-Wells syndrome in June 2006. In July of 2007, they reported advancing ACZ885 into Phase III clinical trial for Muckle-Wells syndrome.

Even if we or our third party collaborators or licensees bring products to market, we may be unable to effectively price our products or obtain adequate reimbursement for sales of our products, which would prevent our products from becoming profitable.

If we or our third party collaborators or licensees succeed in bringing our product candidates to the market, we or they may not be considered cost-effective, and reimbursement to the patient may not be available or may not be sufficient to allow us to sell our products on a competitive basis. In both the United States and elsewhere, sales of medical products and treatments are dependent, in

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part, on the availability of reimbursement to the patient from third-party payors, such as government and private insurance plans. Third-party payors are increasingly challenging the prices charged for pharmaceutical products and services. Our business is affected by the efforts of government and third-party payors to contain or reduce the cost of health care through various means. In the United States, there have been and will continue to be a number of federal and state proposals to implement government controls on pricing. In addition, the emphasis on managed care in the United States has increased and will continue to increase the pressure on the pricing of pharmaceutical products. We cannot predict whether any legislative or regulatory proposals will be adopted or the effect these proposals or managed care efforts may have on our business.

Health care reform measures and other statutory or regulatory changes could adversely affect our business.

The pharmaceutical and biotechnology industries are subject to extensive regulation, and from time to time legislative bodies and governmental agencies consider changes to such regulations that could have significant impact on industry participants. For example, in light of certain highly-publicized safety issues regarding certain drugs that had received marketing approval, the U.S. Congress is considering various proposals regarding drug safety, including some which would require additional safety studies and monitoring and could make drug development more costly. We are unable to predict what additional legislation or regulation, if any, relating to safety or other aspects of drug development may be enacted in the future or what effect such legislation or regulation would have on our business.

The business and financial condition of pharmaceutical and biotechnology companies are also affected by the efforts of governments, third-party payors and others to contain or reduce the costs of health care to consumers. In the United States and various foreign jurisdictions there have been, and we expect that there will continue to be, a number of legislative and regulatory proposals aimed at changing the health care system, such as proposals relating to the reimportation of drugs into the U.S. from other countries (where they are then sold at a lower price) and government control of prescription drug pricing. The pendency or approval of such proposals could result in a decrease in our share price or limit our ability to raise capital or to obtain strategic collaborations or licenses.

If we and our partners are unable to protect our intellectual property, in particular our patent protection for our principal products and processes, and prevent its use by third parties, our ability to compete in the market will be harmed, and we may not realize our profit potential.

We rely on patent protection, as well as a combination of copyright, trade secret, and trademark laws to protect our proprietary technology and prevent others from duplicating our products. However, these means may afford only limited protection and may not:

- prevent our competitors from duplicating our products;
- prevent our competitors from gaining access to our proprietary information and technology, or
- permit us to gain or maintain a competitive advantage.

Because of the length of time and the expense associated with bringing new products to the marketplace, we and our partners hold and are in the process of applying for a number of patents in the United States and abroad to protect our products and important processes and also have obtained or have the right to obtain exclusive licenses to certain patents and applications filed by others. However, the mere issuance of a patent is not conclusive as to its validity or its enforceability. The United States Federal Courts or equivalent national courts or patent offices elsewhere may invalidate our patents or find them unenforceable. In addition, the laws of foreign countries may not protect our intellectual property rights effectively or to the same extent as the laws of the United States. If our intellectual property rights are not adequately protected, we may not be able to commercialize our technologies, products, or services, and our competitors could commercialize our technologies, which could result in a decrease in our sales and market share that would harm our business and operating results. Specifically, the patent position of biotechnology companies generally is highly uncertain and involves complex legal and factual questions. The legal standards governing the validity of biotechnology patents are in transition, and current defenses as to issued biotechnology patents may not be adequate in the future. Accordingly, there is uncertainty as to:

- whether any pending or future patent applications held by us will result in an issued patent, or that if patents are issued to us, that such patents will provide meaningful protection against competitors or competitive technologies,

whether competitors will be able to design around our patents or develop and obtain patent protection for technologies, designs or methods that are more effective than those covered by our patents and patent applications, or

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the extent to which our products could infringe on the intellectual property rights of others, which may lead to costly litigation, result in the payment of substantial damages or royalties, and/or prevent us from using technology that is essential to our products.

We have established an extensive portfolio of patents and applications, both United States and foreign, related to our BPI-related products, including novel compositions, their manufacture, formulation, assay and use. We have also established a portfolio of patents, both United States and foreign, related to our BCE technology, including claims to novel promoter sequences, secretion signal sequences, compositions and methods for expression and secretion of recombinant proteins from bacteria, including immunoglobulin gene products.

If certain patents issued to others are upheld or if certain patent applications filed by others issue and are upheld, we may require licenses from others in order to develop and commercialize certain potential products incorporating our technology or we may become involved in litigation to determine the proprietary rights of others. These licenses, if required, may not be available on acceptable terms, and any such litigation may be costly and may have other adverse effects on our business, such as inhibiting our ability to compete in the marketplace and absorbing significant management time.

Due to the uncertainties regarding biotechnology patents, we also have relied and will continue to rely upon trade secrets, know-how and continuing technological advancement to develop and maintain our competitive position. All of our employees have signed confidentiality agreements under which they have agreed not to use or disclose any of our proprietary information. Research and development contracts and relationships between us and our scientific consultants and potential customers provide access to aspects of our know-how that are protected generally under confidentiality agreements. These confidentiality agreements may be breached or may not be enforced by a court. To the extent proprietary information is divulged to competitors or to the public generally, such disclosure may adversely affect our ability to develop or commercialize our products by giving others a competitive advantage or by undermining our patent position.

Litigation regarding intellectual property can be costly and expose us to risks of counterclaims against us.

We may be required to engage in litigation or other proceedings to protect our intellectual property. The cost to us of this litigation, even if resolved in our favor, could be substantial. Such litigation could also divert management s attention and resources. In addition, if this litigation is resolved against us, our patents may be declared invalid, and we could be held liable for significant damages. In addition, we may be subject to a claim that we are infringing another party s patent. If such claim is resolved against us, we or our collaborators may be enjoined from developing, manufacturing, selling or importing products, processes or services unless we obtain a license from the other party. Such license may not be available on reasonable terms, thus preventing us from using these products, processes or services and adversely affecting our revenue.

Manufacturing risks and inefficiencies may adversely affect our ability to manufacture products for ourselves or others.

We are subject to manufacturing risks which may hinder our ability to provide manufacturing services for our own benefit or to third parties. Additionally, unanticipated fluctuations in customer requirements may lead to manufacturing inefficiencies. We must provide our manufacturing services in compliance with regulatory requirements, in sufficient quantities and on a timely basis, while maintaining acceptable product quality and manufacturing costs. Additional resources and changes in our manufacturing processes may be required for each new product or customer or to meet increasing customer requirements once a contract has been initiated, and this work may not be successfully or efficiently completed.

In addition, the development work and products addressed in new contracts may not share production attributes with our existing projects to the extent we anticipate, and consequently these new contracts may require the development of new manufacturing technologies and expertise. If we are unable to develop manufacturing capabilities as needed, on acceptable terms, our ability to complete these contracts or enter into additional contracts may be adversely affected.

Manufacturing and quality problems may arise in the future as we continue to perform these services for our own benefit and under additional manufacturing contracts. Consequently, our internal development goals or milestones under our contracts may not be achieved in a timely manner or at a commercially reasonable cost, or at all. In addition, we continue to make investments to improve our manufacturing processes and to design, develop and purchase manufacturing equipment that may not yield the improvements that we expect. Inefficiencies or constraints related to our manufacturing may adversely affect our overall financial results. Such inefficiencies or constraints may also result in delays or loss of current or potential customers due to their dissatisfaction.

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The financial terms of future collaborative or licensing arrangements could result in dilution of our share value.

Funding from collaboration partners and others has in the past and may in the future involve issuance by us of our shares. Because we do not currently have any such arrangements, we cannot be certain how the purchase price of such shares, the relevant market price or premium, if any, will be determined or when such determinations will be made. Any such issuance could result in dilution in the value of our issued and outstanding shares.

Because many of the companies we do business with are also in the biotechnology sector, the volatility of that sector can affect us indirectly as well as directly.

As a biotechnology company that collaborates with other biotech companies, the same factors that affect us directly can also adversely impact us indirectly by affecting the ability of our collaborators, partners and others we do business with to meet their obligations to us and reduce our ability to realize the value of the consideration provided to us by these other companies.

For example, in connection with our licensing transactions relating to our BCE technology, we have in the past and may in the future agree to accept equity securities of the licensee in payment of license fees. The future value of these or any other shares we receive is subject both to market risks affecting our ability to realize the value of these shares and more generally to the business and other risks to which the issuer of these shares may be subject.

As we do more business internationally, we will be subject to additional political, economic and regulatory uncertainties.

We may not be able to successfully operate in any foreign market. We believe that, because the pharmaceutical industry is global in nature, international activities will be a significant part of our future business activities and that, when and if we are able to generate income, a substantial portion of that income will be derived from product sales and other activities outside the United States. Foreign regulatory agencies often establish standards different from those in the United States, and an inability to obtain foreign regulatory approvals on a timely basis could put us at a competitive disadvantage or make it uneconomical to proceed with a product s development. International operations and sales may be limited or disrupted by:

- imposition of government controls,
- export license requirements,
- political or economic instability,
- trade restrictions,
- changes in tariffs,
- restrictions on repatriating profits,
- exchange rate fluctuations,
- withholding and other taxation, and

difficulties in staffing and managing international operations.

The loss of key personnel, including our new Chief Executive Officer, could delay or prevent achieving our objectives.

Our research, product development and business efforts could be adversely affected by the loss of one or more key members of our scientific or management staff, particularly our executive officers: Steven B. Engle, our Chairman, Chief Executive Officer and President; J. David Boyle II, our Vice President, Finance and Chief Financial Officer; Patrick J. Scannon, M.D., Ph.D., our Executive Vice President and Chief Biotechnology Officer; and Christopher J. Margolin, our Vice President, General Counsel and Secretary. We currently have no key person insurance on any of our employees.

In August of 2007, Mr. Engle succeeded John L. Castello as President and Chief Executive Officer. Mr. Engle has not previously been affiliated with our company, and our business could be adversely affected if he is not integrated effectively, or in a timely manner, into our company.

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Because we are a relatively small biopharmaceutical company with limited resources, we may not be able to attract and retain qualified personnel.

Our success in developing marketable products and achieving a competitive position will depend, in part, on our ability to attract and retain qualified scientific and management personnel, particularly in areas requiring specific technical, scientific or medical expertise. We had approximately 309 employees as of September 30, 2007, and we anticipate that we will require additional experienced executive, accounting, research and development, legal, administrative and other personnel in the future. There is intense competition for the services of these personnel, especially in California. Moreover, we expect that the high cost of living in the San Francisco Bay Area, where our headquarters and manufacturing facilities are located, may impair our ability to attract and retain employees in the future. If we do not succeed in attracting new personnel and retaining and motivating existing personnel, our operations may suffer and we may be unable to implement our current initiatives or grow effectively.

Calamities, power shortages or power interruptions at our Berkeley headquarters and manufacturing facility could disrupt our business and adversely affect our operations, and could disrupt the businesses of our customers.

Our principal operations are located in Northern California, including our corporate headquarters and manufacturing facility in Berkeley, California. In addition, many of our collaborators and licensees are located in California. All of these locations are in areas of seismic activity near active earthquake faults. Any earthquake, terrorist attack, fire, power shortage or other calamity affecting our facilities or our customers facilities may disrupt our business and could have material adverse effect on our business and results of operations.

We are exposed to an increased risk of product liability claims.

The testing, marketing and sales of medical products entails an inherent risk of allegations of product liability. In the event of one or more large, unforeseen awards of damages against us, our product liability insurance may not provide adequate coverage. A significant product liability claim for which we were not covered by insurance would have to be paid from cash or other assets. To the extent we have sufficient insurance coverage, such a claim would result in higher subsequent insurance rates. In addition, product liability claims can have various other ramifications including loss of future sales opportunities, increased costs associated with replacing products, and a negative impact on our goodwill and reputation, which could also adversely affect our business and operating results.

We may be subject to increased risks because we are a Bermuda company.

Alleged abuses by certain companies that have changed their legal domicile from jurisdictions within the United States to Bermuda have created an environment where, notwithstanding that we changed our legal domicile in a transaction that was approved by our shareholders and fully taxable to our company under United States law, we may be exposed to various prejudicial actions, including:

- blacklisting of our common shares by certain pension funds,
- legislation restricting certain types of transactions, and
- punitive tax legislation.

We do not know whether any of these things will happen, but if implemented one or more of them may have an adverse impact on our future operations or our share price.

If you were to obtain a judgment against us, it may be difficult to enforce against us because we are a foreign entity.

We are a Bermuda company. All or a substantial portion of our assets, including substantially all of our intellectual property, may be located outside the United States. As a result, it may be difficult for shareholders and others to enforce in United States courts judgments obtained against us. We have irrevocably agreed that we may be served with process with respect to actions based on offers and sales of securities made hereby in the United States by serving Christopher J. Margolin, c/o XOMA Ltd., 2910 Seventh Street, Berkeley, California 94710, our United States agent appointed for that purpose. Uncertainty exists as to whether Bermuda courts would enforce judgments of United States courts obtained in actions against us or our directors and officers that are predicated upon the civil liability provisions of the United States securities

laws or entertain original actions brought in Bermuda against us or such persons predicated upon the United States securities laws. There is no treaty in effect between the United States and Bermuda providing for such enforcement, and there are grounds upon which Bermuda courts may not enforce judgments of United States courts. Certain remedies available under the United States federal securities laws may not be allowed in Bermuda courts as contrary to that nation s policy.

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Our shareholder rights agreement or bye-laws may prevent transactions that could be beneficial to our shareholders and may insulate our management from removal.

In February of 2003, we adopted a new shareholder rights agreement (to replace the shareholder rights agreement that had expired), which could make it considerably more difficult or costly for a person or group to acquire control of us in a transaction that our board of directors opposes.

Our bye-laws:

- require certain procedures to be followed and time periods to be met for any shareholder to propose matters to be considered at annual meetings of shareholders, including nominating directors for election at those meetings;
- authorize our board of directors to issue up to 1,000,000 preference shares without shareholder approval and to set the rights, preferences and other designations, including voting rights, of those shares as the board of directors may determine; and
- contain provisions, similar to those contained in the Delaware General Corporation Law that may make business combinations with interested shareholders more difficult.

These provisions of our shareholders rights agreement and our bye-laws, alone or in combination with each other, may discourage transactions involving actual or potential changes of control, including transactions that otherwise could involve payment of a premium over prevailing market prices to holders of common shares, could limit the ability of shareholders to approve transactions that they may deem to be in their best interests, and could make it considerably more difficult for a potential acquirer to replace management.

We may issue additional equity securities and thereby materially and adversely affect the price of our common shares.

We are authorized to issue, without shareholder approval, 1,000,000 preference shares, of which 2,959 were issued and outstanding as of September 30, 2007, which may give other shareholders dividend, conversion, voting, and liquidation rights, among other rights, which may be superior to the rights of holders of our common shares. In addition, we are authorized to issue, without shareholder approval, up to 210,000,000 common shares, of which 131,847,003 were issued and outstanding as of September 30, 2007. If we issue additional equity securities, the price of our common shares may be materially and adversely affected.

If the trading price of our common shares fails to comply with the continued listing requirements of The Nasdaq National Market, we would face possible delisting, which would result in a limited public market for our common shares and make obtaining future debt or equity financing more difficult for us.

If we do not continue to comply with the continued listing requirements for The Nasdaq National Market, then Nasdaq may provide written notification regarding the delisting of our securities. At that time, we would have the right to request a hearing to appeal on Nasdaq s determination and would also have the option to apply to transfer our securities to The Nasdaq SmallCap Market.

We cannot be sure that our price will comply with the requirements for continued listing of our common shares on The Nasdaq National Market, or that any appeal of a decision to delist our common shares will be successful. If our common shares lose their status on Nasdaq s National Market and we are not successful in obtaining a listing on The Nasdaq SmallCap Market, our common shares would likely trade in the over-the-counter market.

If our shares were to trade on the over-the-counter market, selling our common shares could be more difficult because smaller quantities of shares would likely be bought and sold, transactions could be delayed, and security analysts coverage of us may be reduced. In addition, in the event our common shares are delisted, broker-dealers have certain regulatory burdens imposed upon them, which may discourage broker-dealers from effecting transactions in our common shares, further limiting the liquidity thereof. These factors could result in lower prices and larger spreads in the bid and ask prices for common shares.

Such delisting from The Nasdaq National Market or future declines in our share price could also greatly impair our ability to raise additional necessary capital through equity or debt financing, and could significantly increase the ownership dilution to shareholders caused by our issuing equity in financing or other transactions. Consent under the Exchange Control Act 1972 (and its

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related regulations) has been obtained from the Bermuda Monetary Authority for the issue and transfer of our shares, notes and other securities to and between non-residents of Bermuda for exchange control purposes, but this consent is conditional on our shares remaining listed on an appointed stock exchange. We cannot assure you that the Bermuda Monetary Authority will give the same or a similar consent in the event our common shares are no longer listed on The Nasdaq National Market or another appointed stock exchange. In the absence of such a general consent, specific consents of the Bermuda Monetary Authority would be required for certain issues and transfers of our shares, notes and other securities.

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 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

Exhibit Number	
10.1(1)	Employment Agreement effective as of August 3, 2007 between XOMA (US) LLC and Steven B. Engle
10.2(1)	Change of Control Severance Agreement effective as of August 3, 2007 between XOMA Ltd. And Steven B. Engle
10.3(1)	Share Option Agreement Under the XOMA Ltd. 1981 Share Option Plan dated August 3, 2007 between XOMA Ltd. and Steven B. Engle (immediately exercisable share options)
10.4(1)	Share Option Agreement Under the XOMA Ltd. 1981 Share Option Plan dated August 3, 2007 between XOMA Ltd. and Steven B. Engle (incentive share options with scheduled exercisability)
10.5(1)	Share Option Agreement Under the XOMA Ltd. 1981 Share Option Plan dated August 3, 2007 between XOMA Ltd. and Steven B. Engle (non-qualified share options with scheduled exercisability)
10.6(1)	Non-Qualified Share Option Agreement Under the XOMA Ltd. Restricted Share Plan dated August 3, 2007 between XOMA Ltd. and Steven B. Engle
10.7(1)	XOMA Ltd. Non-Qualified Share Option Agreement dated August 3, 2007 between XOMA Ltd. and Steven B. Engle
10.8(1)	Consulting Agreement effective as of August 3, 2007 between XOMA (US) LLC and John L. Castello
10.9(2)	Form of Employment Agreement entered into between XOMA (US) LLC and certain of its executives
10.10(2)	Form of Change of Control Severance Agreement entered into between XOMA Ltd. and certain of its executives
10.11(3)	Non-exclusive License Agreement effective August 27, 2008 between XOMA Ireland Limited and Pfizer, Inc
10.12(4)	Amendment No. 3 to the XOMA Ltd. 1981 Share Option Plan
10.13(4)	Amendment No. 4 to the XOMA Ltd. Restricted Share Plan
10.14(4)	Management Incentive Compensation Plan as amended and restated
31.1	Certification of Steven B. Engle, filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of J. David Boyle II, filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Steven B. Engle, furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of J. David Boyle II, furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.1	Press Release dated November 8, 2007, furnished herewith

(1) Incorporated by reference to the corresponding exhibit to the Company s Form 8-K filed on August 7, 2007 (File No. 0-14710)

(2) Incorporated by reference to the corresponding exhibit to the Company s Form 8-K filed on August 16, 2007 (File No. 0-14710)

(3) Incorporated by reference to the corresponding exhibit to the Company s Form 8-K filed on September 13, 2007 (File No. 0-14710)

(4) Incorporated by reference to the corresponding exhibit to the Company s Form 8-K filed on November 6, 2007 (File No. 0-14710)

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XOMA Ltd.

SIGNATURES

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

XOMA Ltd.

Date: November 8, 2007

By: /s/ STEVEN B. ENGLE
Steven B. Engle
Chairman, Chief Executive Officer and President

Date: November 8, 2007

By: /s/ J. DAVID BOYLE II
J. David Boyle II
Vice President, Finance and Chief Financial Officer