ARQULE INC
Form 10-K
March 02, 2010

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ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2009 COMMISSION FILE NUMBER: 000-21429

ARQULE, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	**04-3221586**
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

19 PRESIDENTIAL WAY, WOBURN, MASSACHUSETTS 01801

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES INCLUDING ZIP CODE)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE:
(781) 994-0300

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

(TITLE OF EACH CLASS)	**NAME OF EACH EXCHANGE ON WHICH REGISTERED**
COMMON STOCK, $.01 PAR VALUE	The NASDAQ Stock Market LLC (NASDAQ Global Market)

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

NONE

Indicate by check mark if the registrant is a well-known issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No ý

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to

such filing requirements for the past 90 days. Yes ý No o

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is 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 o	Accelerated filer ý	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The aggregate market value of voting and non-voting common stock held by non-affiliates of the registrant as of June 30, 2009 was: $274,280,020

There were 44,726,321 shares of the registrant's Common Stock outstanding as of February 16, 2010.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement for the Registrant's Annual Meeting of Shareholders to be held on May 13, 2010, which will be filed with the Securities and Exchange Commission not later that 120 days after the registrant's fiscal year end of December 31, 2009, are incorporated by reference into Part III of the Form 10-K.

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IMPORTANT FACTORS REGARDING FORWARD-LOOKING STATEMENTS

You should carefully consider the risks described below together with all of the other information included in this Form 10-K, including Item 1A "Risk Factors," before making an investment decision. An investment in our common stock involves a high degree of risk. We operate in a dynamic and rapidly changing industry that involves numerous uncertainties. The risks and uncertainties described below are not the only ones we face. Other risks and uncertainties, including those that we do not currently consider material, may impair our business. If any of the risks discussed below actually occur, our business, financial condition, operating results or cash flows could be materially adversely affected. This could cause the trading price of our common stock to decline, and you may lose all or part of your investment.

This Form 10-K, including information incorporated herein by reference, contains forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. All statements that are not descriptions of historical fact are forward-looking statements, based on estimates, assumptions and projections that are subject to risks and uncertainties. These statements can generally be identified by use of forward looking terminology such as "believes", "expects", "intends", "may", "will", "plans", "should", "anticipates," "potential" or similar terminology. Although we believe that the expectations reflected in such forward looking statements are reasonable as of the date thereof, such expectations are based on certain assumptions regarding the progress of product development efforts under collaborative agreements, the execution of new collaborative agreements, receipt of potential milestones and royalties under our collaborative agreements, government regulations, reliance on third parties to conduct clinical trials and perform research and analysis services, adequate financial resources, changes in economic and business conditions, and other factors relating to our growth. Such expectations may not materialize if product development efforts, including any necessary trials of our potential drug candidates, are delayed or suspended, if our compounds fail to demonstrate safety and efficiency, if positive early results are not repeated in later studies or in humans, if the therapeutic and value of our compounds are not realized, if planned acquisitions or negotiations with potential collaborators are delayed or unsuccessful, if we are unsuccessful at integrating acquired assets or technologies, or if other assumptions prove incorrect. The forward-looking statements contained herein represent the judgment of ArQule as of the date of this Form 10-K. ArQule disclaims any intent or obligation to update any forward-looking statement except to the extent required by law.

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PART I

ITEM 1. BUSINESS

BUSINESS OVERVIEW

We are a clinical-stage biotechnology company engaged in the research and development of innovative cancer therapeutics. Our mission is to produce novel medicines with differentiated mechanisms of action that target the specific biological pathways implicated in a wide range of cancers. We employ novel technologies such as our ArQule Kinase Inhibitor Platform ("AKIP ") to design and develop drugs that have the potential to fulfill this mission.

Our products and programs span a continuum of research and development ranging from drug discovery to advanced clinical testing. They are based on our understanding of biological processes that lead to the proliferation and metastasis of cancer cells, combined with our ability to generate product candidates possessing certain pre-selected, drug-like properties and designed to act specifically against cancer cells. We believe that these qualities, when present from the earliest stages of product development, increase the likelihood of producing safe, effective and marketable drugs.

Our lead product is ARQ 197, a non-adenosine triphosphate ("ATP")-competitive inhibitor of the c-Met receptor tyrosine kinase ("c-Met"). C-Met is a promising target for cancer therapy, as evidence suggests that it plays a key role in cancerous cell proliferation, tumor spread, new blood vessel formation and drug resistance. Our ongoing Phase 2 clinical trial program with ARQ 197 encompasses six tumor types, including non-small cell lung cancer, c-Met-associated soft tissue sarcomas, pancreatic adenocarcinoma, hepatocellular carcinoma, germ cell tumors and colorectal cancer. We believe the trials within the Phase 2 program for ARQ 197 offer the potential for proof-of-principle data that can be generated in one or more indications beginning in early 2010 through 2011, as well as the potential for fast-to-market regulatory pathways in certain indications.

We have licensed commercial rights to ARQ 197 for human cancer indications to Daiichi Sankyo Co., Ltd. ("Daiichi Sankyo") in the U.S., Europe, South America and the rest of the world, excluding Japan and certain other Asian countries, where we have licensed commercial rights to Kyowa Hakko Kirin Co., Ltd. ("Kyowa Hakko Kirin"). Our agreements with these partners provide for possible future milestone payments, royalties on product sales, and development funding, in addition to significant payments that we have already received.

Our proprietary pipeline is directed toward molecular targets and biological processes with demonstrated roles in the development of human cancers. The most advanced candidate in this pipeline is ARQ 621, an inhibitor of the Eg5 kinesin motor protein that is in Phase 1 clinical testing. Additional pipeline assets include ARQ 501 and ARQ 761, activators of the cell's DNA damage response mechanism that we plan to develop further on a partnered basis. We are also pursuing pre-clinical development of an inhibitor of the B-RAF kinase that is in toxicology testing leading to a potential Investigational New Drug ("IND") submission in 2010.

Our drug design efforts are focused primarily on AKIP , which we are using to generate compounds designed to inhibit kinases without competing with adenosine triphosphate ("ATP") for binding to the target kinase. ATP is a chemical found in all living cells and is involved in a variety of physiological processes. We have assessed AKIP 's potential to target multiple kinases in oncology and other therapeutic areas, and we are generating and validating compounds that inhibit these kinase targets. With the AKIP technology, we have discovered and optimized a series of small molecule inhibitors of fibroblast growth factor receptor inhibitors that are in pre-clinical development, with the potential submission of an IND for a lead product candidate in 2010. We are also pursuing a drug discovery collaboration with Daiichi Sankyo that utilizes the capabilities of the AKIP technology to discover compounds that inhibit two kinase targets in the field of oncology.

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SELECTED DRUG DEVELOPMENT PIPELINE

The chart below displays certain of our development programs, including their targets and stage of development.

CLINICAL STAGE PRODUCTS

ARQ 197: c-Met Inhibitor

Introduction

ARQ 197 is an orally available, small molecule that inhibits the c-Met receptor tyrosine kinase. Abnormal activation of c-Met is believed to play key roles in cancer cell growth, survival, angiogenesis, invasion and metastasis. We believe that the inappropriate expression of c-Met in many cancers and its role in controlling multiple signal transduction pathways involved in tumor growth and metastasis render it a compelling target for cancer therapy.

ARQ 197 is a specific inhibitor of c-Met and does not compete with ATP for its binding to this kinase. We believe this specificity may help confer an attractive therapeutic profile based on a combination of safety and anti-cancer activity. In clinical studies to date, treatment with ARQ 197 has been well tolerated both as a single agent and in combination with other targeted therapies and cytotoxic agents, and objective tumor responses and prolonged stable disease have been observed across broad ranges of doses and tumors.

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Clinical Trials

Phase 1

Final results of a dose escalation, Phase 1 trial with ARQ 197 conducted at clinical trial sites in the U.S. were presented at the 2009 Annual Meeting of the American Society of Clinical Oncology in June, 2009. The objectives of this trial were to evaluate and establish: safety, maximum tolerated dose, the recommended Phase 2 dose, the pharmacokinetic profile and preliminary anti-tumor activity of ARQ 197.

A total of 74 patients were treated in this trial as of May 1, 2009, with 13 cohorts of patients assessed at doses ranging from 10-360 milligrams twice daily. Adverse events considered drug-related occurred in 30 (40.5 percent) patients, with the most common being fatigue (16.2 percent), nausea (12.2 percent), vomiting (6.8 percent) and diarrhea (5.4 percent). Drug-related serious adverse events occurred in 4 patients. Dose limiting toxicities were reported in 2 patients at 360 milligrams twice daily. These dose limiting toxicities resolved after 6 and 9 days, and treatment continued. No maximum tolerated dose was identified in this trial, although a monotherapy maximum tolerated dose of 360 milligrams twice daily was subsequently determined in a Phase 1 trial conducted at the Royal Marsden Hospital in the U.K.

Investigators concluded that ARQ 197 has a favorable safety profile up to the dose of 360 milligrams twice daily. Although the primary objective of the study was to collect safety data, 61 patients were evaluable for anti-tumor activity. Three patients, with neuroendocrine, prostate and testicular cancers, achieved partial responses per Response Evaluation Criteria In Solid Tumors, or RECIST criteria, for an objective response rate of 4.9 percent in the evaluable population. Thirty-eight patients had a best response of stable disease, and 20 had documented progressive disease. The disease control rate (objective responses and stable disease) among evaluable patients was 67.2 percent, suggesting preliminary evidence of anti-cancer activity and supporting further clinical investigation.

Phase 1 Dosing and Tissue Biopsy Study: Royal Marsden Hospital

Results from a second Phase 1 trial of ARQ 197, conducted at the Royal Marsden Hospital in the U.K. and incorporating serial tumor biopsies and imaging studies investigating the anti-angiogenic activity of selective c-Met inhibition, were also presented at the American Society of Clinical Oncology in June, 2009. The primary objective of this trial was to assess the safety, tolerability and recommended Phase 2 dose of ARQ 197. Secondary objectives included evaluation of pharmacokinetic and pharmacodynamic profiles of ARQ 197, and evaluation of the potential anti-angiogenic activity of selective c-MET inhibition by ARQ 197, a pharmacologic effect suggested by previously reported clinical and pre-clinical data.

A total of 46 patients with advanced solid tumors were enrolled in this trial. The most commonly enrolled tumor types included prostate cancer (12 patients), melanoma (11 patients), gastric cancer (6 patients), sarcoma (4 patients), colorectal cancer (3 patients), and breast cancer (2 patients). The most commonly reported adverse events were fatigue (40.9 percent), nausea (25.0 percent), and vomiting (20.5 percent). The most commonly observed adverse events considered to be at least possibly related to ARQ 197 were fatigue (15.9 percent), nausea (11.4 percent), diarrhea (6.8 percent) and vomiting (6.8 percent). Three patients experienced five dose limiting toxicity events. The recommended Phase 2 dose was established at 360 milligrams twice daily. which reflects an adjustment from a recommended Phase 2 dose of 300 milligrams twice daily based on formulation improvements. Tumor regressions up to 12.4 percent were observed in 2 patients. Stable disease lasting up to 23 weeks was observed in 15 of 24 evaluable patients (62.5 percent), while progressive disease was seen in nine of 24 evaluable patients (37.5 percent).

Evidence of anti-angiogenic effect was suggested by declines of circulating endothelial cells up to 100 percent in 19 of 31 evaluable patients (61 percent) following administration of ARQ 197.

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Additionally, preliminary imaging data documented statistically significant day 7 decreases in radiographic markers, further suggesting an anti-angiogenic effect mediated by ARQ 197.

Investigators concluded that ARQ 197 was safe and well tolerated up to the recommended Phase 2 dose of 360 milligrams twice daily. Systemic exposure to ARQ 197 increased linearly with dose through the maximum tolerated dose. Inhibition of c-MET phosphorylation in tumor biopsies was observed post-treatment at all doses. Clinical improvement in symptoms was observed, as measured by RECIST stable disease up to 23 weeks and tumor regression.

Phase 2 Program

As described in more detail below, we are currently conducting Phase 2 clinical trials with ARQ 197 as monotherapy and in combination with other agents in six tumor types: (1) non-small cell lung cancer, (2) c-Met-associated soft tissue sarcomas, (3) pancreatic adenocarcinoma, (4) hepatocellular carcinoma, (5) germ cell tumors and (6) colorectal cancer. The dose level of ARQ 197 employed in all of these trials is 360 milligrams twice daily. We and our partners may plan trials in additional tumor types based on our expanding knowledge from the current development programs and the potential broad-spectrum utility of ARQ 197 in c-Met-mediated oncogenic processes, as well as its use in combination with established anti-cancer therapies.

Non-Small Cell Lung Cancer

Scientific data show that the development of resistance in patients with non-small cell lung cancer to therapy with inhibitors of the epidermal growth factor receptor such as erlotinib may be linked to an increase in c-Met signaling. We believe the inhibition of c-Met may offer a new strategy in overcoming this resistance and treating these tumors. In addition, pre-clinical efficacy studies in non-small cell lung cancer cells have demonstrated synergy between ARQ 197 and erlotinib in halting cancer cell proliferation.

In March 2008, we initiated a Phase 1/2 clinical trial program of ARQ 197 administered in combination with erlotinib in non-small cell lung cancer. The Phase 1 lead-in trial in this program was designed to determine the safety, tolerability and recommended Phase 2 dose of ARQ 197 when administered in combination with the approved dose of erlotinib (150 milligrams daily), with particular attention given to non-small cell lung cancer patients. During 2008, we successfully completed the Phase 1 trial, demonstrating that the combination of ARQ 197 and erlotinib was well tolerated at the recommended dose for each drug. In October 2008, we began enrolling patients in a Phase 2, randomized, double-blind trial comparing combination therapy with ARQ 197 plus erlotinib against erlotinib plus placebo, with the primary endpoint being progression-free survival.

At the American Society of Clinical Oncology in June, 2009, we presented results from the Phase 1 lead-in trial with ARQ 197 in non-small cell lung cancer. A total of 32 patients were enrolled and treated with escalating doses of ARQ 197 plus the recommended dose of erlotinib. Tumor types enrolled included non-small cell lung cancer (8 patients), colorectal cancer (3 patients), renal cell carcinoma (3 patients) squamous cell carcinoma (3 patients) and pancreatic cancer (2 patients). Adverse events were reported for 26 patients, including three patients with therapy-related serious adverse events. A dose limiting toxicity of reversible neutropenia was observed in two patients at a dose of 360 milligrams twice daily of ARQ 197. Pharmacokinetic data revealed a proportional increase in exposure of ARQ 197 at doses up to 360 milligrams twice daily and no evidence of ARQ 197-erlotinib drug-drug interaction.

Seventeen patients were evaluable for tumor responses, with one unconfirmed partial response, as measured by RECIST, in head and neck cancer, stable disease in 14 patients (82.4 percent) and progressive disease in 3 patients (17.6 percent). The duration of stable disease ranged from 5.9 to 45.4 weeks, with a median duration of 17.1 weeks. Tumor regressions of between 2.3 percent to

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33.3 percent were observed in 5 patients after 8 to 26 weeks on therapy. Eight patients had non-small cell lung cancer, 6 of whom had prior treatment with erlotinib. Five patients who had prior therapy with erlotinib had stable disease lasting more than 17 weeks. The median duration of progression-free survival in non-small cell lung cancer patients in this trial was 26.3 weeks, or more than 6 months, greater than previously published median progression-free survival of 9.7 weeks in 2nd/3rd line non-small cell lung cancer patients with erlotinib monotherapy.

A subsequent presentation of updated data from this trial at the 13th World Lung Conference (July 31 August 4, 2009) showed significantly longer durations of stable disease for non-small cell lung cancer patients and provided insights into key genetic factors independently associated with non-small cell lung cancer disease outcome and prognosis, and with the likelihood of benefit from treatment with epidermal growth factor receptor inhibitors such as erlotinib. Among the three remaining active patients with non-small cell lung cancer for whom data was presented, time on treatment increased from previously reported data, as follows: from 33.6 weeks to 47 weeks; 32.7 weeks to 46 weeks; and 17.6 weeks to 31 weeks.

New genetic information was presented at the World Lung Conference on six of the non-small cell lung cancer patients who had samples available for analysis. Biologic profiles were presented relating to three factors: c-Met gene amplification, epidermal growth factor receptor mutation status, and K-Ras mutation status. All of these factors are independently associated with non-small cell lung cancer disease outcome and prognosis, as well as with the likelihood of therapeutic benefit from epidermal growth factor receptor inhibitors, including erlotinib.

Specifically, three of six evaluated patients were c-Met-amplified (previously associated with poor outcome in non-small cell lung cancer), five of five evaluated patients were epidermal growth factor receptor wild-type (previously associated with poorer response to epidermal growth factor receptor inhibitors), and one of five evaluated patients harbored a K-Ras mutation (previously associated with poorer response to epidermal growth factor receptor inhibitors and extremely unfavorable prognosis in non-small cell lung cancer). Furthermore, of the three non-small cell lung cancer patients who were still being treated with the ARQ 197-erlotinib combination, two of three were c-Met amplified, all were epidermal growth factor receptor wild-type, and one was positive for the K-Ras mutation.

We completed recruitment in the Phase 2 trial in September, 2009 with approximately 170 patients enrolled in the U.S. and Europe. We plan to complete data analyses and announce the results of this trial in the first half of 2010.

C-MetAssociated Soft Tissue Sarcomas

C-Met-associated soft tissue sarcomas included in our trials are clear cell sarcoma, alveolar soft parts sarcoma and translocation-associated renal cell carcinoma. They are linked biologically through a common chromosomal abnormality that drives the over-expression of c-Met and the development of cancer. These tumors are generally resistant to all conventional therapies. We have demonstrated the ability of ARQ 197 to inhibit activation of c-Met and to kill clear cell sarcoma cells *in vitro.*

In October, 2007, we initiated a Phase 2 trial in c-Met associated soft tissue sarcomas that employed an original dose of 120 milligrams twice daily. The dose was increased to 360 milligrams twice daily in October, 2008 following the identification of a maximum tolerated dose in the Royal Marsden trial. The primary objective of the trial was to determine the overall response rate in patients treated with ARQ 197. Secondary objectives include the evaluation of progression-free survival time, as well as six-month and one-year overall survival in these patients.

During the first stage of the study, 23 patients were enrolled and treated with the 120 milligram dose. As announced in October, 2008, among 14 patients evaluable for efficacy, a partial response was observed in a patient with clear cell sarcoma, and 10 patients demonstrated stable disease. We

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subsequently proceeded to the second stage of the study, where additional patients were enrolled at the 360 milligram dose level. We also increased the dose administered to several patients from the first stage who continued to participate in this trial.

We completed recruitment in the Phase 2 trial in February, 2010 with a total of approximately 50 patients enrolled in North America and Europe. We plan to complete final data analyses and announce the results of this trial in the first half of 2010. These final data will be evaluated by Daiichi Sankyo, regulatory authorities and us in formulating decisions about whether to proceed with Phase 3 clinical testing.

Pancreatic Adenocarcinoma

In pancreatic cancer, between 78 and 88 percent of tumor tissue samples from patients are estimated to over-express c-Met, indicating that the c-Met signaling pathway may play a role in the development of this disease and that inhibition of this pathway may represent a viable therapeutic intervention. ARQ 197 has shown anti-cancer activity in animal models of human pancreatic cancer.

In October, 2007, we initiated an open-label, randomized Phase 2 trial in Eastern Europe in which approximately 72 patients with pancreatic adenocarcinoma were expected to be treated with either ARQ 197 or gemcitabine. Eligible patients were randomized to receive either 120 milligrams of ARQ 197 orally twice daily or intravenous infusion of gemcitabine at a dose of 1000 milligrams per meter squared and evaluated for overall survival, progression-free survival and overall response rate.

A review of interim data from this trial conducted in 2008, supported by discussions with key opinion leaders, suggests that chemotherapy is a preferable approach to monotherapy kinase inhibition among the late-stage patients in this trial. We believe, therefore, that targeted therapy such as ARQ 197 may be best employed in the context of combination therapy in pancreatic cancer. Consequently, we have modified the original pancreatic clinical trial protocol by adding a combination arm consisting of ARQ 197 at 360 milligrams twice daily in combination with gemcitabine. To proceed with this plan, we are testing the safety of this combination compared to both individual arms, and we have been dosing patients with gemcitabine-treated tumors, including pancreatic adenocarcinoma. Based on a review of data generated in all arms, we will make a decision about adding a combination arm to the Phase 2 randomized study that will evaluate gemcitabine alone against gemcitabine in combination with ARQ 197 at 360 milligrams twice daily in pancreatic cancer patients.

Hepatocellular Carcinoma

Scientific literature provides evidence of the aberrant activation of the c-Met cell signaling pathway in hepatocellular carcinoma. The dysregulation of c-Met and hepatocyte growth factor expression has been shown to be common in this disease and associated with poor prognoses in patients with hepatocellular carcinoma. We believe that ARQ 197 offers a new therapeutic approach which may have clinical utility as monotherapy and in combination with existing therapies.

We initiated a Phase 1-2 clinical trial program of ARQ 197 in hepatocellular carcinoma in March, 2009. This program includes trials of ARQ 197 both as a single agent and in combination with sorafenib. We dosed the first patient in the Phase 1 ARQ 197 monotherapy safety trial in hepatocellular carcinoma in March, 2009, and we dosed the first patient in the Phase 1 ARQ 197-sorafenib combination therapy safety trial in June, 2009.

Following the evaluation of patients in the Phase 1 monotherapy trial, we initiated enrollment in a Phase 2 monotherapy trial with ARQ 197 in hepatocellular carcinoma in September, 2009. We expect to enroll approximately 100 patients with unresectable hepatocellular carcinoma who have failed one prior systemic therapy in this randomized, double-blind trial comparing patients treated with ARQ 197 to those treated with placebo, with the primary endpoint being time to progression. A Phase 2 ARQ

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197-sorafenib combination therapy trial in hepatocellular carcinoma will be initiated pending the evaluation of safety data in the Phase 1 run-in trial.

Data from the Phase 1 single agent safety trial in hepatocellular carcinoma were presented at the American Society of Clinical Oncology Gastrointestinal Cancers Symposium in January, 2010. ARQ 197 was shown to be well tolerated in this patient population, and no drug related worsening of liver function was observed.

Germ Cell Tumors

The c-Met receptor tyrosine kinase is expressed in human testicular tissue, and analysis of archived testicular tumor specimens by ArQule has confirmed its presence in two thirds of tumor samples. In addition, early clinical evidence from our Phase 1 trial, including a partial response, as measured by Response Evaluation Criteria in Solid Tumors, suggests that inhibition of c-Met with ARQ 197 has anti-cancer activity in this tumor type.

In January, 2010, Daiichi Sankyo initiated a Phase 2, single agent trial with ARQ 197 in germ cell tumors, including testicular and non-central nervous system tumors. The primary aim of this trial is to determine the objective response rate in patients with relapsed or refractory germ cell tumors treated with ARQ 197. Secondary objectives include determination of the progression free survival, overall survival, and safety and tolerability of ARQ 197 in this population. The study will be conducted by Daiichi Sankyo.

Colorectal Cancer

In pre-clinical studies, ARQ 197 has been demonstrated to be have anti-cancer activity against a human colorectal cancer xenograft model. Furthermore, the development of resistance to therapy with epidermal growth factor receptor inhibitors such as cetuximab, which along with the chemotherapeutic agent, irinotecan, is part of an existing combination therapy for colorectal cancer, may be linked to an increase in c-Met signaling.

In February, 2010, Daiichi Sankyo initiated a Phase 1/2 clinical trial designed to evaluate the safety of ARQ 197 administered in combination with irinotecan and cetuximab in patients with metastatic colorectal cancer who possess the wild-type form of the KRAS gene. Pending the successful completion of the Phase 1 safety run-in portion of the trial, the randomized, double-blind, placebo controlled Phase 2 portion of the trial will be initiated, comparing ARQ 197 in combination with irinotecan and cetuximab to placebo with the same two drugs. The primary objective of Phase 2 will be progression-free survival. This Phase 1/2 study will be conducted by Daiichi Sankyo.

ARQ 621: Eg5 Inhibitor

Introduction

ARQ 621 is a second-generation, small molecule inhibitor of the Eg5 kinesin motor protein. Recently published data have shown that over-expression of Eg5 causes genomic instability and tumor formation in animals, suggesting a potential role of Eg5 as an oncogene (cancer-causing gene). We believe that selective inhibition of Eg5 represents an attractive targeted therapy in cancer.

ARQ 621 has been shown in pre-clinical studies to potently and selectively inhibit Eg5 while sparing other members of the kinesin protein superfamily. Exposure to ARQ 621 causes apoptosis and cell death in multiple human cancer cell lines *in vitro* and *in vivo*. At efficacious doses in animal studies, there is no observed evidence of hematological changes and bone marrow toxicity, the same side effects that have hampered the development by other companies of first-generation Eg5 inhibitors by virtue of limiting dosing regimens.

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Clinical Trial

In December 2008, the FDA accepted an IND for ARQ 621, and in March, 2009, the first patient was dosed in a Phase 1 trial with this compound. The primary objective of this trial is to determine the safety, tolerability and a recommended Phase 2 dose. Patients with metastatic solid tumors who are refractory to available therapies or for whom no standard systemic therapy exists are being enrolled. The number of patients to be enrolled will depend on the number of patient cohorts investigated until dose-limiting toxicity is reached, which we believe will occur in the first half of 2010.

ARQ 501 and ARQ 761: E2F-1 Activators

ARQ 501 and ARQ 761 are designed to kill cancer cells selectively while sparing normal cells through the direct activation of DNA damage response/checkpoint pathways believed to be regulated by the E2F-1 regulatory protein, thereby restoring the ability of the cell to recognize unrepaired DNA damage and initiating the process of apoptosis, or programmed cell death, in these cells. ARQ 501 is the first product generated in this program, while ARQ 761 and ARQ 171 are second-generation compounds.

As previously reported, Roche had an option to license worldwide rights for the development and commercialization of all products resulting from our E2F-1 program in the field of cancer therapy. Roche notified us in December 2008 that it did not intend to exercise its option to license the E2F-1 program, and therefore Roche's rights to develop and commercialize product candidates under our agreement terminated at the end of 2008. On January 30, 2009, the Company notified Roche that, in accordance with the terms of the agreement, it had exercised its right to terminate the agreement. As a result, all rights and licenses granted by the Company to Roche under the agreement were also terminated. We retain all rights to the E2F-1 program, have filed an IND for ARQ 761, and are currently exploring partnering options for the future development of this compound.

PRE-CLINICAL PROGRAMS AND DISCOVERY PLATFORM

B-RAF Kinase Inhibition

Mutations of the B-RAF Kinase have been identified in a wide array of cancers, including a significant percentage of melanomas, papillary thyroid carcinomas and colon cancers. We have identified a proprietary series of potent inhibitors of B-RAF with desirable drug-like properties as shown both *in vitro* and *in vivo*. We are pursuing pre-clinical development of a lead candidate from this program. Pending the successful completion of pre-clinical safety assessment, we anticipate filing an IND for a B-RAF inhibitor in 2010.

ArQule Kinase Inhibitor Platform (AKIP)

Introduction

Oncology research and development activities conducted by biopharmaceutical companies are increasingly focused on kinases, which play pivotal roles in modulating diverse cellular activities and have been implicated as important mediators of certain forms of cancer and other diseases. The success of kinase inhibitors such as Tarceva, Gleevec and Nexavar has focused attention on the kinase field, resulting in the increased development of next-generation inhibitors that target cancers and other diseases such as inflammation. The current market for protein kinase inhibitors is estimated to exceed $7 billion and to reach $19 billion by 2013.

During 2008, we discovered a novel binding mode of ARQ 197 to its target that effects inhibition of the c-Met receptor kinase without competing with ATP for binding. We have completed an initial research program with the objective of mapping the human kinome (consisting of 518 human kinase genes) for similar binding sites, and we have identified comparable sites in approximately 270 kinases in

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multiple therapeutic areas, leading to the establishment of AKIP . We believe we have within this platform the capability to rationally design novel kinase inhibitors that encompass new chemical spaces and allow for an expanding intellectual property estate.

We are actively designing and testing such novel kinase inhibitor compounds *in silico* (on the computer) to create new libraries of lead compounds that can be synthesized and purified rapidly using our proprietary robotic parallel chemistry platform. This platform is coupled to high throughput robotic-assisted kinase screens and biophysical assays.

We believe the application of our discovery engine to find novel kinase inhibitors will enable us to expand into multiple chemical scaffolds that could generate novel intellectual property. We believe that *in silico* design and testing will shorten drug discovery timelines relative to drug discovery using traditional approaches. Furthermore, the ability of small molecules that inhibit kinases without competing with ATP for binding (the ATP binding site is highly conserved across different kinases) can lead to fewer off-target side effects.

We anticipate that these novel kinase inhibitors, when targeted against selected therapeutically relevant kinases, will have utility in a broad range of human diseases in addition to cancer. We will seek to expand the applications of this proprietary drug discovery platform through collaborative research programs as well as through our own internal discovery and development activities in multiple therapeutic areas.

Daiichi Sankyo AKIP Oncology Collaboration

In November 2008, we entered into our first collaboration utilizing AKIP in an agreement with Daiichi Sankyo. Pursuant to this agreement, we are applying our proprietary technology and know-how from this platform for the discovery of selective inhibitors of two target kinases in the field of oncology.

ArQule's Fibroblast Growth Factor Program

During 2009, our independent application of the AKIP platform focused on the discovery of inhibitors of fibroblast growth factor receptor. In November, 2009, we presented data at the meeting of the American Association for Cancer Research, the National Cancer Institute and the European Organization for Research and Treatment of Cancer demonstrating the capabilities of this platform to generate a series of small molecule inhibitors of fibroblast growth factor receptor that are not ATP-competitive and show potent anti-tumor activity in fibroblast growth factor receptor-driven human and animal cancer models.

Lead compounds from this program showed marked pharmacodynamic suppression of fibroblast growth factor receptor2, an isoform or sub-type of fibroblast growth factor receptor, and demonstrated corresponding growth inhibition in human gastric carcinoma cell lines. Growth of human gastric carcinoma tumor xenografts in athymic mice was significantly inhibited after nine daily oral administrations of prototype compounds, with a number of animals having their tumor burden eliminated. We are currently pursuing the development of our fibroblast growth factor receptor program independently, and pending the successful completion of pre-clinical activities, we may file an IND for a lead compound from this program in 2010.

CORPORATE PARTNERSHIPS

Daiichi Sankyo Co., Ltd.

We have entered into two agreements with Daiichi Sankyo that form the basis of a strategic relationship for the development and discovery of novel oncology therapeutics. The agreement signed on December 18, 2008, is focused on the co-development of ARQ 197 to treat cancer. The agreement

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signed on November 7, 2008, is focused on the application of our AKIP platform to develop a new generation of highly selective, anti-cancer kinase inhibitors.

ARQ 197 Agreement

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

The agreement provides for a $60 million cash upfront licensing payment from Daiichi Sankyo to us, which we received in December 2008. In addition, it includes significant development and sales milestone payments. We and Daiichi Sankyo will co-develop and share equally the costs of Phase 2 and Phase 3 clinical studies, with our share of Phase 3 costs payable solely from milestone and royalty payments by Daiichi Sankyo. Upon commercialization, we will receive tiered double-digit royalties from Daiichi Sankyo on net sales of ARQ 197 commensurate with the magnitude of the transaction. We retain the option to participate in the commercialization of ARQ 197 in the U.S. On a combined basis, our agreements with Daiichi Sankyo and Kyowa Hakko Kirin (see Kyowa Hakko Kirin below), include total upfront payments of $90 million and provide for total upfront and potential milestone payments in excess of $750 million.

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

We believe this alliance with Daiichi Sankyo will help realize the therapeutic potential of ARQ 197 and define its utility as monotherapy and as part of combination therapy in multiple cancer indications. It also allows us to establish a founding commercial presence in the U.S. that will complement Daiichi Sankyo's primary commercialization effort for ARQ 197.

Kinase Inhibitor Discovery Agreement

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

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

The duration and termination of the agreement is tied to future events. Unless earlier terminated due to breach, insolvency or upon 90 days notice by Daiichi Sankyo, the agreement terminates on the later of (i) the expiration of the research collaboration period, or (ii) various periods specified in the agreement for development and commercialization of products. If Daiichi Sankyo has commercialized a

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licensed product or products, the agreement will continue in force until such time as all royalty terms for all licensed products have ended. The royalty term, on a country-by country basis for a product, ends as of the later of (i) the expiration of the last valid claim under a patent covering the manufacture, use, or sale of a licensed product or (ii) a certain number of years from the date of the commercial sale of the licensed product in such country.

In May, 2009 we entered into an agreement with Daiichi Sankyo related to potential future milestones and royalties for our AKIP collaboration, under which we could receive up to $265 million in potential development and sales milestone payments for each product selected for clinical development. Upon commercialization of a licensed product, we would also receive tiered, double-digit royalties on its net sales.

Kyowa Hakko Kirin Co., Ltd.

On April 27, 2007, we announced an exclusive license agreement with Kyowa Hakko Kirin to develop and commercialize ARQ 197 in Japan and parts of Asia. The agreement includes $123 million in upfront and potential development milestone payments from Kyowa Hakko Kirin to ArQule, including $30 million in upfront licensing payments that we received in 2007. In addition, the agreement includes sales milestone payments.

In addition to the upfront and possible development and regulatory milestone payments totaling $123 million, the Company will be eligible for future milestone payments based on the achievement of certain levels of net sales. The Company will recognize the payments, if any, as revenue in accordance with its revenue recognition policies. As of December 31, 2009, the Company has not recognized any revenue from these sales milestone payments, and there can be no assurance that it will do so in the future.

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

Upon commercialization, ArQule will receive tiered royalties in the mid-teen to low-twenty percent range from Kyowa Hakko Kirin on net sales of ARQ 197. Kyowa Hakko Kirin will be responsible for clinical development costs and commercialization of the compound in the Asian territory, consisting of Japan, China (including Hong Kong), South Korea and Taiwan.

In February, 2008, we received a $3 million milestone payment from Kyowa Hakko Kirin marking the initiation by Kyowa Hakko Kirin of a Phase 1, dose escalation trial in Japan with ARQ 197. This payment was made under the terms of the exclusive license agreement between the two companies.

Pfizer, Inc.

We have received milestone payments from Wyeth related to compounds we provided to them as part of our previous chemistry services operations. In 2009, Pfizer acquired Wyeth, and we recently learned that Pfizer is actively developing one of these compounds for the treatment of Alzheimer's disease. Although we do not participate in the development of this compound, we may be eligible to receive certain development milestone and royalty payments from Pfizer should this compound proceed through clinical development and be commercialized.

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BUSINESS STRATEGY

Our strategy is to build a fully integrated, commercial-stage biotechnology company that discovers, develops, manufactures, markets and sells safe, innovative, and effective small molecule drugs, currently in the field of oncology. Specifically, we intend to accomplish this through the following activities:

- implementation of a broad clinical development program across multiple tumor types with our lead product candidate, ARQ 197, as monotherapy and in combination with other targeted therapies or cytotoxic agents;

- application of our proprietary drug discovery technology to discover novel drugs in disease indications for which we believe we can develop products with advantages over current therapies or where no current therapy exists;

- ongoing portfolio prioritization to select only our most promising product candidates for further development and thereby to reduce overall development risk and maximize market opportunities;

- pursuit of partnerships or alliances with pharmaceutical and biotechnology companies to offset spending, balance risk, and gain expertise;

- maintenance and expansion of our portfolio of patents, know-how and trade secrets; and

- commercialization or co-commercialization of our drugs in the U.S. and receipt of royalties on sales in the rest of the world.

2010 Operational Goals

ARQ 197 / c-Met Program

During 2010, we plan to pursue the clinical development of ARQ 197 through:

- analysis of clinical data from the Phase 2 trial in NSCLC tumors in the first half of the year, followed by initiation of a Phase 3 trial in the second half of the year, if the final analysis of Phase 2 data, as well as discussions with our partner, Daiichi Sankyo, and regulatory authorities, support such a trial;

- analysis of clinical data from the Phase 2 trial in c-Met-associated soft tissue sarcomas in the first half of the year, followed by initiation of a Phase 3 trial, if the final analysis of Phase 2 data, as well as discussions with Daiichi Sankyo and regulatory authorities, support such a trial;

- substantial completion of patient accrual in the Phase 2 monotherapy trial in HCC;

- completion of patient accrual in the Phase 1 combination therapy trial in sorafenib-treated tumors as a potential lead-in to a Phase 2 combination therapy trial in hepatocellular carcinoma, if safety data analysis, as well as discussions with Daiichi Sankyo and regulatory authorities, support such a trial;

- completion of patient accrual in the Phase 1 combination therapy trial in gemcitabine-treated tumors as a potential lead-in to a Phase 2 combination therapy trial in pancreatic cancer and other gemcitabine-treated tumors, if safety data analysis, as well as discussions with Daiichi Sankyo and regulatory authorities, support such a trial;

accrual of patients in the recently initiated Phase 2 trial in colorectal cancer;

accrual of patients in the recently initiated Phase 2 trial in germ cell tumors.

ARQ 621 / Eg5 Program

completion of patient enrollment in ongoing Phase 1 trial;

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initiation of a Phase 2 trial if data analysis from Phase 1 trial and discussions with regulatory authorities support such a trial.

Pre-clinical Pipeline

During 2010, we plan to complete pre-clinical development and to file one IND for a product from either:

B-RAF kinase program;

FGFR kinase program.

AKIP Discovery Platform

continue to execute our AKIP collaboration with Daiichi Sankyo, which is focused on two kinase targets in the field of oncology;

seek additional collaborations that apply the capabilities of this platform toward validated kinase targets in oncology or other therapeutic areas.

Development Strategy

Our strategy for developing specific compounds into commercial products has the following components:

Grow organically and through business development. We plan to grow both organically and through business development activities that take advantage of our product and technology assets. Organic growth will be based on our advancement of internally defined product candidates from pre-clinical through clinical development. These candidates will be based upon scientific platforms within the Company and directed toward targets with validated roles in oncogenic processes and potentially in other therapeutic areas. Their design will be informed by our combined expertise in chemistry and cancer biology that we believe differentiates us from many of our competitors.

Simultaneously, we will consider a broad range of business development activities potentially encompassing product and technology acquisitions, licensing agreements and corporate combinations that will help expand the overall scope of product development and potentially accelerate the implementation of a commercialization infrastructure. Such activities offer the opportunity to leverage the capabilities of a potential partner with resources complementary to ours in drug discovery and development. We may also continue to invest in technology and personnel to enhance or expand our capabilities in drug discovery.

Focus on cancer, a market with a large unmet need. Cancer is the second most common cause of death in the western world. According to the American Cancer Society, approximately 562,000 cancer-related deaths were projected to occur and 1.4 million new cases were projected to be diagnosed in the U.S. during 2009. Demographic trends and improved screening are expected to increase the rate of cancer diagnoses, as 77 percent of cancers occur in the over-55 year old population. The National Cancer Institute estimates that between 2002 and 2006 the median age of cancer patients at death was 73, and the overall healthcare cost of cancer in the U.S. during 2008 was $228 billion.

Medical therapy for cancer has historically included surgery, cytotoxic (poisonous to cells) chemotherapy and radiation. While chemotherapies have evolved, many are still harmful to all rapidly dividing cells. More recently, a number of alternative therapies that are target specific have been introduced. We believe that targeted approaches to treating cancer, such as those we are pursuing, have the potential to be more selective for cancer cells than traditional chemotherapies.

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Cancer compounds are eligible for potential accelerated regulatory approval, and we will pursue opportunities for such approval as appropriate. Once on the market, with supportive data the agents may be approved for additional indications.

Utilize our AKIP discovery platform. We have discovered a novel binding mode of ARQ 197 to its target, the c-Met receptor kinase. We have completed initial research in the human kinome (consisting of 518 human kinase genes) and identified similar binding sites in approximately 270 kinases, which has led to the establishment of AKIP . We believe we have within this platform the capability to design novel kinase inhibitors with a novel, non-ATP competitive mechanism of action. In so doing, we plan to exploit unencumbered chemical space with the potential for an expanding intellectual property estate. We will seek to expand our proprietary drug discovery platform through additional collaborative research programs as well as through our own internal discovery and development activities in multiple therapeutic areas.

Benefit from the resources and strengths of collaborators. In April, 2007, we announced that we entered into an exclusive license agreement with Kyowa Hakko Kirin to develop and commercialize ARQ 197 in Japan and parts of Asia, and in November, 2008, we entered into a strategic relationship with Daiichi Sankyo to develop and commercialization ARQ 197 in those areas of the world not covered by the Kyowa Hakko Kirin agreement, as well as to develop a new generation of highly selective kinase inhibitors by applying our AKIP platform. We benefit from the resources and expertise of these partners, and we intend to pursue future partnership arrangements as appropriate when the capabilities of a potential partner complement our strengths in drug discovery and development.

PATENTS AND PROPRIETY RIGHTS

We rely principally on patent and trade secret protection for our intellectual property, both in the U.S. and other countries. While many patent applications have been filed in the U.S., the European Union ("E.U.") and other foreign countries with respect to our cancer programs, the majority of these have not yet been issued or allowed. The patent positions of companies in the biotechnology industry and the pharmaceutical industry are highly uncertain and involve complex legal and factual questions. Therefore, we cannot predict the breadth of claims, if any, that may be allowed under any of our patent applications, or the enforceability of any of our issued patents.

Patents extend for varying periods according to the date of patent filing or grant and the legal term of patents in the various countries where patent protection is obtained. The actual protection afforded by a patent, which can vary from country to country, depends on the type of patent, the scope of its coverage and the availability of legal remedies in the country.

As and when needed to support our current or future research and development programs, we may from time to time obtain rights under patents and other intellectual property owned by other parties through permanent or limited duration licenses or assignments of relevant intellectual property. These may include exclusive and nonexclusive licenses from medical and academic institutions, and industry sources as well as generally available commercial licenses. For our current clinical and research programs, we are not a party to any material intellectual property agreement under which we could lose access to a technology necessary to continue research and development of our products if we failed to fulfill our obligations thereunder. We anticipate that we will continue to seek intellectual property rights from external sources where the applicable technology complements our research and development efforts.

For our c-Met program, we have an issued patent in Japan for the composition of matter of the Company's lead compound, ARQ 197. This issued patent will expire in February 2026. We also have an issued patent in the U.S. relating to the preparation of an intermediate in the synthesis of ARQ 197, which expires in December 2020. In addition, we have received a notice of allowance and fees due

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from the U.S. Patent and Trademark Office for a patent covering the composition of matter of ARQ 197. The U.S. Patent and Trademark Office has made an initial determination that the patent will be entitled to a patent term adjustment of 674 days beyond its normal expiration date of February 2026 to December 2028 (and in addition, there is the possibility of a patent term extension based upon regulatory review). We also have notices of allowance from the Republic of Korea and the Republic of Singapore for composition of matter patent applications covering ARQ 197. These patents will expire in February 2026. Furthermore, we have pending U.S., European and other foreign applications covering the composition of matter and pharmaceutical compositions containing this compound, as well as its therapeutic uses in the treatment of cancer and other diseases.

With respect to the lead compounds in our Eg5 and FGFR programs, we have filed patent applications in the U.S., Europe and other foreign applications covering composition of matter and pharmaceutical compositions of these compounds as well as their therapeutic uses in the treatment of cancer and other diseases. Furthermore, through the application of our AKIP discovery platform to the discovery of small molecule kinase inhibitors, we have filed numerous composition of matter patent applications in various countries.

Regarding the E2F-1 Program, we have issued patents and pending applications that cover the formulations, syntheses and therapeutic uses of ARQ 501 in the treatment of cancer. ARQ 501 is derived from a naturally occurring substance, and we do not have patents that cover the composition of this compound. Our current lead compound in the E2F-1 Program, ARQ 761, is a reformulation of ARQ 501 and we have pending U.S., European and other foreign applications covering the composition of this compound, pharmaceutical compositions containing this compound, and the therapeutic uses of this compound in the treatment of cancer. Our issued and allowed patents for the E2F-1 Program have expiration dates which range from February 2018 to July 2025.

In an effort to maintain the confidentiality and ownership of our trade secrets and proprietary information, we require all of our employees and consultants to sign confidentiality agreements. Employees and consultants involved in scientific and technical endeavors also sign invention assignment agreements. We intend these confidentiality and assignment agreements to protect our proprietary information by controlling the disclosure and use of technology to which we have rights. These agreements also provide that we will own all the proprietary technology developed at ArQule or developed using our resources.

"ArQule", the ArQule logo, "Activated Checkpoint Therapy", and "AMAP" are trademarks of ArQule that are registered in the U.S. Patent and Trademark Office. The term "AKIP" is a trademark of ArQule.

COMPETITION

The pharmaceutical and biotechnology industries are highly competitive. We face intense competition from organizations such as large pharmaceutical companies, biotechnology companies and academic and research organizations. The major pharmaceutical and biotechnology organizations competing with us have greater capital resources, larger overall research and development staff and facilities and considerably more experience in drug development and commercialization. Consequently, we face competition on several fronts, including:

Competition for collaborators and investors;

Recruitment and retention of highly qualified scientific and management personnel;

Competition for qualified subjects for our clinical studies of our drug candidates, which may result in longer and more costly clinical trials;

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With respect to our cancer drug development programs, other companies have potential drugs in preclinical and clinical trials that may result in effective, commercially successful treatments for the same cancers we target;

Advancement of a discovery and development portfolio of anti-cancer candidates that are selective for cancer cells and applicable across a broad spectrum of cancer types;

Securing partners to co-develop and advance our drug candidates through later-stage clinical trials and beyond.

In the area of small molecule anti-cancer therapeutics, we have identified a number of companies that have clinical development programs and focused research and development in small molecule approaches to cancer, including: Ariad Pharmaceuticals, Inc., Array BioPharma Inc., Astex Therapeutics, Cell Genesys, Inc., Cell Therapeutics, Inc., Curis, Inc., Cytokinetics, Inc., Exelixis, Inc., GlaxoSmithKline, Idera Pharmaceuticals, Inc., Infinity Pharmaceuticals, Inc., Onyx Pharmaceuticals, Inc., OSI Pharmaceuticals, Inc., Oxigene, Inc., Pharmacopeia, Inc., Plexxikon, Inc.,Telik, Inc., and Vertex Pharmaceuticals Inc.

In addition, with respect to ARQ 197, we are aware of a number of companies that are or may be pursuing a number of different approaches to c-Met inhibition, including Amgen Inc., AVEO Pharmaceuticals, Inc., Bristol-Myers Squibb Company, Cephalon, Inc., Compugen Ltd., Eli Lilly & Company, Exelixis, Inc., Genentech, Inc., GlaxoSmithKline, Johnson & Johnson, Merck & Co., Inc., Methylgene Inc., Pfizer, Schering-Plough, and Supergen Inc. There can be no assurance that our competitors will not develop more effective or more affordable products or technology or achieve earlier product development and commercialization than ArQule, thus rendering our technologies and/or products obsolete, uncompetitive or uneconomical.

GOVERNMENT REGULATION

Virtually all pharmaceutical and biotechnology products that our collaborative partners or we develop will require regulatory approval by governmental agencies prior to commercialization. The nature and the extent to which these regulations apply vary depending on the nature of the products. In particular, human pharmaceutical products are subject to rigorous preclinical and clinical testing and other approval procedures by the FDA or the applicable regulatory authorities in countries other than the U.S. Various federal and, in some cases, state statutes and regulations also govern or influence the manufacturing, safety, labeling, storage, record keeping and marketing of these products. The process of obtaining these approvals and the subsequent compliance with appropriate statutes and regulations are time consuming and require substantial resources, and the outcome of these regulatory activities is uncertain.

Generally, in order to gain marketing authorization, a company first must conduct preclinical studies in the laboratory and in animal models to gain preliminary information on a compound's activity and to identify potential safety problems. Preclinical studies must be conducted in accordance with applicable regulations of the relevant regulatory authority (e.g. FDA in the U.S., European Medicines Agency ("EMA") in E.U.). The results of these studies are submitted as a part of an IND application with the FDA or a Clinical Trial Application ("CTA") application with the appropriate regulatory authority outside of the United States. The regulatory agency involved must review the data in the application before human clinical trials of an investigational drug can commence. If the regulatory authority does not object, a drug developer can begin clinical trials after expiration of a specified statutory period following submission of the application. Notwithstanding that the regulatory authority did not respond during the thirty-day, post-submission review period, the regulatory authority may at any time re-evaluate the adequacy of the application and require additional information about any aspect of the IND or CTA application and corresponding clinical trial, e.g. preclinical testing, drug formulation and manufacture, dosing regimens and drug administration or potential safety risks.

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In order to eventually commercialize any products, we or our collaborator will be required to initiate and oversee clinical studies under an IND or CTA to demonstrate the safety and efficacy that are necessary to obtain marketing approval. Clinical trials are normally done in three phases and generally take several years, but may take longer to complete. Furthermore, a regulatory authority may suspend clinical trials at any time if it believes that the subjects participating in trials are being exposed to unacceptable risks or if the regulatory authority finds deficiencies in the conduct of the trials or other problems with our product under development.

After completion of clinical trials of a new product, regulatory marketing approval must be obtained. If the product is classified as a new pharmaceutical, our collaborator or we will be required to file a New Drug Application ("NDA") or Marketing Authorization Application ("MAA"), and receive approval before commercial marketing of the drug. The marketing application contains, among other things, the results of the non-clinical and clinical testing of the drug. Marketing applications submitted to any regulatory authority can take several years to obtain approval and the regulatory authority is not obligated to grant approval at all. A regulatory agency can condition marketing approval on the conduct of costly post-marketing follow-up studies or can place restrictions on the sale or marketing of the drug in order to manage risks.

Even if regulatory clearances are obtained, a marketed product is subject to continual review and ongoing regulatory obligations. If and when a regulatory authority approves any of our or our collaborators' products under development, the manufacture and marketing of these products will be subject to continuing regulation, including compliance with current Good Manufacturing Practices ("cGMP"), adverse event reporting requirements and prohibitions on promoting a product for unapproved uses or making false or misleading statements or omissions with respect to a drug in advertising or promotion. Later discovery of previously unknown problems or failure to comply with the applicable regulatory requirements may result in restrictions on the marketing of a product or withdrawal of the product from the market as well as possible civil or criminal sanctions. Various federal and, in some cases, state statutes and regulations also govern or influence the manufacturing, safety, labeling, storage, record keeping and marketing of pharmaceutical products.

For marketing outside the U.S., we or our partners will be subject to foreign regulatory requirements governing human clinical trials, marketing approval and post-marketing activities for pharmaceutical products and biologics. The requirements governing the conduct of clinical trials, product licensing, pricing and reimbursement vary widely from country to country.

EMPLOYEES

As of February 1, 2010, we employed 111 people in Woburn, Massachusetts. Of that total, 82 are engaged in research and development and 29 in general and administration, and 41 hold Ph.D.s, 4 hold M.D.s and 24 hold Masters in the Sciences.

CERTAIN OTHER INFORMATION

We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission ("SEC"). You may read and copy any document we file at the SEC's Public Reference Room at 100 F Street, N.E., Washington D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. The SEC maintains a website at *http://www.sec.gov* that contains reports, proxy and information statements and other information concerning filers. We also maintain a web site at *http://www.arqule.com* that provides additional information about our company and links to documents we file with the SEC. The Company's Corporate Governance Guidelines; the charters of the Audit Committee, the Compensation, Nominating and Governance Committee, and the Science Committee; and the Code of Conduct are also available on the Company's website.

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EXECUTIVE OFFICERS

Set forth below is certain information regarding our current executive officers, including their respective ages as of February 1, 2010.

NAME	AGE	POSITION
Paolo Pucci	48	Chief Executive Officer and a Director
Peter S. Lawrence	46	President and Chief Operating Officer
Dr. Brian Schwartz	48	Chief Medical Officer
Dr. Thomas C.K. Chan	54	Chief Scientific Officer

Paolo Pucci
Chief Executive Officer

Mr. Pucci joined ArQule as Chief Executive Officer and a member of the board of directors in June 2008 from Bayer A.G., where he served as senior vice president and president in charge of the Bayer-Schering Pharmaceuticals Global Oncology/Specialized Therapeutics Business Units. Previously Mr. Pucci was senior vice president of Bayer Pharmaceuticals Global Specialty Business Unit, president of U.S. Pharmaceutical Operations and a member of the Bayer Pharmaceuticals Global Management Committee. At Bayer, Mr. Pucci was involved in a broad range of activities related to Nexavar® (sorafenib), an oral multiple kinase inhibitor to treat liver and kidney cancers. These activities included clinical development, regulatory review, corporate alliance management, product launch and marketing. Mr. Pucci joined Bayer as head of its Italian Pharmaceutical operations in 2001. Prior to Bayer, Mr. Pucci held positions of increasing responsibility with Eli Lilly, culminating with his appointment as managing director, Eli Lilly Sweden AB. At Lilly, his responsibilities included operations, sales, marketing and strategic planning. Mr. Pucci holds an MBA from the University of Chicago and is a graduate of the Universita Degli Studi Di Napoli in Naples, Italy.

Peter S. Lawrence
President and Chief Operating Officer

Mr. Lawrence joined ArQule as Executive Vice President and Chief Business Officer in April 2006. He was named Chief Operating Officer in October 2007 and President in April 2008. Previously he was at Pod Venture Partners, an international venture capital firm which he co-founded in 2001 and where he most recently served as general partner. He helped drive the strategic growth of that firm, including deal sourcing and structuring, syndication and business expansion activities. Previously, Mr. Lawrence was an attorney and partner at Mintz, Levin, Cohn, Ferris Glovsky and Popeo, P.C., from 1991 to 2001. At Mintz Levin, he served as external corporate counsel to public and private companies, managed a transactional legal practice and provided strategic guidance to clients through periods of rapid growth and transformative corporate events. His public financing experiences include the initial public offering and numerous financings for America Online Inc. (AOL), as well as public financings for Biogen, Human Genome Sciences, Hybridon and many other companies. He worked on numerous mergers and acquisitions, including Roche/Compuchem, AOL/Time Warner, Steinway Piano, DEC/Intel, and Mitotix/GPC Biotech. Mr. Lawrence worked at Gaston & Snow from 1989 to 1991 in the firm's Corporate Law Department. He holds a Bachelor's degree from Amherst College and a J.D. from Boston University School of Law.

Brian Schwartz, M.D.
Chief Medical Officer

Dr. Schwartz joined ArQule in July 2008 from Ziopharm Oncology, Inc., where as Senior Vice president, clinical and regulatory affairs, and Chief Medical Officer he built and led clinical, regulatory, and quality assurance departments responsible for the development of new cancer drugs. Prior to

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Ziopharm, Dr. Schwartz held a number of positions at Bayer Healthcare. His experience in oncology has encompassed the clinical development of novel cytostatic, cytotoxic and immunological agents. At Bayer, Dr. Schwartz was a key physician responsible for the global clinical development of Nexavar® (sorafenib) and led the clinical team through a successful Phase 3 trial in renal cell cancer, leading to FDA approval. He has extensive regulatory experience working with the FDA's Oncology Division, the European Medicines Agency (EMA), and numerous other health authorities. Dr. Schwartz has also been responsible for U.S. clinical and regulatory activities, including Phase 4 studies and interactions with the National Cancer Institute and other oncology cooperative groups. Dr. Schwartz received his medical degree from the University of Pretoria, South Africa, practiced medicine, and worked at the University of Toronto prior to his career in industry.

Thomas C. K. Chan, Ph.D.
Chief Scientific Officer

Dr. Chan joined ArQule in December 2005 as Vice President, pharmacology and toxicology. He was named Chief Scientific Officer in January 2008 and manages all research and early development activities, including new oncology drug candidate selection at ArQule. He is also responsible for toxicology and clinical pharmacology of the Company's drug candidates currently in human clinical trials. Dr. Chan was previously at MacroChem Corporation from 2001 to 2005, where he served as Chief Technology Officer and Vice President, research and development. He was also Senior Director, pharmacology and toxicology, at EPIX Medical, Inc. from 1997 to 2000, and Director of therapeutic development at Creative Biomolecules from 1993 to 1997. Prior to his career in industry, Dr. Chan held a number of academic appointments, most recently as a director of the Purdue University Cancer Center and a tenured professor at Purdue University and Indiana University. He is a member of several NIH Study Sections and consults for the U.S. Department of Defense on their prostate and breast cancer research programs. Dr. Chan received his doctorate in pharmacology/toxicology from the University of British Columbia, and he was a postdoctoral fellow in hematology/oncology at the Cancer Center of the University of California, San Diego School of Medicine.

ITEM 1A. RISK FACTORS

RISKS RELATING TO OUR INDUSTRY AND BUSINESS STRATEGY

Development of our products is at an early stage and we may not successfully develop a drug candidate that becomes a commercially viable drug.

The discovery and development of drugs is inherently risky and involves a high rate of failure. Discovery and development of commercial drugs are relatively new to us. Our drug candidates and drug research programs are in early stages and require significant, time-consuming and costly research and development, testing and regulatory approvals.

Our leading clinical-stage product candidate, ARQ 197, is based on inhibition of the c-Met receptor tyrosine kinase. Two of our other product candidates, ARQ 501 (Phase 2) and ARQ 761 (IND filed), are based on activation of the DNA damage response mechanism mediated by the E2F-1 transcription factor and a third, ARQ 621 (Phase 1), is based on inhibition of the Eg5 kinesin spindle protein. Although drugs have been approved that inhibit the activity of protein kinases and other enzymes and mitotic proteins such as tubulins, to our knowledge, no company has received regulatory approval for a drug based on the specific proteins targeted by any of our product candidates. Our approaches and scientific platforms may not lead to the development of approvable or marketable drugs.

In addition to our clinical-stage programs, we have a limited number of pre-clinical and research-stage programs in our pipeline. Our viability as a company depends, in part, on our ability to continue to create drug candidates for ourselves and our collaborators. Numerous significant factors will affect

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the success of our drug research and development efforts, including the biology and chemistry complexity involved, availability of appropriate technologies, the uncertainty of the scientific process and the capabilities and performance of our employees. Our research and development capabilities may not be adequate to develop additional, viable drug candidates.

We must show the safety and efficacy of our product candidates through expensive, time consuming preclinical testing and clinical trials, the results of which are uncertain and governed by exacting regulations.

Our product candidates are in clinical or preclinical stages of development and may not prove to be sufficiently safe or effective in more advanced human clinical trials. We will need to conduct extensive further testing of all of our product candidates, expend significant additional resources and possibly partner emerging programs to realize commercial value from any of our product candidates.

Before obtaining regulatory approvals for the commercial sale of our products, we must demonstrate through preclinical studies (laboratory or animal testing) and clinical trials (human testing) that our proposed products are safe and effective for use in each target indication. This testing is expensive and time-consuming, and failure can occur at any stage. If we terminate a preclinical or clinical program, we will have expended resources in an effort that will not provide a return on our investment and missed the opportunity to have allocated those resources to potentially more productive uses.

Clinical trials must meet FDA and foreign regulatory requirements. We have limited experience in designing, conducting and managing the preclinical studies and clinical trials necessary to obtain regulatory approval for our product candidates in any country. We or our collaborative partners may encounter problems in clinical trials that may cause us or the FDA or foreign regulatory agencies to delay, suspend or terminate our clinical trials at any phase. These problems could include our inability to manufacture or obtain sufficient quantities of materials produced in accordance with current Good Manufacturing Practice, or cGMP, for use in our clinical trials, conduct clinical trials at our preferred sites, enroll a sufficient number of patients for our clinical trials at one or more sites, or begin or successfully complete clinical trials in a timely fashion, if at all. Furthermore, we, the FDA or foreign regulatory agencies may suspend clinical trials of our product candidates at any time if we or they believe the subjects participating in the trials are being exposed to unacceptable health risks as a result of adverse events occurring in our trials or if we or they find deficiencies in the clinical trial process or conduct of the investigation.

Acceptable results from initial preclinical studies and clinical trials of products under development are not necessarily indicative of results that will be obtained from subsequent or more extensive preclinical studies and clinical testing in humans. Clinical trials may not demonstrate sufficient safety and efficacy to obtain the required regulatory approvals or result in marketable products. Failure to adequately demonstrate the safety and efficacy of a product under development will delay and could prevent its regulatory approval.

A number of companies in the pharmaceutical industry, including biotechnology companies, have suffered significant setbacks in advanced clinical trials, even after generating promising results in earlier trials.

Though it is part of our strategy to pursue clinical development to take advantage of available accelerated regulatory approval processes, there is no guarantee that our product candidates will show the evidence predictive of clinical benefit necessary to qualify for such regulatory treatment.

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Delays in clinical testing could result in increased costs to us and delay our ability to obtain regulatory approval and commercialize our product candidates.

Clinical trials typically take several years to complete. The duration and cost of clinical trials will vary greatly depending on the nature, complexity, and intended use of the drug being tested. We may not complete clinical testing within the time frame we have planned, or at all. At any time, a clinical trial can be placed on "clinical hold" or temporarily or permanently stopped for a variety of reasons, principally for safety concerns. We may experience numerous unforeseen events during, or as a result of, the clinical trial process that could delay or prevent us from receiving regulatory approval or commercializing our product candidates, including the following:

- our clinical trials may produce negative or inconclusive results, and we may decide, or regulators may require us, to provide additional information about formulation or manufacture of our product candidates or clinical trial design or to conduct additional clinical and/or pre-clinical testing or to abandon programs;
- trial results may not meet the level of statistical significance required by the FDA or other regulatory agencies;
- enrollment in our clinical trials for our product candidates may be slower than we anticipate, resulting in significant delays;
- we, or regulators, may suspend or terminate our clinical trials if the participating patients are being exposed to unacceptable health risks;
- the effects of our product candidates on patients may not be the desired effects or may include undesirable side effects or other characteristics that may delay or preclude regulatory approval or limit their commercial use, if approved; and
- the FDA or other regulatory agencies may lack experience in evaluating the safety and efficacy of drugs based on our development platforms, which could lengthen the regulatory review process.

Completion and duration of clinical trials depends on, among other things, our ability to enroll a sufficient number of patients, which is a function of many factors, including:

- the incidence among the general population of diseases which contain therapeutic endpoints chosen for evaluation;
- the eligibility criteria defined in the protocol;
- the size of the patient population required for analysis of the trial's therapeutic endpoints;
- our ability to recruit clinical trial investigators and sites with the appropriate competencies and experience;
- our ability to obtain and maintain patient consents; and
- competition for patients by clinical trial programs for other treatments.

We have limited clinical development and commercialization experience.

We have limited experience conducting clinical trials and have never obtained regulatory approvals for any drug. To date, we have filed five IND applications, and we have initiated sixteen Phase 1 clinical trials of which eleven have been completed, and seven Phase 2 clinical trials of which four have been completed. We have not conducted a Phase 3, or pivotal, clinical trial, filed an NDA or commercialized a drug. We have no experience as a company in the sale, marketing or distribution of pharmaceutical products and do not currently have a sales and marketing organization. Developing

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commercialization capabilities will be expensive and time-consuming, and could delay any product launch. We may not be able to develop a successful commercial organization. To the extent we are unable or determine not to acquire these resources internally, we will be forced to rely on third-party clinical investigators, clinical research organizations, marketing organizations or our collaboration partners. If we were unable to establish adequate capabilities independently or with others, our drug development and commercialization efforts could fail, and we may be unable to generate product revenues.

If our drug discovery and development programs do not progress as anticipated, our revenue and stock price could be negatively impacted.

We estimate the timing of a variety of preclinical, clinical, regulatory and other milestones for planning purposes, including when a drug candidate is expected to enter clinical trials, how soon patients will be recruited and enrolled in these trials, when a clinical trial will be completed and when an application for regulatory approval will be filed. We base our estimates on facts that are currently known to us and on a variety of assumptions, many of which are beyond our control. If we or our collaborators do not achieve milestones when anticipated, we will not receive the corresponding revenue, and our stock price could decline. In addition, our research and clinical testing may be delayed or abandoned if we or our competitors subsequently discover other compounds that show improved safety or efficacy compared to our product candidates, which could limit our ability to generate revenues, cause us to incur additional expense and cause the market price of our common stock to decline significantly.

RISKS RELATED TO OUR FINANCIAL CONDITION

We have incurred significant losses since our inception and anticipate that we will incur significant continued losses for the next several years, and our future profitability is uncertain.

From our inception in 1993 through December 31, 2009 we have incurred cumulative losses of approximately $369 million. These losses have resulted principally from the costs of our research activities, acquisitions, enhancements to our technology and clinical trials. In the past we derived our revenue primarily from license and technology transfer fees and payments for compound deliveries associated with our discontinued chemistry services operations; research and development funding paid under our agreements with collaboration partners; and to a limited extent, milestone payments.

We expect our expenses to increase significantly as we spend additional amounts to fund research, development, clinical testing and commercialization of our drug candidates. We currently have two product candidates in various stages of clinical development. We anticipate filing an IND application for an additional product candidate in 2010. As a result, we will need to generate significant additional revenues to achieve profitability.

To attain profitability, we will need to develop clinical products successfully and market and sell them effectively, either by ourselves or with collaborators. We have never generated revenue from the commercialization of our product candidates, and there is no guarantee that we will be able to do so. Even if were to generate product revenues and achieve profitability, we may not be able to maintain or increase profitability. Because of the numerous risks and uncertainties associated with the development of drugs, we are unable to predict the extent of any future losses or when we will become profitable, if at all. If we fail to become profitable, or if we are unable to fund our continuing losses, we may be unable to continue our business.

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We may need substantial additional funding and due to global capital and credit market conditions or for other reasons, we may be unable to raise capital when needed, or on terms favorable to us, which could force us to delay, reduce or eliminate our drug discovery, product development and commercialization activities.

Volatility and disruption in the global capital and credit markets in 2008 and 2009 have led to a tightening of business credit and investment capital in the United States and internationally. If global economic and financial market conditions deteriorate or remain weak for an extended period of time, our efforts to raise capital will face additional difficulties.

Developing drugs, conducting clinical trials, and commercializing products are expensive. Our future funding requirements will depend on many factors, including:

- the progress and cost of our ongoing and future collaborative and independent clinical trials and other research and development activities and our ability to share such costs of our clinical development efforts with third parties;
- the costs and timing of obtaining regulatory approvals;
- the costs of filing, prosecuting, maintaining, defending and enforcing any patent applications, claims, patents and other intellectual property rights;
- the cost and timing of securing manufacturing capabilities for our clinical product candidates and commercial products, if any;
- the costs and timing of commercializing our product candidates, including establishing or contracting for sales, marketing and distribution capabilities, if any such candidates receive regulatory approval for commercial sale; and
- the costs of any acquisitions of or investments in businesses, products and technologies.

We may seek the capital necessary to fund our operations through public or private equity offerings, debt financings, or collaboration and licensing arrangements. To the extent that we raise additional capital through the sale of equity or convertible debt securities, our stockholders' ownership interests will be diluted and the terms of such securities may include liquidation or other preferences that adversely affect our stockholders' rights. Other debt-financing arrangements may require us to pledge certain assets and enter into covenants that would restrict certain business activities or our ability to incur further indebtedness. If we raise additional funds through collaboration and licensing arrangements with third parties, we may have to relinquish rights to certain product candidates that we might otherwise seek to develop or commercialize independently, or grant licenses on terms that are not favorable to us. There can be no assurance that sufficient funds will be available to us when required, on satisfactory terms, or at all. If we are unable to obtain additional funds when needed, we may have to delay, reduce the scope of or eliminate some of our development and commercialization programs, or obtain funds through other arrangements on unattractive terms, which could prevent us from successfully executing our business strategy.

Funds associated with certain of our auction rate securities may not be accessible for an undetermined period of time and our auction rate securities may experience a decline in value, which would adversely affect our liquidity.

We have invested a portion of our available cash in a certain type of debt obligation known as auction rate securities. Our auction rate securities ("ARS") are obligations backed by U.S. federal and state agencies and, consequently, have strong credit ratings. Generally, ARS are structured with short-term interest reset dates, but with contractual maturities that can be well in excess of ten years. At the end of each reset period, investors have the right to sell their ARS or continue to hold the securities at par value and receive interest payments. If an auction for ARS fails, i.e. sell orders exceed buy orders and, therefore, under auction rules none of the securities may be sold, the principal

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amounts of ARS for which the auction failed would not be accessible by investors until a successful auction occurred, a buyer was found outside the auction process or the underlying securities matured.

Auction failures occurred during 2008 and 2009 with respect to certain of our ARS thereby rendering illiquid our ARS holdings, which as of December 31, 2009 were $59.5 million at par value. As a result of this occurrence, on July 8, 2008, we entered into a collateralized, revolving credit line agreement for up to $47.5 million with UBS Bank USA (the "Facility"). The Facility is secured by a first priority lien and security interest in the ARS held by us in an account with UBS Financial Services Inc., an affiliate of UBS Bank USA. UBS Financial Services had served as our financial advisor with respect to our ARS holdings and had purchased them on our behalf. The credit line is uncommitted and any outstanding balance, including interest, is payable upon demand. The balance under the Facility at December 31, 2009 was $44.4 million.

On November 3, 2008, we accepted an offer by UBS AG, the parent of UBS Bank USA and UBS Financial Services Inc., of certain rights to cause UBS AG to purchase our ARS. The repurchase rights were offered in connection with UBS AG's obligations under settlement agreements with the U.S. Securities and Exchange Commission and other federal and state regulatory authorities. The offering, the settlement agreements, and the respective rights and obligations of the parties, including a release by us of UBS AG and its employees and agents from certain specified claims relating to UBS AG's marketing and sale of auction rate securities, are described in a prospectus issued by UBS AG dated October 7, 2008.

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

As a result of accepting UBS AG's offer, if our ARS have not previously been sold by us or by UBS AG on our behalf, we can require UBS AG to repurchase our ARS at par value at any time during the period from June 30, 2010 through July 2, 2012. Proceeds of sales of our ARS will first be applied to repayment of the Facility with the balance for our account.

UBS AG's obligations under the offer are not secured by its assets and do not require UBS AG to obtain any financing to support its obligations. UBS AG has disclaimed any assurance that it will have sufficient financial resources to satisfy its obligations. If UBS AG does not have sufficient financial resources to meet its obligations under its offering, we may not have access to the full principal amount of our ARS.

We have federal and state net operating losses ("NOL") and research and development credit carryforwards which, if we were to become profitable, could be used to offset/defer federal and state income taxes. Such carryforwards may not, under certain circumstances related to changes in ownership of our stock, be available to us.

As of December 31, 2009, we had federal NOL, state NOL, and research and development credit carryforwards of approximately $179 million, $117 million and $21 million respectively, which expire at various dates through 2029. Such carryforwards could potentially be used to offset certain future federal and state income tax liabilities. Utilization of carryforwards may be subject to a substantial annual limitation pursuant to Section 382 of the Internal Revenue Code of 1986, as amended, as well as similar state provisions due to ownership changes that have occurred previously or that could occur in the future. In general, an ownership change, as defined by Section 382, results from transactions increasing the ownership of certain shareholders or public groups in the stock of a corporation by more

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than 50 percentage points over a three-year period. We recently undertook a detailed study of our NOL and research and development credit carryforwards to determine whether such amounts are likely to be limited by Section 382. As a result of this analysis, we currently do not believe Sections 382's limitations will significantly impact our ability to offset income with available NOL and research and development credit carryforwards. However, future ownership changes under Section 382 may limit our ability to fully utilize these tax benefits.

Any limitation may result in expiration of a portion of the carryforwards before utilization. If we were not able to utilize our carryforwards, we would be required to use our cash resources to pay taxes that would otherwise have been offset, thereby reducing our liquidity.

RISKS RELATED TO REGULATORY APPROVAL

Our product candidates are subject to a lengthy and uncertain regulatory process that may not result in the necessary regulatory approvals, which would adversely affect our ability to commercialize products. We have only limited experience in regulatory affairs.

Our product candidates, as well as the activities associated with their research, development and commercialization, are subject to extensive regulation by the FDA in the United States and by comparable authorities in other countries, for example EMA in the E.U. These regulations govern or influence the manufacturing, assessment of benefit and risk, safety, labeling, storage, records and marketing of these products.

Failure to obtain regulatory approval for a product candidate would prevent us from commercializing that product candidate. We have not applied for or received regulatory approval to market any of our product candidates in any jurisdiction and have only limited experience in preparing and filing the applications necessary to gain regulatory approvals. The process of obtaining regulatory approvals is expensive, often takes many years, if approval is obtained at all, and can vary substantially based upon the type, complexity and novelty of the product candidates involved.

The regulatory process requires preclinical testing, and data obtained from preclinical and clinical activities are susceptible to varying interpretations, which could delay, limit or prevent regulatory approval. In addition, the results of later trials may not confirm the positive results of earlier preclinical studies or trials. Delays or rejections may also be encountered based upon changes in regulatory policy for product approval during the period of product development and regulatory agency review. Changes in regulatory approval policy, regulations or statutes or the process for regulatory review during the development or approval phases of our product candidates may cause delays in the approval or rejection of an application. We are currently in Phase 1 and Phase 2 clinical testing of ARQ 197 and Phase 1 clinical testing of ARQ 621. We have never conducted a Phase 3, or pivotal, clinical trial, nor have we filed or prosecuted the applications necessary to gain regulatory approvals.

A company first must conduct preclinical studies in the laboratory and in animal models to gain preliminary information on a candidate compound's activity and to identify potential safety problems. Preclinical studies must be conducted in accordance with applicable regulations of the relevant regulatory authority (e.g. the FDA in the United States, the EMA in E.U.). The results of these studies are submitted as a part of an IND application with the FDA or a CTA application with the appropriate regulatory authority outside of the United States. The regulatory agency involved must review the data in the application before human clinical trials of an investigational drug can commence. If the regulatory authority does not object, a drug developer can begin clinical trials after expiration of a specified statutory period following submission of the application. Notwithstanding that the regulatory authority did not respond during the thirty-day, post-submission review period, the regulatory authority may at any time re-evaluate the adequacy of the application and require additional information about any aspect of the IND or CTA application and corresponding clinical trial, e.g. preclinical testing, drug formulation and manufacture, dosing regimens and drug administration or potential safety risk. Before

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a new marketing application can be filed with the FDA or other regulatory authority, the product candidate must undergo extensive clinical trials. Any clinical trial may fail to produce results satisfactory to the regulatory authority, typically for lack of safety or efficacy or for safety risks. For example, the regulatory authority could determine that the design of a clinical trial is inadequate to produce reliable results or convincing results.

Even if our drug candidates obtain regulatory approval, we and our collaborators will be subject to ongoing government regulation.

Even if regulatory authorities approve any of our drug candidates, the manufacture, marketing and sale of these drugs will be subject to strict and ongoing regulation. Compliance with such regulations may consume substantial financial and management resources and expose us and our collaborators to the potential for other adverse circumstances. For example, a regulatory authority can place restrictions on the sale or marketing of a drug in order to manage the risks identified during initial clinical trials or after the drug is on the market. A regulatory authority can condition the approval for a drug on costly post-marketing follow-up studies. Based on these studies, if a regulatory authority does not believe that the drug demonstrates a clinical benefit to patients or an acceptable safety profile, it could limit the indications for which a drug may be sold or revoke the drug's marketing approval. In addition, identification of certain side effects either during clinical trials or after a drug is on the market may result in reformulation of a drug, additional preclinical and clinical trials, labeling changes, termination of ongoing clinical trials or withdrawal of approval. Any of these events could delay or prevent us from generating revenue from the commercialization of these drugs and cause us to incur significant additional costs.

Even if we or our collaborators bring products to market, we may be unable to effectively price our products or obtain adequate reimbursement for sales of our products, which would have an adverse effect on our revenues.

Third party payors, such as government and private insurance plans, frequently require companies to provide rebates and predetermined discounts from list prices and are increasingly challenging the prices charged for pharmaceuticals and other medical products. Our products may not be considered cost-effective, and reimbursement to the patient may not be available or be sufficient to allow the sale of our products on a competitive basis. We, or our collaborators, may not be able to negotiate favorable reimbursement rates for our products. If we, or our collaborators, fail to obtain an adequate level of reimbursement for our products by third-party payors, sales of the drugs would be adversely affected or there may be no commercially viable market for the products.

We face potential liability related to the privacy of health information we obtain from research institutions.

Most health care providers, including research institutions from which we or our collaborators obtain patient information, are subject to privacy regulations promulgated under the Health Insurance Portability and Accountability Act of 1996, or HIPAA. Although we are not directly regulated by HIPAA, we could face substantial criminal penalties if we knowingly receive individually identifiable health information from a health care provider or research institution that has not satisfied HIPPA's disclosure standards. In addition, certain state privacy laws may apply directly to our operations and/or those of our collaborators and may impose restrictions on our use and dissemination of individuals' health information. Moreover, patients about whom we or our collaborators obtain information, as well as the providers who share this information with us, may have contractual rights that limit our ability to use and disclose the information. Claims that we have violated individuals' privacy rights or breached our contractual obligations, even if we are not found liable, could be expensive and time-consuming to defend and could result in adverse publicity that could harm our business.

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RISKS RELATED TO COLLABORATIONS

Part of our business strategy involves collaborative out-licensing of our drug candidates while retaining commercialization or co-promotional rights in parts of the world. We may not be able to find collaborators or successfully form suitable collaborations to further our drug development and commercialization efforts.

We may seek collaborators for our drug development and commercialization efforts. We may enter into these collaborations to obtain external financing for drug development and to obtain access to drug development and commercialization expertise. The availability of partners depends on the willingness of pharmaceutical and biotechnology companies to collaborate in drug discovery activities. Only a limited number of pharmaceutical and biotechnology companies would fit our requirements. The number could decline further through consolidation, or the number of collaborators with interest in our drugs could decline. If the number of our potential collaborators were to decline, the remaining collaborators may be able to negotiate terms less favorable to us.

We face significant competition in seeking drug development collaborations, both from other biotechnology companies and from the internal capabilities and compound pipelines of the pharmaceutical and biotechnology companies themselves. This competition is particularly intense in the oncology field. Our ability to interest such companies in forming co-development and commercialization arrangements with us will be influenced by, among other things:

- the compatibility of technologies;
- the potential partner's acceptance of our approach to drug discovery;
- the novelty, quality and commercial potential of any drug candidate we may succeed in developing; and
- our ability, and collaborators' perceptions of our ability, to achieve intended results in a timely fashion, with acceptable quality and cost.

Even if we are able to gain the interest of potential drug development partners, the negotiation, documentation and implementation of collaborative arrangements are complex and time-consuming. Collaborations may not be available on commercially acceptable terms and, if formed, may not be commercially successful or, if successful, may not realize sufficient benefit for us. If we are unable to form collaborations, we may not gain access to the financial resources and industry expertise necessary to develop and commercialize drug products or successfully market any products we develop on our own and, therefore, be unable to generate revenue from our products.

Our success depends in part on the efforts of our current and possible future collaborators, who will likely have substantial control and discretion over the continued development and commercialization of drug candidates which are the subjects of our collaborations.

Our current collaborators, Kyowa Hakko Kirin and Daiichi Sankyo have, and future collaborators will have significant discretion in determining the efforts and amount of resources that they dedicate to our collaborations. Our collaborators may determine not to proceed with clinical development or commercialization of a particular drug candidate for a number of reasons that are beyond our control, even under circumstances where we might have continued such a program. In addition, our rights to receive milestone payments and royalties from our collaborators will depend on our collaborators' abilities to establish the safety and efficacy of our drug candidates, obtain regulatory approvals and achieve market acceptance of products developed from our drug candidates. We may also depend on our collaborators to manufacture clinical scale quantities of some of our drug candidates and, possibly, for commercial scale manufacture, distribution and direct sales. Our collaborators may not be successful in manufacturing our drug candidates or successfully commercializing them.

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We face additional risks in connection with our existing and future collaborations, including the following:

- our collaborators may develop and commercialize, either alone or with others, products that are similar to or competitive with the products that are the subject of the collaboration with us;
- our collaborators may underfund or not commit sufficient resources to the testing, marketing, distribution or other development of our drug candidates;
- our collaborators may not properly maintain or defend our intellectual property rights or they may utilize our proprietary information in such a way as to invite litigation that could jeopardize or potentially invalidate our intellectual property or proprietary information or expose us to potential liability;
- our collaborators may encounter conflicts of interest, changes in business strategy or other business issues which could adversely affect their willingness or ability to fulfill their obligations to us (for example, pharmaceutical and biotechnology companies historically have re-evaluated their priorities following mergers and consolidations, which have been common in recent years in these industries); and
- disputes may arise between us and our collaborators delaying or terminating the research, development or commercialization of our drug candidates, resulting in significant litigation or arbitration that could be time-consuming and expensive, or causing collaborators to act in their own self-interest and not in the interest of our stockholders;
- we might not have the financial or human resources to meet our obligations or take advantage of our rights under the terms of our existing and future collaborations; and
- our existing collaborators may exercise their respective rights to terminate without cause their collaborations with us, in which event, we might not be able to complete development and commercialization of ARQ 197 and other drug candidates on our own.

We may not receive any further milestone, royalty or license payments under our current collaborations.

Although we have received license fees and other payments to date under our current drug development collaborations with Kyowa Hakko Kirin and Daiichi Sankyo, we may not receive any royalty payments or additional license and milestone fees under such agreements. Our receipt of any future milestone, royalty or license payments depends on many factors, including whether our collaborators want or are able to continue to pursue potential drug candidates, intellectual property issues, unforeseen complications in the development or commercialization process, and the ultimate commercial success of the drugs.

RISKS RELATED TO RELATIONSHIPS WITH THIRD PARTY VENDORS

We rely heavily on third parties such as contract research organizations, to conduct clinical trials and perform research and analysis services for us. If third parties upon which we rely do not perform as contractually required or expected, we may not be able to develop further, obtain regulatory approval for or commercialize our product candidates.

We do not have the ability or the human resources to perform all of the testing or conduct all of the clinical trials that are necessary in connection with the development of our product candidates. We are using third-party clinical research organizations to oversee many of our ongoing clinical trials and expect to use the same or similar organizations for certain of our future clinical trials. Our reliance on these third parties reduces our control over these activities. We may face delays outside of our control if these parties do not perform their obligations in a timely or competent fashion or if we are forced to change service providers or if the quality or accuracy of the data they obtain is compromised due to

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their failure to adhere to our clinical protocols or regulatory requirements or for other reasons. These risks are heightened if we conduct clinical trials outside of the United States, where it may be more difficult to ensure that studies are conducted in compliance with FDA requirements. Any third party that we hire to conduct clinical trials may also provide services to our competitors, which could compromise the performance of their obligations to us. If we experience significant delays in the progress of our clinical trials and in our plans to file NDAs, the commercial prospects for product candidates could be harmed and our ability to generate product revenue would be delayed or prevented.

We have limited manufacturing experience. We primarily rely on third parties to provide sufficient quantities of our product candidates to conduct pre-clinical and clinical studies. We have no control over our manufacturers' and suppliers' compliance with manufacturing regulations, and their failure to comply could interrupt our drug supply.

To date, our product candidates have been manufactured in relatively small quantities for preclinical and clinical trials. We have no experience in manufacturing any of our product candidates on a large scale and have contracted with third party manufacturers to provide material for clinical trials and to assist in the development and optimization of our manufacturing processes and methods. Our ability to conduct clinical trials and commercialize our product candidates will depend on the ability of such third parties to manufacture our products on a large scale at a competitive cost and in accordance with cGMP and other regulatory requirements. Significant scale-up of manufacturing may result in unanticipated technical challenges and may require additional validation studies that the FDA must review and approve. If we are not able to obtain contract cGMP manufacturing on commercially reasonable terms, obtain or develop the necessary materials and technologies for manufacturing, or obtain intellectual property rights necessary for manufacturing, we may not be able to conduct or complete clinical trials or commercialize our product candidates. There can be no assurance that we will be able to obtain such requisite terms, materials, technologies and intellectual property necessary to successfully manufacture our product candidates for clinical trials or commercialization. Our product candidates require precise, high-quality manufacturing. The failure to achieve and maintain these high manufacturing standards, including the incidence of manufacturing errors, could result in patient injury or death, product recalls or withdrawals, delays or failures in product testing or delivery, cost overruns or other problems that could seriously hurt our business.

The facilities used by our contract manufacturers may undergo inspections by the FDA for compliance with cGMP regulations before our product candidates produced there can receive marketing approval. If these facilities do not satisfy cGMP requirements in connection with the manufacture of our product candidates, we may need to conduct additional validation studies, or find alternative manufacturing facilities, either of which would result in significant cost to us as well as a delay of up to several years in obtaining approval for any affected product candidate. In addition, after approval of a product candidate for commercial use, our contract manufacturers and any alternative contract manufacturer we may utilize will be subject to ongoing periodic inspection by the FDA and corresponding state and foreign agencies for compliance with cGMP regulations, similar foreign regulations and other regulatory standards. We do not have control over our contract manufacturers' compliance with these regulations and standards. Any failure by our third-party manufacturers or suppliers to comply with applicable regulations could result in sanctions being imposed (including fines, injunctions and civil penalties), failure of regulatory authorities to grant marketing approval of our product candidates, delays, suspension or withdrawal of approvals, license revocation, seizures or recalls of product candidates or products, operating restrictions and criminal prosecution.

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Materials necessary to manufacture our product candidates currently under development may not be available on commercially reasonable terms, or at all, which may delay our development and commercialization of these drugs.

Some of the materials necessary for the manufacture of our product candidates currently under development may, from time to time, be available either in limited quantities, or from a limited number of manufacturers, or both. We and/or our collaborators need to obtain these materials for our clinical trials and, potentially, for commercial distribution when and if we obtain marketing approval for these compounds. Suppliers may not sell us these materials at the time we need them or on commercially reasonable terms. If we are unable to obtain the materials needed for the conduct of our clinical trials, product testing and potential regulatory approval could be delayed, adversely impacting our ability to develop the product candidates. If it becomes necessary to change suppliers for any of these materials or if any of our suppliers experience a shutdown or disruption in the facilities used to produce these materials, due to technical, regulatory or other problems, it could significantly hinder or prevent manufacture of our drug candidates and any resulting products.

RISKS RELATED TO OUR COMMON STOCK

Our stock price may be extremely volatile.

The trading price of our common stock has been highly volatile. We believe the trading price of our common stock will remain highly volatile and may fluctuate substantially due to factors such as:

- adverse results or delays in clinical trials;
- announcement of FDA approval or non-approval, or delays in the FDA review process, of our or our collaborators' product candidates or those of our competitors or actions taken by regulatory agencies with respect to our, our collaborators' or our competitors' clinical trials;
- announcement of new products by us or our competitors;
- quarterly variations in our or our competitors' results of operations, including as a result of recognition of upfront licensing or other fees, the timing and amount of expenses incurred for clinical development, regulatory approval and commercialization of our product candidates;
- litigation, including intellectual property infringement lawsuits, involving us;
- financing transactions;
- developments in the biotechnology and pharmaceutical industries;
- the general performance of the equity markets and in particular the biopharmaceutical sector of the equity markets;
- departures of key personnel or board members;
- developments concerning current or future collaborations;

FDA or international regulatory actions affecting our industry generally; and

third-party reimbursement policies.

This volatility and general market declines in our industry over the past several years have affected the market prices of securities issued by many companies, often for reasons unrelated to their operating performance, and may adversely affect the price of our common stock. In the past, securities class action litigation has often been instituted following periods of volatility in the market price of a company's securities. A securities class action suit against us could result in potential liabilities, substantial costs and the diversion of management's attention and resources, regardless of the outcome of the action.

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Some of our existing stockholders can exert control over us, and their interests could conflict with the best interests of our other stockholders.

Due to their combined stock holdings, our principal stockholders (stockholders holding more than 5% of our common stock), acting together, may be able to exert significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. In addition, this concentration of ownership may delay or prevent a change in control of our company, even when a change may be in the best interests of our stockholders. Furthermore, the interests of these stockholders may not always coincide with our interests as a company or the interests of other stockholders. Accordingly, these stockholders could cause us to enter into transactions or agreements that would not be widely viewed as beneficial.

If our officers, directors or principal stockholders sell substantial amounts of our common stock (including shares issued upon the exercise of options and warrants) in the public market, the market price of our common stock could fall. These sales also might make it more difficult for us to sell equity or equity- related securities in the future at a time and price that we deem appropriate.

Anti-takeover provisions in our charter documents and under Delaware law could make an acquisition of us, which may be beneficial to our stockholders, more difficult and may prevent or deter attempts by our stockholders to replace or remove our current management.

Provisions in our corporate charter and bylaws and Delaware law may discourage, delay or prevent an acquisition of our company, a change in control, or attempts by our stockholders to replace or remove members of our current Board of Directors. Because our Board of Directors is responsible for appointing the members of our management team, these provisions could in turn affect any attempt by our stockholders to replace current members of our management team. These provisions include:

a Board of Directors having three classes of directors with a three-year term of office that expires as to one class each year, commonly referred to as a "staggered board";

a prohibition on actions by our stockholders by written consent;

the inability of our stockholders to call special meetings of stockholders;

the ability of our Board of Directors to issue preferred stock without stockholder approval, which could be used to institute a "poison pill" that would work to dilute the stock ownership of a potential hostile acquirer, effectively preventing acquisitions that have not been approved by our Board of Directors;

limitations on the removal of directors; and

advance notice requirements for director nominations and stockholder proposals.

Moreover, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which prohibits a person who owns in excess of 15% of our outstanding voting stock from merging or combining with us for a period of three years after the date of the transaction in which the person acquired in excess of 15% of our outstanding voting stock, unless the merger or combination is approved in a prescribed manner. As a result, it is difficult for a third party to acquire control of us without the approval of our Board of Directors and, therefore, mergers with and acquisitions of us that our stockholders may consider in their best interests may not occur.

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Because we do not intend to pay dividends, stockholders will benefit from an investment in our common stock only if it appreciates in value.

We have never declared or paid any cash dividends on our common stock. We currently intend to retain our future earnings, if any, to finance the expansion of our business and do not expect to pay any cash dividends in the foreseeable future. As a result, the success of an investment in our common stock will depend entirely upon any future appreciation. There is no guarantee that our common stock will appreciate in value or even maintain the price at which stockholders have purchased their shares.

RISKS RELATING TO COMPETITION

The drug research and development industry is highly competitive, and we compete with some companies that have a broader range of capabilities and better access to resources than we do.

The pharmaceutical and biotechnology industries are characterized by rapid and continuous technological innovation. We compete with companies worldwide that are engaged in the research and discovery, licensing, development and commercialization of drug candidates, including, in the area of small molecule anti-cancer therapeutics, biotechnology companies such as Ariad Pharmaceuticals, Inc.; Array BioPharma Inc.; Astex Therapeutics; Cell Genesys, Inc.; Cell Therapeutics, Inc.; Curis, Inc.; Exelixis, Inc.; Idera Pharmaceuticals, Inc.; Infinity Pharmaceuticals, Inc.; Onyx Pharmaceuticals, Inc.; OSI Pharmaceuticals, Inc.; Oxigene, Inc.; Pharmacopeia, Inc.; Plexxikon, Inc. Telik, Inc.; and Vertex Pharmaceuticals, Inc. and many others.

With respect to ARQ 197 specifically, we are aware of a number of biotechnology and pharmaceutical companies that are or may be pursuing approaches to c-Met inhibition, including Amgen Inc.; AVEO Pharmaceuticals, Inc.; Bristol-Myers Squibb Company; Cephalon, Inc.; Compugen Ltd.; Eli Lilly & Company; Exelixis, Inc.; Genentech, Inc.; GlaxoSmithKline; Johnson & Johnson; Merck & Co., Inc.; Methylgene Inc.; Pfizer Inc, Schering-Plough; and Supergen Inc. and others.

Even if we are successful in bringing products to market, we face substantial competitive challenges in effectively marketing and distributing our products. Companies and research institutions, including large pharmaceutical companies with much greater financial resources and more experience in developing products, conducting clinical trials, obtaining FDA and foreign regulatory approvals and bringing new drugs to market are developing products within the field of oncology. Some of these entities already have competitive products on the market or product candidates in more advanced stages of development than we do. By virtue of having or introducing competitive products on the market before us, these entities may gain a competitive advantage. In addition, there may be product candidates of which we are not aware at an earlier stage of development that may compete with our product candidates. Some of our competitors have entered into collaborations with leading companies within our target markets.

We are in a rapidly evolving field of research. Consequently, our technology may be rendered non-competitive or obsolete by approaches and methodologies discovered by others, both before and after we have gone to market with our products. We also face competition from existing therapies that are currently accepted in the marketplace and from the impact of adverse events in our field that may affect regulatory approval or public perception.

We anticipate that we will face increased competition in the future as new companies enter the market and advanced technologies become available. If we are unable to successfully compete in our chosen field, we will not become profitable.

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We may not be able to recruit and retain the scientists and management we need to compete.

Our success depends on our ability to attract, retain and motivate highly skilled scientific personnel and management, and our ability to develop and maintain important relationships with leading academic institutions, clinicians and scientists. We are highly dependent on our senior management and scientific staff, and the loss of the services of one or more of our other key employees could have an adverse effect on the successful completion of our clinical trials or the commercialization of our product candidates.

We compete intensely with pharmaceutical and biotechnology companies, including our collaborators, medicinal chemistry outsourcing companies, contract research and manufacturing organizations, and academic and research institutions in the recruitment of scientists and management. The shortage of personnel with experience in drug development could lead to increased recruiting, relocation and compensation costs, which may exceed our expectations and resources. If we cannot hire additional qualified personnel, the workload may increase for both existing and new personnel. If we are unsuccessful in our recruitment efforts, we may be unable to execute our strategy.

RISKS RELATED TO INTELLECTUAL PROPERTY

Our patents and other proprietary rights may fail to protect our business. If we are unable to adequately protect our intellectual property, third parties may be able to use our technology which could adversely affect our ability to compete in the market.

To be successful and compete, we must obtain and protect patents on our products and technology and protect our trade secrets. Where appropriate, we seek patent protection for certain aspects of the technology we are developing, but patent protection may not be available for some of our product candidates or their use, synthesis or formulations. The patent position of biotechnology firms is highly uncertain, involves complex legal and factual questions, and has recently been the subject of much litigation. No consistent policy has emerged from the U.S. Patent and Trademark Office or the courts regarding the breadth of claims allowed or the degree of protection afforded under many biotechnology patents. In addition, there is a substantial backlog of biotechnology patent applications at the U.S. Patent and Trademark Office. As a consequence of these factors, the approval or rejection of patent applications may take several years.

We do not know whether our patent applications will result in issued patents. In addition, the receipt of a patent might not provide much practical protection. If we receive a patent with a narrow scope it will be easier for competitors to design products that do not infringe our patent. We cannot be certain that we will receive any additional patents, that the claims of our patents will offer significant protection for our technology, or that our patents will not be challenged, narrowed, invalidated or circumvented.

Competitors may interfere with our patent protection in a variety of ways. Competitors may claim that they invented the claimed invention before us. Competitors may also claim that we are infringing on their patents and that, therefore, we cannot practice our technology as claimed under our patents. Competitors may also contest our patents by showing the patent examiner that the invention was not original, was not novel or was obvious. In litigation, a competitor could claim that our issued patents are not valid for a number of reasons. If a court agrees, our patents could be narrowed, invalidated or rendered unenforceable, or we may be forced to stop using the technology covered by these patents or to license the technology from third parties. As a company, we have no meaningful experience with competitors interfering with our patents or patent applications and therefore may not have the experience we would need to aggressively protect our patents should such action become necessary.

The laws of some foreign countries do not protect intellectual property rights to the same extent as the laws of the United States. Many companies have encountered significant problems in protecting

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and defending such rights in foreign jurisdictions. Many countries, including certain countries in Europe, have compulsory licensing laws under which a patent owner may be compelled to grant licenses to third parties. In addition, many countries limit the enforceability of patents against government agencies or government contractors. In these countries, the patent owner may have limited remedies, which could materially diminish the value of the patent. Compulsory licensing of life-saving drugs is also becoming increasingly popular in developing countries either through direct legislation or international initiatives. Such compulsory licenses could be extended to include some of our product candidates, which could limit our potential revenue opportunities. Moreover, the legal systems of certain countries, particularly certain developing countries, do not favor the aggressive enforcement of patent and other intellectual property protection, which makes it difficult to stop infringement.

Drug candidates we develop that are approved for commercial marketing by the FDA would be subject to the provisions of the Drug Price Competition and Patent Term Restoration Act of 1984, known as the "Hatch-Waxman Act." The Hatch-Waxman Act provides companies with marketing exclusivity for varying time periods during which generic versions of a drug may not be marketed and allows companies to apply to extend patent protection for up to five additional years. It also provides a means for approving generic versions of a drug once the marketing exclusivity period has ended and all relevant patents have expired. The period of exclusive marketing, however, may be shortened if a patent is successfully challenged and defeated, which could reduce the amount of revenue we receive for such product.

Agreements we have with our employees, consultants and collaborators may not afford adequate protection for our trade secrets, confidential information and other proprietary information.

In addition to patent protection, we also rely on copyright and trademark protection, trade secrets, and know-how. It is unclear whether our trade secrets and know-how will prove to be adequately protected. To protect our trade secrets and know-how, we require our employees, consultants and advisors to execute agreements regarding the confidentiality and ownership of such proprietary information. We cannot guarantee, however, that these agreements will provide us with adequate protection against improper use or disclosure of confidential information and there may not be adequate remedies in the event of unauthorized use or disclosure. Our employees, consultants or advisors may unintentionally or willfully disclose our information to competitors. In addition, in some situations, these agreements may conflict with, or be subject to, the rights of third parties with whom our employees, consultants or advisors had or have previous employment or consulting relationships. Like patent litigation, enforcing a claim that a third party illegally obtained and is using our trade secrets is expensive and time-consuming and the outcome is unpredictable. In addition, courts outside the United States are sometimes less willing than our federal and state courts to protect trade secrets. Furthermore, others may independently develop substantially equivalent knowledge, methods and know-how. Our failure or inability to protect our proprietary information and techniques may inhibit or limit our ability to compete effectively or exclude certain competitors from the market.

Our success will depend partly on our ability to operate without infringing upon or misappropriating the proprietary rights of others.

There are many patents in our field of technology and we cannot guarantee that we do not infringe on those patents or that we will not infringe on patents granted in the future. If a patent holder believes a product of ours infringes on its patent, the patent holder may sue us even if we have received patent protection for our technology.

If we do not prevail in litigation or if other parties have filed, or in the future should file, patent applications covering products and technologies that we have developed or intend to develop, we may have to obtain licenses from third parties, which may not be available on commercially reasonable terms, or at all, and may require us to pay substantial royalties or grant a cross-license to some of our

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patents to another patent holder. Additionally, we may have to change the formulation of a product candidate so that we do not infringe third-party patents. Such reformulation may be impossible to achieve or which may require substantial time and expense. If we are unable to cost-effectively redesign our products so they do not infringe a patent, we may be unable to sell some of our products. Any of these occurrences will result in lost revenues and profits for us.

The drug research and development industry has a history of patent and other intellectual property litigation, and we may be involved in costly intellectual property lawsuits.

The drug research and development industry has a history of patent and other intellectual property litigation, and we believe these lawsuits are likely to continue. Legal proceedings relating to intellectual property would be expensive, take significant time and divert management's attention from other business concerns. We face potential patent infringement suits by companies that control patents for drugs or potential drugs similar to our product candidates or other suits alleging infringement of their intellectual property rights. There could be issued patents of which we are not aware that our products infringe or patents that we believe we do not infringe that we are ultimately found to infringe. The publication of discoveries in the scientific or patent literature frequently occurs substantially later than the date on which the underlying discoveries were made and patent applications were filed. Because patent applications can take many years to issue, there may be currently pending applications of which we are unaware that may later result in issued patents that we infringe with our drug candidates or resulting products. In addition, technology created under our research and development collaborations may infringe the intellectual property rights of third parties, in which case we may not receive milestone or royalty revenue from those collaborations.

If we do not prevail in an infringement lawsuit brought against us, we might have to pay substantial damages and we could be required to stop the infringing activity or obtain a license to use the patented technology or redesign our products so as not to infringe the patent. We may not be able to enter into licensing arrangements at a reasonable cost or effectively redesign our products. Any inability to secure licenses or alternative technology could delay the introduction of our products or prevent us from manufacturing or selling products.

RISKS RELATED TO EMPLOYEES AND FACILITIES

Our operations could be interrupted by damage to our laboratory facilities.

Our operations are dependent upon the continued use of our specialized laboratories and equipment in Woburn, Massachusetts. Catastrophic events, including fires or explosions, could damage our laboratories, equipment, scientific data, work in progress or inventories of chemical compounds and biological materials and may materially interrupt our business. We employ safety precautions in our laboratory activities in order to reduce the likelihood of the occurrence of these catastrophic events; however, we cannot eliminate the chance that such an event will occur. Rebuilding our facilities could be time consuming and result in substantial delays in our development of products and in fulfilling our agreements with our collaborators.

Security breaches may disrupt our operations and adversely affect our operating results.

Our network security and data recovery measures may not be adequate to protect against computer viruses, break-ins, and similar disruptions from unauthorized tampering with our computer systems. The misappropriation, theft, sabotage or any other type of security breach with respect to any of our proprietary and confidential information that is electronically stored, including research or clinical data, could have a material adverse impact on our business, operating results and financial condition. Additionally, any break-in or trespass of our facilities that results in the misappropriation, theft, sabotage or any other type of security breach with respect to our proprietary and confidential

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information, including research or clinical data, or that results in damage to our research and development equipment and assets could have a material adverse impact on our business, operating results, and financial condition.

RISKS RELATED TO PRODUCT LIABILITY

If our use of chemical and biological materials and hazardous materials violates applicable laws or causes personal injury, we may be liable for damages.

Our drug discovery activities, including the analysis and synthesis of chemical compounds, involve the controlled use of chemicals, including flammable, combustible, toxic and radioactive materials that are potentially hazardous if misused. Federal, state and local laws and regulations govern our use, storage, handling and disposal of these materials. These laws and regulations include the Resource Conservation and Recovery Act, the Occupational Safety and Health Act, local fire and building codes, regulations promulgated by the Department of Transportation, the Drug Enforcement Agency and the Department of Energy, the Department of Health and Human Services, and the laws of Massachusetts where we conduct our operations. We may incur significant costs to comply with these laws and regulations in the future and current or future environmental laws and regulations may impair our research, development and production efforts. Notwithstanding our extensive safety procedures for handling and disposing of materials, the risk of accidental contamination or injury from these materials cannot be completely eliminated. In the event of an accident, our business could be disrupted and we could be liable for damages. Our liability may exceed our insurance coverage and our total assets and have a negative impact on our financial condition and results of operations.

We may be exposed to potential liability related to the development, testing or manufacturing of compounds we develop and our insurance coverage may not be sufficient to cover losses.

We are developing, clinically testing and manufacturing potential therapeutic products for use in humans. In connection with these activities, we could be liable if persons are injured or die while using these drugs. We may have to pay substantial damages and/or incur legal costs to defend claims resulting from injury or death, and we may not receive expected royalty or milestone payments if commercialization of a drug is limited or ended as a result of such claims. We have product liability and clinical trial insurance that contains customary exclusions and provides coverage per occurrence at levels, in the aggregate, which we believe are customary and commercially reasonable in our industry given our current stage of drug development. Our product liability insurance does not cover every type of product liability claim that we may face or loss we may incur and may not adequately compensate us for the entire amount of covered claims or losses or for the harm to our business reputation. Also, we may be unable to maintain our current insurance policies or obtain and maintain necessary additional coverage at acceptable costs, or at all.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

In November 1999, we moved our main operations to a new facility in Woburn, Massachusetts, which includes approximately 128,000 square feet of laboratory and office space. This facility was designed to our specific requirements. In March 2001, we purchased this building and the land on which it sits and a developable adjacent parcel of land for $18.2 million and $2.3 million, respectively, in an arms-length transaction with the original developer.

On May 2, 2005, we completed a transaction to sell the Woburn facility and simultaneously leased the facility from the purchaser. The lease was subsequently amended on June 30, 2005. Under the

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terms of the transaction, the purchaser obtained two parcels of land and our headquarters building in exchange for a cash payment of approximately $40.1 million. We are leasing our existing facility and the associated land for a period of ten years at an average annual rental rate of $3.4 million. We also have options to extend the lease term for up to an additional ten years. See Note 6, "Property and Equipment" in the Notes to Consolidated Financial Statements appearing in Item 8 in this Annual Report on Form 10-K.

In March 2002, we entered into an eight year lease, expiring on February 28, 2010, with Pacific Shores Development LLC for approximately 34,000 square feet of laboratory and office space in Redwood City, California. Our monthly lease payment is $75,823 per month, subject to annual escalation provisions. In the third quarter of 2004, we entered into a sublease, which expires on February 28, 2010, for the California facility. See Note 9, "Restructuring Actions" in the Notes to Consolidated Financial Statements appearing in Item 8 in this Annual Report on Form 10-K.

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to stockholders for a vote during the fourth quarter of 2009.

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PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

STOCK PERFORMANCE GRAPH

The following graph shows the cumulative total stockholder return on our common stock over the period from December 31, 2004 to December 31, 2009, as compared with that of the NASDAQ Stock Market Index (U. S. Companies) and the NASDAQ Biotechnology Index, based on an initial investment of $100 in each on December 31, 2004. Total stockholder return is measured by dividing share price change plus dividends, if any, for each period by the share price at the beginning of the respective period, and assumes reinvestment of dividends.

COMPARISON OF CUMULATIVE TOTAL RETURN OF ARQULE, INC.,
NASDAQ STOCK MARKET (U.S. COMPANIES) INDEX
AND NASDAQ BIOTECHNOLOGY INDEX

	12/31/04	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09
ArQule, Inc.	100.00	105.70	102.25	100.17	72.88	63.73
NASDAQ Market (U.S. Companies) Index	100.00	102.13	112.20	121.67	58.62	84.20
NASDAQ Biotechnology Index	100.00	102.84	103.89	108.65	94.93	109.77

ArQule's common stock is traded on the NASDAQ Global Market under the symbol "ARQL".

The following table sets forth, for the periods indicated, the range of the high and low sale prices for ArQule's common stock:

	HIGH	LOW
2008		
First Quarter	$ 6.09	$ 3.53
Second Quarter	4.55	3.25
Third Quarter	4.06	2.30
Fourth Quarter	4.70	1.75
2009		
First Quarter	$ 4.91	$ 2.62
Second Quarter	6.38	3.71
Third Quarter	6.35	4.50
Fourth Quarter	4.65	3.17
2010		
First Quarter (through February 16, 2010)	$ 3.96	$ 2.97

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As of February 16, 2010, there were approximately 98 holders of record and approximately 6,048 beneficial shareholders of our common stock.

Dividend Policy

We have never paid cash dividends on our common stock and we do not anticipate paying any cash dividends in the foreseeable future. We currently intend to retain future earnings, if any, for use in our business.

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ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data have been derived from our audited historical consolidated financial statements, certain of which are included elsewhere in this Annual Report on Form 10-K. The following selected financial data should be read in conjunction with our consolidated financial statements and related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing elsewhere in this Annual Report on Form 10-K.

All amounts for 2006 and 2005 have been restated to reflect our discontinued chemistry services operations. The following data is in thousands, except per share data.

	YEAR ENDED DECEMBER 31,				
	2009*	2008*	2007*	2006*	2005
STATEMENT OF OPERATIONS DATA:					
Revenue:					
Research and development revenue(a)(b)(c)(d)	$ 25,198	$ 14,141	$ 9,165	$ 6,626	$ 6,628
Costs and expenses:					
Research and development	49,495	49,629	53,727	47,428	24,646
General and administrative	13,317	16,918	15,069	11,560	8,688
Total costs and expenses	62,812	66,547	68,796	58,988	33,334
Loss from continuing operations	(37,614)	(52,406)	(59,631)	(52,362)	(26,706)
Interest income	1,089	3,342	6,259	5,139	3,700
Interest expense	(655)	(472)			(369)
Other income (expense)(e)	1,594	(1,328)			
Loss on investment					(250)
Net loss from continuing operations	(35,586)	(50,864)	(53,372)	(47,223)	(23,625)
Income from discontinued operations(f)				15,783	16,105
Net loss before income taxes	(35,586)	$ (50,864)	$ (53,372)	$ (31,440)	$ (7,520)
Provision for income taxes	(550)				
Net loss	$ (36,136)	$ (50,864)	$ (53,372)	$ (31,440)	$ (7,520)
Basic and diluted income (loss) per share:					
Net loss from continuing operations	$ (0.82)	$ (1.16)	$ (1.33)	$ (1.33)	$ (0.68)
Income from discontinued operations(f)				0.45	0.46
	$ (0.82)	$ (1.16)	$ (1.33)	$ (0.88)	$ (0.22)
Weighted average common shares outstanding basic and diluted	44,169	43,870	40,040	35,539	34,619

*

As of January 1, 2006, all share-based payments have been recognized in the statements of operations based on their fair values. The Company adopted the modified prospective transition method and, consequently, has not adjusted results from prior years.
Stock-based compensation

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expense was approximately $3.4 million, $5.7 million, $5.0 million and $3.2 million for the years ended December 31, 2009, 2008, 2007 and 2006, respectively.

	DECEMBER 31,				
	2009	2008	2007	2006	2005
Cash, cash equivalents and marketable securities (g)(h)	$ 154,677	$ 141,890	$ 135,082	$ 95,832	$ 140,643
Marketable securities-long term	8,814	64,219			
	$ 163,491	$ 206,109	$ 135,082	$ 95,832	$ 140,643
Working capital	73,569	59,680	111,797	80,557	105,646
Notes payable	46,100	47,750			
Total assets(i)	171,880	214,212	142,210	104,820	156,684
Total stockholders' equity(g)(h)	11,535	43,467	88,041	79,954	105,458

(a)

In April 2004, ArQule entered into an alliance with Roche to discover and develop drug candidates targeting the E2F biological pathway. Roche provided immediate research funding of $15 million, and provided financial support for ongoing research and development through the first quarter of 2008.

(b)

In April 2007, ArQule entered into an exclusive license agreement with Kyowa Hakko Kirin to develop and commercialize ARQ 197 in Japan and parts of Asia. The agreement includes upfront licensing fees of $30 million, which were received in 2007. In addition the agreement provides for potential development milestones of $93 million, as well as sales milestones and royalty payments upon commercialization.

(c)

In November 2008, ArQule and Daiichi Sankyo entered into a research collaboration, exclusive license and co-commercialization agreement for the discovery of therapeutic compounds that selectively inhibit certain kinases. The agreement includes upfront licensing fees of $15 million, which were received in 2008, payments for research support for the first and second years of the collaboration, and licensing fees for compounds discovered as a result of this research. ArQule will also receive milestone payments related to clinical development, regulatory review and sales and royalty payments on net sales of compounds from the collaboration.

(d)

In December 2008, ArQule entered into an exclusive license agreement with Daiichi Sankyo to develop and commercialize ARQ 197 in U.S., Europe, South America and the rest of the world, excluding Japan and parts of Asia. The agreement includes upfront licensing fees of $60 million, which were received in 2008. In addition the agreement provides for potential development and sales milestones of $560 million, and royalty payments upon commercialization.

(e)

In the fourth quarter of 2008, we agreed to participate in a settlement agreement with UBS AG whereby we received a Put Option to repurchase $62.4 million of our auction rate securities at par value at any time during the period from June 30, 2010 through July 2, 2012. We accounted for the Put Option as a freestanding financial instrument and elected to record the value under the fair value option for financial assets and financial liabilities. The fair value of the Put Option of $6.7 million was recorded as other income and was reported in other income (expense) in the statement of operations. Simultaneously, the Company transferred these auction rate securities from available-for-sale to trading securities. The transfer to trading securities reflects the Company's intent to exercise the Put Option during the period June 30, 2010 to July 2, 2012. This resulted in an other-than-temporary impairment of $8.0 million in 2008 which was recorded in other income (expense) in the statement of operations.

In 2009 the fair value of the Put Option decreased by $1.6 million resulting in a loss and the fair value of our auction rate securities increased by $3.2 million resulting in a gain. The Put Option

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loss and auction rate securities gain were both recorded in other income (expense) in the statement of operations.

(f)

In the fourth quarter of 2006, we completed our exit from our chemistry services operations and disposed of the related assets. We have reported the results of the chemistry services operations as discontinued operations in 2006, since the related cash flows of our chemistry services operations were eliminated from our ongoing operations and we do not have any significant continuing involvement in the operations of the component or the assets that were disposed.

(g)

In January 2005, we completed a stock offering in which we sold 5.8 million shares of common stock at a price of $5.25 for net proceeds of $28.3 million after commissions and offering expenses.

(h)

In June 2007, we completed a stock offering in which we sold 7.0 million shares of common stock at a price of $7.75 for net proceeds of $50.5 million after commissions and offering expenses. In July 2007, we sold an additional 0.5 million shares of common stock upon exercise of a portion of the underwriters over-allotment option at a price of $7.75 for net proceeds of $3.6 million after offering expenses.

(i)

In June 2005, we completed a transaction to sell our headquarters facility in Woburn, Massachusetts, and to simultaneously lease the facility from the purchaser. We received a cash payment of approximately $39.3 million, net of commissions and closing costs, and entered into a ten year lease at an average annual rental rate of $3.4 million. As a result of the transaction, we reduced our net fixed assets by $33.7 million, representing the net book value of the real estate sold, and realized a gain on the sale of $5.5 million, which was deferred and is being amortized over the initial ten-year term of the lease as a reduction in rent expense.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

We are a clinical-stage biotechnology company engaged in the research and development of innovative cancer therapeutics. Our mission is to produce novel medicines with differentiated mechanisms of action that target the specific biological pathways implicated in a wide range of cancers. We employ novel technologies such as our ArQule Kinase Inhibitor Platform ("AKIP ") to design and develop drugs that have the potential to fulfill this mission.

Our products and programs span a continuum of research and development ranging from drug discovery to advanced clinical testing. They are based on our understanding of biological processes that lead to the proliferation and metastasis of cancer cells, combined with our ability to generate product candidates possessing certain pre-selected, drug-like properties and designed to act specifically against cancer cells. We believe that these qualities, when present from the earliest stages of product development, increase the likelihood of producing safe, effective and marketable drugs.

Our lead product is ARQ 197, a non-adenosine triphosphate ("ATP")-competitive inhibitor of the c-Met receptor tyrosine kinase ("c-Met"). C-Met is a promising target for cancer therapy, as evidence suggests that plays a key roll in cancerous cell proliferation, tumor spread, new blood vessel formation and drug resistance. Our ongoing Phase 2 clinical trial program with ARQ 197 encompasses six tumor types, including non-small cell lung cancer, c-Met-associated soft tissue sarcomas, pancreatic adenocarcinoma, hepatocellular carcinoma, germ cell tumors and colorectal cancer. We believe the trials within the Phase 2 program for ARQ 197 offer the potential for proof-of-principle data that can be generated in one or more indications beginning in early 2010 through 2011, as well as the potential for fast-to-market regulatory pathways in certain indications.

We have licensed commercial rights to ARQ 197 for human cancer indications to Daiichi Sankyo Co., Ltd. ("Daiichi Sankyo") in the U.S., Europe, South America and the rest of the world, excluding Japan and certain other Asian countries, where we have licensed commercial rights to Kyowa Hakko Kirin Co., Ltd. ("Kyowa Hakko Kirin"). Our agreements with these partners provide for possible future milestone payments, royalties on product sales, and development funding, in addition to significant payments that we have already received.

Our proprietary pipeline is directed toward molecular targets and biological processes with demonstrated roles in the development of human cancers. The most advanced candidate in this pipeline is ARQ 621, an inhibitor of the Eg5 kinesin motor protein that is in Phase 1 clinical testing. Additional pipeline assets include ARQ 501 and ARQ 761, activators of the cell's DNA damage response mechanism that we plan to develop further on a partnered basis. We are also pursuing pre-clinical development of an inhibitor of the B-RAF kinase that is in toxicology testing leading to a potential Investigational New Drug ("IND") submission in 2010.

Our drug design efforts are focused primarily on the AKIP , which we are using to generate compounds designed to inhibit kinases without competing with adenosine triphosphate ("ATP") for binding to the target kinase. ATP is a chemical found in all living cells and is involved in a variety of physiological processes. We have assessed AKIP 's potential to target multiple kinases in oncology and other therapeutic areas, and we are generating and validating compounds that inhibit these kinase targets. With the AKIP technology, we have discovered and optimized a series of small molecule inhibitors of fibroblast growth factor receptor inhibitors that are in pre-clinical development, with the potential submission of an IND for a lead product candidate in 2010. We are also pursuing a drug discovery collaboration with Daiichi Sankyo that utilizes the capabilities of the AKIP technology to discover compounds that inhibit two kinase targets in the field of oncology.

We have incurred a cumulative deficit of $368.6 million from inception through December 31, 2009. We expect research and development costs to increase during the course of 2010, due to clinical

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testing of our lead product candidates. We recorded a net loss for 2007, 2008, 2009 and expect a net loss for 2010.

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

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

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

On April 27, 2007, we entered into an exclusive license agreement with Kyowa Hakko Kirin to develop and commercialize ARQ 197, a small molecule, selective inhibitor of the c-Met receptor tyrosine kinase, in Japan and parts of Asia. A $3 million portion of an upfront licensing fee was received by the Company under this agreement in the first quarter of 2007, and an additional $27 million in upfront licensing fees was received on May 7, 2007. The agreement includes $123 million in upfront and potential development milestone payments from Kyowa Hakko Kirin to ArQule, including the $30 million cash upfront licensing payments. In February 2008, we received a $3 million milestone payment from Kyowa Hakko Kirin. Upon commercialization, ArQule will receive tiered royalties in the mid-teen to low-twenty percent range from Kyowa Hakko Kirin on net sales of ARQ 197. Kyowa Hakko Kirin will be responsible for all clinical development costs and commercialization of the compound in certain Asian countries, consisting of Japan, China (including Hong Kong), South Korea and Taiwan. In addition to the upfront and possible regulatory milestone payments totaling $123 million, the Company will be eligible for future milestone payments based on the achievement of certain levels of net sales. The Company will recognize the payments, if any, as revenue in accordance with its revenue recognition policies. As of December 31, 2009, the Company has not recognized any

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revenue from these sales milestone payments, and there can be no assurance that it will do so in the future. Revenue for this agreement is recognized using the contingency-adjusted performance model with an estimated development period through April 2016.

In May, 2009 we entered into an agreement with Daiichi Sankyo related to potential future milestones and royalties for our AKIP collaboration, under which we could receive up to $265 million in potential development and sales milestone payments for each product selected for clinical development. Upon commercialization of a licensed product, we would also receive tiered, double-digit royalties on its net sales.

LIQUIDITY AND CAPITAL RESOURCES

	December 31,			% increase (decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008
	(in millions)				
Cash, cash equivalents and marketable securities short-term	$ 154.7	$ 141.9	$ 135.1	9%	5%
Marketable securities long-term	8.8	64.2		(86)%	
Notes payable	46.1	47.8		(3)%	
Working capital	73.6	59.7	111.8	23%	(47)%

	December 31,		
	2009	2008	2007
	(in millions)		
Cash flow from:			
Operating activities	$ (41.8)	$ 27.5	$ (16.0)
Investing activities	(62.6)	55.3	(35.8)
Financing activities	(0.9)	48.3	56.3

Cash flow from operating activities. Our uses of cash for operating activities have primarily consisted of salaries and wages for our employees, facility and facility-related costs for our offices and laboratories, fees paid in connection with preclinical and clinical studies, laboratory supplies and materials, and professional fees. The sources of our cash flow from operating activities have consisted primarily of payments from our collaborators for services performed or upfront payments for future services. In 2009, our net use of cash was primarily driven by the difference between cash receipts from our collaborators, and payments for operating expenses which resulted in a net cash outflow of $41.8 million.

Cash flow from investing activities. Our net cash used in investing activities of $62.6 million in 2009 was comprised of net purchases of marketable securities of $62.0 million, partially offset by acquisitions of fixed assets of $0.7 million. The composition and mix of cash, cash equivalents and marketable securities may change frequently as a result of the Company's constant evaluation of conditions in financial markets, the maturity of specific investments, and our near term liquidity needs.

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

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

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expectation due to changes in interest rates or we may suffer losses in principal if we are forced to sell securities that decline in market value due to changes in interest rates.

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

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

As a result of accepting the Offering, the Company received a Put Option from UBS to repurchase the securities at par value at any time during the period from June 30, 2010 through July 2, 2012, if the Company's auction rate securities have not previously been sold by the Company or by UBS on its behalf. The Company has accounted for the Put Option as a freestanding financial instrument and elected to record the value under the fair value option for financial assets and financial liabilities. The Company has classified its auction rate securities as trading securities reflecting the Company's intent to exercise the Put Option during the period June 30, 2010 to July 2, 2012. The net increase in value of our Put Option and auction rate securities totaling $1.6 million for the year ended 2009 was recorded as a gain in other income (expense) in the statement of operations. The net decrease in value of our Put Option and auction rate securities totaling $1.3 million for the year ended 2008 was recorded as a loss in other income (expense) in the statement of operations.

Our marketable securities portfolio as of December 31, 2009 and 2008 includes $59.5 million (at cost) and $65.3 million (at cost), respectively, invested in auction rate securities all of which were associated with auctions that failed subsequent to February 12, 2008.

On July 8, 2008, we entered into a collateralized, revolving credit line agreement for up to $47.5 million with UBS Bank USA (the "Facility"). The Facility is secured by a first priority lien and security interest in the auction rate securities held by us in an account with UBS Financial Services Inc., an affiliate of UBS Bank USA. The credit line is uncommitted and any outstanding balance, including interest, is payable upon demand. Variable rate advances under the Facility currently bear interest at a rate not to exceed the weighted average interest rate that we earn from the underlying auction rate securities securing the loan. The Facility replaced the $15 million standard margin loan agreement with UBS Financial Services Inc. that we entered into on May 8, 2008. In July 2008, we drew down $46.1 million under the Facility. The funds are available for research and development efforts, including clinical trials, and for general corporate purposes, including working capital.

In accordance with the Offering by UBS, the $46.1 million borrowed under the Facility remains payable on demand; however, if UBS Bank USA should exercise its right to demand repayment of any portion of the Company's indebtedness prior to the date the Company can exercise its repurchase rights (other than for reasons specified in the prospectus), UBS and certain of its affiliates will arrange

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for alternative financing on terms and conditions substantially the same as those contained in the Facility. If alternative financing cannot be established, then UBS or one of its affiliates will purchase the Company's pledged auction rate securities at par.

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

Cash flow from financing activities. Our net cash used by financing activities of $0.9 million in the year ended December 31, 2009 was from the $1.6 million payment on our notes payable, partially offset by additional cash inflow of $0.7 million from stock option exercises and employee stock plan purchases.

Our net cash provided by financing activities of $48.3 million in the year ended December 31, 2008 was primarily from the $46.1 million we borrowed under our collateralized, revolving credit line agreement (as described above) and the $1.7 million we borrowed under a margin loan agreement with another financial institution collateralized by $2.9 million of our auction rate securities.

Our net cash provided by financing activities of $56.3 million in 2007 was comprised primarily of the proceeds from our June 2007 stock offering, wherein we sold 7 million shares of common stock at $7.75 per share for aggregate net proceeds of $50.5 million after commissions and offering expenses. During July 2007, the Company received net proceeds of $3.6 million when the underwriters exercised a portion of their over-allotment option and purchased an additional 502,000 shares of common stock. Stock option exercises and employee stock plan purchases provided additional cash inflow of $2.2 million.

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

Our contractual obligations were comprised of the following as of December 31, 2009 (in thousands):

	Payment due by period				
Contractual Obligations	**Total**	**Less than 1 year**	**1 - 3 years**	**3 - 5 years**	**More than 5 years**
Notes payable	$ 46,100	$ 46,100	$	$	$
Operating lease obligations	17,900	3,476	7,096	6,258	1,070
Purchase obligations	8,156	8,156			
Total	$ 72,156	$ 57,732	$ 7,096	$ 6,258	$ 1,070

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Purchase obligations are comprised primarily of outsourced preclinical and clinical trial expenses and payments to license certain intellectual property to support the Company's research efforts. Interest on notes payable is variable and is excluded from the table above. Notes payable of $44.4 million currently bear interest at a rate not to exceed our weighted average auction rate security coupon rate and $1.7 million currently bear interest at LIBOR plus 125 basis points.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

A "critical accounting policy" is one which is both important to the portrayal of the Company's financial condition and results and requires management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Management believes the following are critical accounting policies. For additional information, please see the discussion of our significant accounting policies in Note 2 to the Consolidated Financial Statements included in Item 8 of this Form 10-K.

Research and Development Revenue

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

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

Sale Leaseback Accounting

On May 2, 2005, we completed a transaction to sell our Woburn headquarters facility and two parcels of land in exchange for a cash payment of $39.3 million, net of commissions and closing costs. Simultaneously with that sale, we entered into an agreement to lease back the entire facility and the associated land. The lease was subsequently amended on June 30, 2005. The amended lease has a term of ten years with an average annual rental rate of $3.4 million. We also have options to extend the lease term for up to an additional ten years. We are applying sale leaseback accounting to the transaction and are treating the lease as an operating lease. As a result of this transaction, we reduced our net fixed assets by $33.7 million, representing the net book value of the assets sold on the date of the lease amendment, and realized a gain on the sale of $5.5 million, which has been deferred and will be amortized over the initial ten year lease term as a reduction in rent expense.

Stock-Based Compensation

Our stock-based compensation cost is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the employees' requisite service period (generally the vesting period of the equity grant). We estimate the fair value of stock options using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of stock options

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include the exercise price of the award, expected option term, expected volatility of our stock over the option's expected term, risk-free interest rate over the option's expected term, and the expected annual dividend yield. We believe that the valuation technique and approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of our stock option grants.

Cash Equivalents and Marketable Securities

We consider all highly liquid investments purchased within three months of original maturity date to be cash equivalents. We invest our available cash primarily in U.S. Treasury bill funds, money market funds, commercial paper fully guaranteed by the FDIC under the Temporary Liquidity Guarantee Program (TLGP), commercial paper, and U.S. federal and state agency backed certificates, including auction rate securities that have investment grade ratings. Auction rate securities are structured with short-term interest reset dates of generally less than 90 days, but with contractual maturities that can be well in excess of ten years. At the end of each reset period, which occurs every seven to twenty-eight days, investors can sell or continue to hold the securities at par value. We generally classify our marketable securities as available-for-sale at the time of purchase and re-evaluate such designation as of each consolidated balance sheet date. The Company classifies its investments as either current or long-term based upon the investments' contractual maturities and the Company's ability and intent to convert such instruments to cash within one year. We report available-for-sale investments at fair value as of each balance sheet date and include any unrealized gains and, to the extent deemed temporary, unrealized losses in stockholders' equity. Realized gains and losses are determined using the specific identification method and are included in other income (expense) in the statement of operations. Certain of our marketable securities are classified as trading securities and any changes in the fair value of those securities are recorded as other income (expense) in the statement of operations.

We determine on a quarterly basis the fair value of our investment portfolio. Investments are considered to be impaired when a decline in fair value below cost basis is determined to be other-than-temporary. We evaluate whether a decline in fair value below cost basis is other-than-temporary using available evidence regarding our investments. In the event that the cost basis of a security exceeds its fair value, we evaluate, among other factors, the duration of the period that, and extent to which, the fair value is less than cost basis, the financial health of and business outlook for the issuer, including industry and sector performance, and operational and financing cash flow factors, overall market conditions and trends, our intent to sell the investment and if it is more likely than not that we would be required to sell the investment before its anticipated recovery. Once a decline in fair value is determined to be other-than-temporary, a write-down is recorded in the consolidated statements of operations and a new cost basis in the security is established.

RESULTS OF OPERATIONS

The following are the results of operations for the years ended December 31, 2009, 2008 and 2007:

Revenue

				% increase (decrease)	
	2009	**2008**	**2007**	**2008 to 2009**	**2007 to 2008**
	(in millions)				
Research and development revenue	$ 25.2	$ 14.1	$ 9.2	78%	54%

2009 as compared to 2008: Research and development revenue in 2009 is comprised of revenue from the Daiichi Sankyo development and research collaboration agreements entered into in 2008 and the Kyowa Hakko Kirin exclusive license agreement. The increase in 2009 is primarily due to revenue from Daiichi Sankyo. Revenue of $8.2 million was recognized in 2008 from the Roche alliance agreement that was terminated in December 2008.

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2008 as compared to 2007: Research and development revenue in 2008 is comprised of revenue from the Kyowa Hakko Kirin exclusive license agreement, the Daiichi Sankyo development and research collaborations agreements entered into in 2008, and the Roche alliance agreement. The increase in 2008 is primarily due to revenue from Kyowa Hakko Kirin. Following the termination of the Roche alliance agreement in 2008, $1.6 million of deferred revenue was recognized in 2008, in addition to the $6.6 million recurring annual amount. No further revenues will be recognized under the collaboration with Roche.

Research and development

				% increase (decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008
	(in millions)				
Research and development	$ 49.5	$ 49.6	$ 53.7		(8)%

2009 as compared to 2008: The $0.1 million decrease in research and development expense in 2009 is primarily due to (i) a decrease of $2.4 million in outsourced costs related to the phase 1 and 2 clinical programs with ARQ 501 and ARQ 171, (ii) a decrease of $0.3 million in other outsourced preclinical and product development costs, (iii) a $3.8 million increase in outsourced costs related to the phase 1 and 2 clinical programs for ARQ 197, and (iv) a $1.1 million decrease in personnel and related costs. At December 31, 2009, we had 82 employees dedicated to our research and development program, up from 77 employees at December 31, 2008.

2008 as compared to 2007: The $4.1 million decrease in research and development expense in 2008 is primarily due to (i) a decrease of $7.4 million in outsourced costs related to the phase 1 and 2 clinical programs with ARQ 501 and ARQ 171, (ii) a decrease of $4.5 million in connection with the Company's sponsored research agreement with Boston Biomedical Institute ("BBI") that was completed in 2008, (iii) a $1.4 million increase in outsourced costs related to the phase 1 and 2 clinical programs for ARQ 197 (iv) an increase of $2.8 million in other outsourced preclinical and product development costs, and (v) $3.7 million in additional personnel and related costs, including $0.5 million incurred in conjunction with the separation agreement of our prior chief medical officer. At December 31, 2008, we had 77 employees dedicated to our research and development program, down from 78 employees at December 31, 2007.

Overview

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

We have not accumulated and tracked our internal historical research and development costs or our personnel and personnel-related costs on a program-by-program basis. Our employee and infrastructure resources are allocated across several projects, and many of our costs are directed to broadly applicable research endeavors. As a result, we cannot state the costs incurred for each of our oncology programs on a program-by-program basis.

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The expenses incurred by us to third parties for pre-clinical and clinical trials in the current quarter and since inception of our lead clinical stage program were as follows (in millions):

Oncology program	Current status	Year Ended December 31, 2009	Program-to-date
c-Met program ARQ 197	Phase 2	$ 18.9	$ 53.1

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

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

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

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

the number of clinical sites included in the trials;

the length of time required to enroll suitable patients;

the number of patients that ultimately participate in the trials;

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

the efficacy and safety profile of the product.

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

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

As a result of the uncertainties discussed above, we are unable to determine the duration and completion costs of our oncology programs or when and to what extent we will receive cash inflows

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from the commercialization and sale of a product. Our inability to complete our oncology programs in a timely manner or our failure to enter into appropriate collaborative agreements could significantly increase our capital requirements and could adversely impact our liquidity. These uncertainties could force us to seek additional, external sources of financing from time-to-time in order to continue with our product development strategy. Our inability to raise additional capital, or to do so on terms reasonably acceptable to us, would jeopardize the future success of our business.

General and administrative

				% increase (decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008
	(in millions)				
General and administrative	$ 13.3	$ 16.9	$ 15.1	(21)%	12%

2009 compared to 2008: General and administrative expense in 2009 decreased by $3.6 million principally due to $2.0 million of stock compensation costs incurred in 2008 resulting from senior management transitions that did not recur in 2009, a decrease of $0.7 million in personnel and related costs and lower professional fees of $0.6 million. General and administrative headcount was 29 at December 31, 2009, compared to 30 at December 31, 2008.

2008 compared to 2007: General and administrative expense increased $1.8 million in 2008 primarily due to increased stock-based compensation expense resulting from senior management transitions. General and administrative headcount was 30 at December 31, 2008, compared to 32 at December 31, 2007.

Restructuring

In December 2002, we announced a major restructuring of our operations in order to realign our workforce and expedite the transition towards becoming a drug discovery company. The restructuring actions included closing our facility in Redwood City, California.

The facility-related accrual, which represents the difference between our lease obligation for the California facility and the amount of sublease payments it will receive under its sublease agreement, will be paid out through 2010.

Activities against the restructuring accrual in 2008 and 2009 were as follows (in thousands):

	Balance as of December 31, 2007	2008 Provisions	2008 Payments	Balance as of December 31, 2008
Facility-related	$ 1,366	$	$ (628)	$ 738
Total restructuring accrual	$ 1,366	$	$ (628)	$ 738

	Balance as of December 31, 2008	2009 Provisions	2009 Payments	Balance as of December 31, 2009
Facility-related	$ 738	$	$ (660)	$ 78
Total restructuring accrual	$ 738	$	$ (660)	$ 78

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Interest income, interest expense and other income (expense)

	2009	2008	2007	% increase (decrease) 2008 to 2009	% increase (decrease) 2007 to 2008
	(in millions)				
Interest income	$ 1.1	$ 3.3	$ 6.3	(67)%	(47)%
Interest expense	(0.7)	(0.5)		39%	
Other income (expense)	1.6	(1.3)		220%	

Interest income is comprised primarily of interest income derived from our portfolio of cash, cash equivalents and investments. Interest income decreased in 2009 and 2008 due to lower interest rates earned on our portfolio. Interest expense in 2009 and 2008 was incurred on our notes payable.

Other income (expense) in 2009 includes an unrealized gain on our auction rate securities of $3.2 million, partially offset by an other-than-temporary impairment of $1.6 million on our auction rate security Put Option. Other income (expense) in 2008 includes an other-than-temporary impairment on our auction rate securities of $8.0 million, partially offset by a $6.7 million gain upon recognition of the fair value of our auction rate security Put Option received from our 2008 settlement agreement with UBS.

Provision for income taxes

The Company recorded $0.6 million of federal income tax expense in 2009 attributable to alternative minimum tax ("AMT"). The Company's taxable income for the year ended December 31, 2009 primarily results from timing differences in recognition of research and development revenues. For purposes of AMT the Company can only offset 90% of its current period taxable income with net operating loss carryforwards. The remaining 10% is subject to federal AMT at a tax rate of 20%. Although the Company is entitled to an AMT credit against future federal regular income tax, the Company recorded a valuation allowance against this credit since it is more likely than not that this tax credit will not be realized. There was no current or deferred tax expense for the years ended December 31, 2008 or 2007.

RECENT ACCOUNTING PRONOUNCEMENTS

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

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

In December 2007, new authoritative guidance on accounting for business combinations and noncontrolling interests in consolidated financial statements was issued. The new guidance requires an acquiring company to measure all assets acquired and liabilities assumed, including contingent considerations and all contractual contingencies, at fair value as of the acquisition date. In addition, an acquiring company is required to capitalize IPR&D and either amortize it over the life of the product, or write it off if the project is abandoned or impaired. The new guidance is effective for transactions

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occurring on or after January 1, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

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

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

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

In June 2009, we adopted new authoritative guidance on accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The adoption of the new guidance did not impact our financial statements. We evaluated all events or transactions that occurred after December 31, 2009 and we did not have any material recognizable subsequent events.

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

In October 2009, the FASB approved for issuance Accounting Standards Update ("ASU") 2009-13, *Revenue Arrangements with Multiple Deliverables* (currently within the scope of FASB Accounting Standards Codification ("ASC") Subtopic 605-25). This statement provides principles for allocation of consideration among its multiple elements, allowing more flexibility in identifying and accounting for separate deliverables under an arrangement. The ASU introduces an estimated selling price method for valuing the elements of a bundled arrangement if vendor-specific objective evidence or third-party evidence of selling price is not available, and significantly expands related disclosure requirements. This standard is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Alternatively, adoption may be on a retrospective basis, and early application is permitted. The Company is currently evaluating the impact of adopting this pronouncement.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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Our cash and marketable securities include U.S. Treasury bill funds, money market funds, and U.S. federal and state agency backed certificates, including auction rate securities that have strong credit ratings.

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

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

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

As a result of accepting UBS's offer, the Company received a Put Option from UBS to repurchase the securities at par value at any time during the period from June 30, 2010 through July 2, 2012, if the Company's auction rate securities have not previously been sold by the Company or by UBS on its behalf. The Company has accounted for the Put Option as a freestanding financial instrument and elected to record the value under the fair value option. As a result, $6.7 million was recorded in other income (expense) which represents the fair value of the Put Option during the year ended December 31, 2008. Simultaneously, the Company transferred these auction rate securities from available-for-sale to trading securities. The transfer to trading securities reflects the Company's intent to exercise the Put Option during the period June 30, 2010 to July 2, 2012. As a result of our intention to exercise the Put Option, we no longer demonstrate the ability and intent to hold our auction rate securities and recorded an other-than-temporary impairment totaling $8.0 million which was recorded as other expense in the year ended December 31, 2008. In the year ended December 31, 2009 we recorded an unrealized gain on our auction rate securities of $3.2 million, partially offset by an other-than-temporary impairment of $1.6 million on our auction rate security Put Option.

ArQule's marketable securities portfolio as of December 31, 2007 was $124.2 million. The portfolio included $92.6 million (at cost) invested in auction rate securities of which, $67.7 million (at cost) were associated with auctions that failed subsequent to February 12, 2008. In the year ended December 31, 2008, ArQule sold $27.3 million (at cost) of auction rate securities that were held at December 31, 2007. ArQule's marketable securities portfolio as of December 31, 2008 was $65.3 million (at cost) invested in auction rate securities all of which were associated with auctions that failed subsequent to February 12, 2008. On July 8, 2008, we entered into a collateralized, revolving credit line agreement for up to $47.5 million with UBS Bank USA (the "Facility"). In July 2008, we drew down $46.1 million

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under the Facility. During 2009, certain of our auction rate securities were redeemed and the note payable balance under the Facility was reduced to $44.4 million at December 31, 2009.

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

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ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of ArQule, Inc.

In our opinion, the accompanying consolidated balance sheets and related consolidated statements of operations, of stockholders' equity and comprehensive loss, and of cash flows present fairly, in all material respects, the financial position of ArQule, Inc. and its subsidiaries at December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 13 to the consolidated financial statements, the Company changed the manner in which it accounts for income tax contingencies in 2007.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Boston, Massachusetts
March 2, 2010

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ARQULE, INC.

CONSOLIDATED BALANCE SHEETS

	December 31,	
	2009	2008
	(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 36,551	$ 141,890
Marketable securities	118,126	
Prepaid expenses and other current assets	2,476	772
Total current assets	157,153	142,662
Marketable securities-long term	8,814	64,219
Property and equipment, net	4,585	5,620
Other assets	1,328	1,711
Total assets	$ 171,880	$ 214,212
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 12,360	$ 14,260
Notes payable	46,100	47,750
Current portion of deferred revenue	24,572	20,420
Current portion of deferred gain on sale leaseback	552	552
Total current liabilities	83,584	82,982
Restructuring accrual, net of current portion		78
Deferred revenue, net of current portion	74,321	84,693
Deferred gain on sale leaseback, net of current portion	2,440	2,992
Total liabilities	160,345	170,745
Commitments and contingencies (Note 14)		
Stockholders' equity:		
Preferred stock, $0.01 par value; 1,000,000 shares authorized; no shares issued or outstanding		
Common stock, $0.01 par value; 100,000,000 shares authorized; 44,772,945 and 44,153,237 shares issued and outstanding at December 31, 2009 and 2008, respectively	448	442
Additional paid-in capital	379,621	375,478
Accumulated other comprehensive income	55	
Accumulated deficit	(368,589)	(332,453)
Total stockholders' equity	11,535	43,467
Total liabilities and stockholders' equity	$ 171,880	$ 214,212

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

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ARQULE, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	YEAR ENDED DECEMBER 31,		
	2009	2008	2007
	(IN THOUSANDS, EXCEPT PER SHARE DATA)		
Revenue:			
Research and development revenue	$ 25,198	$ 14,141	$ 9,165
Costs and expenses:			
Research and development	49,495	49,629	53,727
General and administrative	13,317	16,918	15,069
	62,812	66,547	68,796
Loss from operations	(37,614)	(52,406)	(59,631)
Interest income	1,089	3,342	6,259
Interest expense	(655)	(472)	
Other income (expense)	1,594	(1,328)	
Net loss before taxes	(35,586)	(50,864)	(53,372)
Provision for income taxes	(550)		
Net loss	$ (36,136)	$ (50,864)	$ (53,372)
Basic and diluted loss per share:			
Net loss per share	$ (0.82)	$ (1.16)	$ (1.33)
Weighted average common shares outstanding-basic and diluted	44,169	43,870	40,040

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

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ARQULE, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE LOSS
(IN THOUSANDS, EXCEPT SHARE DATA)

	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	ACCUMULATED OTHER COMPREHENSIVE INCOME/(LOSS)	ACCUMULATED DEFICIT	STOCKHOLDERS' EQUITY	TOTAL COMPREHENSIVE LOSS
	SHARES	PAR VALUE					
Balance at December 31, 2006	35,811,709	$ 358	$ 307,965	$ (152)	$ (228,217)	$ 79,954	
Stock option exercises and issuance of stock	351,621	4	1,757			1,761	
Employee stock purchase plan	95,783	1	474			475	
Stock based compensation expense			4,971			4,971	
Issuance of common stock from stock offering, net	7,502,000	75	54,029			54,104	
Change in unrealized loss on marketable securities				148		148	$ 148
Net loss					(53,372)	(53,372)	(53,372)
Balance at December 31, 2007	43,761,113	438	369,196	(4)	(281,589)	88,041	
2007 Comprehensive loss							$ (53,224)
Stock option exercises and issuance of stock	246,931	2	180			182	
Employee stock purchase plan	145,193	2	394			396	
Stock based compensation expense			5,708			5,708	
Change in unrealized loss on marketable securities				4		4	$ 4
Net loss					(50,864)	(50,864)	(50,864)
Balance at December 31, 2008	44,153,237	442	375,478		(332,453)	43,467	
2008 Comprehensive loss							$ (50,860)
Stock option exercises and issuance of stock	427,797	4	218			222	
Employee stock purchase plan	191,911	2	494			496	
Stock based compensation expense			3,431			3,431	
Change in unrealized gain on marketable securities				55		55	$ 55
Net loss					(36,136)	(36,136)	(36,136)
Balance at December 31, 2009	44,772,945	$ 448	$ 379,621	$ 55	$ (368,589)	$ 11,535	
2009 Comprehensive loss							$ (36,081)

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

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ARQULE, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	YEAR ENDED DECEMBER 31,		
	2009	2008	2007
	(IN THOUSANDS)		
Cash flows from operating activities:			
Net loss	$ (36,136)	$ (50,864)	$ (53,372)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,695	1,702	1,714
Amortization of premium/discount on marketable securities	917	20	26
Amortization of deferred gain on sale leaseback	(552)	(552)	(552)
Non-cash stock compensation.	3,431	5,708	4,971
Loss (gain) on auction rate securities put option	1,610	(6,684)	
Loss (gain) on auction rate securities	(3,204)	8,012	
Loss on disposal of fixed assets.		14	160
Changes in operating assets and liabilities:			
Prepaid expenses and other current assets	(1,704)	654	736
Other assets	383	80	486
Accounts payable and accrued expenses	(1,900)	98	3,886
Restructuring accrual, net of current portion.	(78)	(660)	(628)
Deferred revenue	(6,220)	69,940	26,597
Net cash provided by (used in) operating activities	(41,758)	27,468	(15,976)
Cash flows from investing activities:			
Purchases of marketable securities	(94,086)	(8,789)	(181,555)
Proceeds from sale or maturity of marketable securities	32,097	67,473	147,020
Additions to property and equipment	(660)	(3,519)	(1,236)
Proceeds from disposal of property and equipment		94	
Net cash provided by (used in) investing activities	(62,649)	55,259	(35,771)
Cash flows from financing activities:			
Proceeds from notes payable		47,750	
Payment of notes payable	(1,650)		
Proceeds from registered direct stock offering, net			54,104
Proceeds from issuance of common stock	718	578	2,236
Net cash provided by (used in) financing activities	(932)	48,328	56,340
Net increase (decrease) in cash and cash equivalents.	(105,339)	131,055	4,593
Cash and cash equivalents, beginning of period	141,890	10,835	6,242
Cash and cash equivalents, end of period	$ 36,551	$ 141,890	$ 10,835

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

The Company paid interest on debt of $655, $472 and $0 in 2009, 2008 and 2007, respectively.

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

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

1. ORGANIZATION AND NATURE OF OPERATIONS

We are a clinical-stage biotechnology company organized as a Delaware corporation in 1993 and engaged in the research and development of innovative cancer therapeutics. Our mission is to produce novel medicines with differentiated mechanisms of action that target the specific biological pathways implicated in a wide range of cancers.

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

Our proprietary pipeline is directed toward molecular targets and biological processes with demonstrated roles in the development of human cancers. The most advanced candidate in this pipeline is ARQ 621, an inhibitor of the Eg5 kinesin motor protein that is in Phase 1 clinical testing. Additional pipeline assets include ARQ 501 and ARQ 761, activators of the cell's DNA damage response mechanism that we plan to develop further on a partnered basis. We are also pursuing pre-clinical development of an inhibitor of the B-RAF kinase. Our drug design efforts are focused primarily on AKIP ", which we are using to generate compounds designed to inhibit a variety of kinases without competing with adenosine triphosphate ("ATP") for binding to the target kinase. With the AKIP technology, we have discovered and optimized a series of small molecule inhibitors of fibroblast growth factor receptor inhibitors that are in pre-clinical development.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Significant accounting policies followed in the preparation of these financial statements are as follows:

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Cash Equivalents and Marketable Securities

We consider all highly liquid investments purchased within three months of original maturity date to be cash equivalents. We invest our available cash primarily in U.S. Treasury bill funds, money market funds, commercial paper fully guaranteed by the FDIC under the Temporary Liquidity Guarantee Program (TLGP), commercial paper, and U.S. federal and state agency backed certificates, including auction rate securities that have investment grade ratings. Auction rate securities are structured with short-term interest reset dates of generally less than 90 days, but with contractual maturities that can be well in excess of ten years. At the end of each reset period, which occurs every seven to twenty-eight days, investors can sell or continue to hold the securities at par value. We generally classify our

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

marketable securities as available-for-sale at the time of purchase and re-evaluate such designation as of each consolidated balance sheet date. The Company classifies its investments as either current or long-term based upon the investments' contractual maturities and the Company's ability and intent to convert such instruments to cash within one year. We report available-for-sale investments at fair value as of each balance sheet date and include any unrealized gains and, to the extent deemed temporary, unrealized losses in stockholders' equity. Realized gains and losses are determined using the specific identification method and are included in other income (expense) in the statement of operations. Certain of our marketable securities are classified as trading securities and any changes in the fair value of those securities are recorded as other income (expense) in the statement of operations.

We determine on a quarterly basis the fair value of our investment portfolio. Investments are considered to be impaired when a decline in fair value below cost basis is determined to be other-than-temporary. We evaluate whether a decline in fair value below cost basis is other-than-temporary using available evidence regarding our investments. In the event that the cost basis of a security exceeds its fair value, we evaluate, among other factors, the duration of the period that, and extent to which, the fair value is less than cost basis, the financial health of and business outlook for the issuer, including industry and sector performance, and operational and financing cash flow factors, overall market conditions and trends, our intent to sell the investment and if it is more likely than not that we would be required to sell the investment before its anticipated recovery. Once a decline in fair value is determined to be other-than-temporary, a write-down is recorded in the consolidated statements of operations and a new cost basis in the security is established.

Fair Value of Financial Instruments

At December 31, 2009 and 2008 our financial instruments consist of cash, cash equivalents, accounts payable, accrued expenses and notes payable. The carrying amount of these financial instruments approximate their fair values. At December 31, 2009 and 2008, our financial instruments also included marketable securities and an auction rate security Put Option which are reported at fair value.

Property and Equipment

Property and equipment are recorded at cost and depreciated using the straight-line method over their estimated useful lives. Assets under capital leases and leasehold improvements are amortized over the shorter of their estimated useful lives or the term of the respective leases by use of the straight-line method. Maintenance and repair costs are expensed as incurred.

Revenue Recognition Research and Development Revenue

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

Research and development payments from our collaborators are recognized as research and development revenue using the contingency adjusted performance model. Under this model, when

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

Research and Development Costs

Costs of internal research and development, which are expensed as incurred, are comprised of the following types of costs incurred in performing research and development activities and those incurred in connection with research and development revenue: salaries and benefits, allocated overhead and occupancy costs, clinical trial and related clinical manufacturing costs, contract services, and other outside costs. We incurred research and development expenses of $49,495 $49,629, and $53,727, in 2009, 2008, and 2007, respectively.

Restructuring Charges/Credits

The Company accounts for restructuring charges/credits in accordance with the authoritative guidance on accounting for costs associated with exit or disposal activities. Accruals are established for one-time employee termination benefits in the same period that the appropriate level of management and the Board of Directors approve and commit the Company to a termination that meets the following criteria and has been communicated to employees: (i) specifically identifies the number, location and job level of employees to be terminated, (ii) specifies the benefits terminated employees are to receive, and (iii) assures that employees will be terminated within sixty days. Accruals are established for property and equipment and facility-related costs for facilities that have been abandoned and which have no future economic benefit to the Company at the time the Company ceases to occupy the facility.

Accruals for property and equipment and facility related costs of abandoned facilities require significant management judgment and the use of estimates, including assumptions concerning our ability to sublease certain operating leases for abandoned real estate and the ability of a sublessee to fulfill its contractual sublease obligation. Estimates of the time required to sublease facilities and sublease rates the Company will receive are based on management's analysis of the local real estate markets and general economic conditions in the regions of the abandoned facilities. If either the time it takes to sublease these facilities or the actual sublease rates achieved differ from the Company's assumptions, we may be required to adjust our restructuring accrual and record a restructuring charge or credit. When abandoned facilities are subleased, the Company must estimate the ability of the sublessee to satisfy the contractual lease obligation based on its financial position and projected ability to generate future working capital. If the sublessee's actual performance on the sublease is different from the Company estimates, we may be required to adjust our restructuring accrual and record a restructuring charge or credit.

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Impairment or Disposal of Long-Lived Assets

We assess our long-lived assets for impairment whenever events or changes in circumstances (a "triggering event") indicate that the carrying value of a group of long-lived assets may not be recoverable.

Segment Data

Management uses consolidated financial information in determining how to allocate resources and assess performance. For this reason, we have determined that we are principally engaged in one operating segment. See Note 15 with respect to significant customers. Substantially all of our revenue since inception has been generated in the United States and substantially all of our long-lived assets are located in the United States.

Income Taxes

Income taxes have been accounted for using the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance against deferred tax assets is recorded if, based upon the weight of all available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

Earnings (Loss) Per Share

The computations of basic and diluted earnings (loss) per common share are based upon the weighted average number of common shares outstanding and potentially dilutive securities. Potentially dilutive securities include stock options. Options to purchase 5,215,189, 5,600,583 and 4,477,862 shares of common stock were not included in the 2009, 2008 and 2007 computations of diluted net loss per share, respectively, because inclusion of such shares would have an anti-dilutive effect.

Stock-Based Compensation

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

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

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

calculating the fair values of our stock options granted in the years ended December 31, 2009, 2008 and 2007.

The following table presents stock-based compensation expense for the years ended December 31, 2009, 2008 and 2007 included in our Consolidated Statements of Operations:

	2009	2008	2007
Research and development	$ 1,415	$ 1,615	$ 2,118
General and administrative	2,016	4,093	2,853
Total compensation expense	$ 3,431	$ 5,708	$ 4,971

In the years ended December 31, 2009, 2008 and 2007, no stock-based compensation expense was capitalized and there were no recognized tax benefits associated with the stock-based compensation charge. The stock-based compensation charge reduced basic and diluted net loss in the years ended December 31, 2009, 2008 and 2007 by $0.08, $0.13 and $0.12 per share, respectively.

The fair value of stock options and employee stock purchase plan shares granted in the years ended December 31, 2009, 2008 and 2007 respectively were estimated on the grant date using the Black-Scholes option-pricing model with the following assumptions:

	2009	2008	2007
Dividend yield(1)	0.0%	0.0%	0.0%
Expected volatility factor(2)	61%	53 - 60%	55 - 62%
Risk free interest(3)	1.8 - 2.4%	1.6 - 3.2%	3.3 - 4.9%
Expected term, excluding options issued pursuant to the Employee Stock Purchase Plan(4)	5.8 - 6.4 years	5.6 - 6.2 years	4.0 - 5.9 years
Expected term Employee Stock Purchase Plan(5)	6 months	6 months	6 months

(1) We have historically not paid dividends on our common stock and we do not anticipate paying any dividends in the foreseeable future.

(2) Measured using an average of historical daily price changes of our stock. The weighted average expected volatility in 2009, 2008 and 2007 was approximately 61%, 55% and 61%, respectively.

(3) The risk-free interest rate for periods equal to the expected term of share option based on the U.S. Treasury yield in effect at the time of grant.

(4) The expected term is the number of years that we estimate, based on historical experience, that options will be outstanding before exercise or cancellation. The range in expected term is the result of certain groups of employees exhibiting different exercising behavior.

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(5) The expected term of options issued in connection with our Employee Stock Purchase Plan is 6 months based on the terms of the plan.

Comprehensive Loss

Comprehensive loss is comprised of net loss and other comprehensive gain (loss). Other comprehensive income was $55, $4 and $148 in 2009, 2008 and 2007 respectively, composed of unrealized gains and losses on marketable securities.

Recent Accounting Pronouncements

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

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

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

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

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

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

In June 2009, we adopted new authoritative guidance on accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The adoption of the new guidance did not impact our financial statements. We evaluated all events or transactions that occurred after December 31, 2009 and we did not have any material recognizable subsequent events.

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

In October 2009, the FASB approved for issuance Accounting Standards Update ("ASU") 2009-13, *Revenue Arrangements with Multiple Deliverables* (currently within the scope of FASB Accounting Standards Codification ("ASC") Subtopic 605-25). This statement provides principles for allocation of consideration among its multiple elements, allowing more flexibility in identifying and accounting for separate deliverables under an arrangement. The EITF introduces an estimated selling price method for valuing the elements of a bundled arrangement if vendor-specific objective evidence or third-party evidence of selling price is not available, and significantly expands related disclosure requirements. This standard is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Alternatively, adoption may be on a retrospective basis, and early application is permitted. The Company is currently evaluating the impact of adopting this pronouncement.

3. RELATED PARTIES

In January 2007, we entered into a $5.0 million, sponsored research agreement with the newly established Boston Biomedical, Inc. ("BBI"), an independent corporation led by our former chief scientific officer. BBI conducts scientific research under the agreement that includes a number of *in vivo* and *in vitro* studies, reports and publications related to mechanisms of action and biomarkers for our lead products, which are in human clinical trials. As of December 31, 2008, our responsibilities under this agreement have been fulfilled, and no further payments are due to BBI from us. See Note 16 to the consolidated financial statements for further terms of the agreement.

4. COLLABORATIONS AND ALLIANCES

Daiichi Sankyo Co., Ltd. Kinase Inhibitor Discovery Agreement

On November 7, 2008, we entered into a research collaboration, exclusive license and co-commercialization agreement with Daiichi Sankyo under which we will apply our proprietary technology and know-how from our AKIP platform for the discovery of therapeutic compounds that

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

4. COLLABORATIONS AND ALLIANCES (Continued)

selectively inhibit certain kinases. The agreement defines two such kinase targets, and Daiichi Sankyo will have an option to license compounds directed to these targets following the completion of certain pre-clinical studies.

The agreement provides for a $15 million upfront payment, which we received in November 2008, research support payments for the first and second years of the collaboration, $3.6 million of which we received in December 2008, licensing fees for compounds discovered as a result of this research, milestone payments related to clinical development, regulatory review and sales, and royalty payments on net sales of compounds from the collaboration. We retain the option to co-commercialize licensed products developed under this agreement in the U.S.

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

Revenue for this agreement is recognized using the contingency-adjusted performance model with an estimated performance period through November 2012. For the year ended December 31, 2009 and 2008, $7.2 million and $0.7 million, respectively, was recognized as revenue. At December 31, 2009, $19.5 million remains in deferred revenue.

Daiichi Sankyo Co., Ltd. ARQ 197 Agreement

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

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

The duration and termination of the agreement is tied to future events. Unless earlier terminated due to breach, insolvency or upon 90 days notice if prior to phase 3 clinical trials or 180 days notice if on or after the beginning of phase 3 clinical trials by Daiichi Sankyo, the agreement shall continue until the later of (i) such time as Daiichi Sankyo is no longer developing at least one licensed product or (ii) if Daiichi Sankyo has commercialized a licensed product or products, such time as all royalty terms

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

4. COLLABORATIONS AND ALLIANCES (Continued)

for all licensed products have ended. The royalty term, on a country-by country basis for a product, ends as of the later of (i) the expiration of the last valid claim under a patent covering the manufacture, use, or sale of a licensed product or (ii) a certain number of years from the date of the commercial sale of the licensed product in such country.

Revenue for this agreement is recognized using the contingency-adjusted performance model with an estimated development period through December 2013. For the years ended December 31, 2009 and 2008, $13.9 million and $0.4 million, respectively, was recognized as revenue. At December 31, 2009, $54.8 million remains in deferred revenue.

Kyowa Hakko Kirin Co., Ltd. Licensing Agreement

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

In addition to the upfront and possible regulatory milestone payments totaling $123 million, the Company will be eligible for future milestone payments based on the achievement of certain levels of net sales. The Company will recognize the payments, if any, as revenue in accordance with its revenue recognition policies. As of December 31, 2009, the Company has not recognized any revenue from these sales milestone payments, and there can be no assurance that it will do so in the future.

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

Revenue for this agreement is recognized using the contingency-adjusted performance model with an estimated development period through April 2016. For each of the years ended December 31, 2009 and 2008, $4.0 million was recognized as revenue. At December 31, 2009 $24.5 million remains in deferred revenue.

Roche Research and Development Alliance

On April 2, 2004, we announced an alliance with Hoffmann-La Roche ("Roche") to discover and develop drug candidates targeting the E2F biological pathway, including ARQ 501, and ARQ 171.

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

4. COLLABORATIONS AND ALLIANCES (Continued)

Under the terms of the agreement, Roche obtained an option to license drugs resulting from our E2F program in the field of cancer therapy and provided immediate research funding of $15 million and financial support for ongoing research and development.

Roche had an option to license worldwide rights for the development and commercialization of all products resulting from the E2F-1 program in the field of cancer therapy based on our delivery of a clinical data package from certain trials with ARQ 501, as well as a recommended Phase 2 dose for a second-generation E2F-1 compound.

On December 17, 2008, Roche notified the Company of its intention not to exercise its option to license the E2F program. Roche's rights to develop and commercialize potential drugs under the agreement terminated as of December 31, 2008. As a result, the Company will not receive any further payments under this agreement. On January 30, 2009, the Company notified Roche that, in accordance with the terms of the agreement, it had exercised its right to terminate the agreement. As a result, all rights and licenses granted by the Company to Roche under the agreement will also be terminated.

Under this agreement we received approximately $33 million in research and development support from Roche, all of which has been recognized as revenue through December 31, 2008. In the year ended December 31, 2008, we recognized revenue from Roche of approximately $8.2 million, including $1.6 million of deferred revenue upon the termination of the Roche alliance agreement in 2008. Revenue of approximately $6.6 million was recognized in each of the years ended December 31, 2007and 2006. No further revenues will be recognized under the collaboration with Roche.

5. MARKETABLE SECURITIES AND FAIR VALUE MEASUREMENTS

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

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

Investments are considered to be impaired when a decline in fair value below cost basis is determined to be other-than-temporary. We evaluate whether a decline in fair value below cost basis is other-than-temporary using available evidence regarding our investments. In the event that the cost basis of a security exceeds its fair value, we evaluate, among other factors, the duration of the period that, and extent to which, the fair value is less than cost basis, the financial health of and business outlook for the issuer, including industry and sector performance, and operational and financing cash flow factors, overall market conditions and trends, our intent to sell the investment and if it is more

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

5. MARKETABLE SECURITIES AND FAIR VALUE MEASUREMENTS (Continued)

likely than not that we would be required to sell the investment before its anticipated recovery. Once a decline in fair value is determined to be other-than-temporary, a write-down is recorded in the consolidated statements of operations and a new cost basis in the security is established. In April 2009, additional authoritative guidance was issued to provide greater clarity about the credit and noncredit component of an other-than-temporary impairment event and to more effectively communicate when an other-than-temporary impairment event has occurred. The new guidance applies to debt securities. The new guidance was effective for periods ending after June 15, 2009. The adoption of this new guidance did not have a significant impact on our financial statements.

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

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

As a result of accepting the Offering, the Company received a Put Option from UBS to repurchase the securities at par value at any time during the period from June 30, 2010 through July 2, 2012, if the Company's auction rate securities have not previously been sold by the Company or by UBS on its behalf. The Company has accounted for the Put Option as a freestanding financial instrument and elected to record the value under the fair value option for financial assets and financial liabilities. The Company has classified its auction rate securities as trading securities reflecting the Company's intent to exercise the Put Option during the period June 30, 2010 to July 2, 2012. The net increase in value of our Put Option and auction rate securities totaling $1.6 million in the year ended December 31, 2009 was recorded as a gain in other income (expense) in the statement of operations.

ArQule's marketable securities portfolio as of December 31, 2008 included $65.3 million (at cost) and $59.5 million (at cost) at December 31, 2009 invested in auction rate securities all of which were associated with auctions that failed subsequent to February 12, 2008.

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

5. MARKETABLE SECURITIES AND FAIR VALUE MEASUREMENTS (Continued)

On July 8, 2008, we entered into a collateralized, revolving credit line agreement for up to $47.5 million with UBS Bank USA (the "Facility"). In July 2008, we drew down $46.1 million under the Facility. During 2009, certain of our auction rate securities were redeemed and the note payable balance under the Facility was reduced to $44.4 million at December 31, 2009.

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

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

December 31, 2009	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Security type				
U.S. Federal Treasury and U.S. government agencies securities	$ 42,034	$ 26	$ (2)	$ 42,058
Corporate debt securities-short term	18,770	14	(1)	18,783
	60,804	40	(3)	60,841
Corporate debt securities-long term	6,236	23	(5)	6,254
Total available-for-sale marketable securities	$ 67,040	$ 63	$ (8)	$ 67,095

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

December 31, 2009	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Security type				
Auction rate securities	$ 59,579	$	$ (4,808)	$ 54,771
Auction rate put option		5,074		5,074
Total trading securities	$ 59,579	$ 5,074	$ (4,808)	$ 59,845

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

5. MARKETABLE SECURITIES AND FAIR VALUE MEASUREMENTS (Continued)

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

The underlying collateral of our auction rate securities consists primarily of student loans, the majority of which are supported by the federal government as part of the Federal Family Education Loan Program (FFELP). The credit ratings for all of our auction rate securities were AAA when originally purchased. At December 31, 2009, $48.9 million at par value were rated AAA and $10.6 million at par value were rated A.

At December 31, 2009, the Company's marketable securities include auction rate securities and auction rate put option totaling $57.2 million and marketable securities-long term include auction rate securities of $2.6 million. At December 31, 2008, the Company's marketable securities-long term include auction rate securities and auction rate put option totaling $64.2 million. The auction rate securities and put option are classified as trading securities and any future gains and losses will be recorded as other income (expense) in the statement of operations.

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

	December 31, 2009	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	$ 35,044	$ 35,044	$	$
Marketable securities	118,126		60,841	57,285
Marketable securities long term	8,814		6,254	2,560
Total	$ 161,984	$ 35,044	$ 67,095	$ 59,845

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

5. MARKETABLE SECURITIES AND FAIR VALUE MEASUREMENTS (Continued)

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

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

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

The following tables roll forward the fair value of our auction rate securities and put option, whose fair values are determined by Level 3 inputs for 2009:

	Amount ($ in millions)
Balance at December 31, 2008	$ 64.2
Gain on auction rate securities and put option	1.6
Settlements	(6.0)
Balance at December 31, 2009	$ 59.8

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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5. MARKETABLE SECURITIES AND FAIR VALUE MEASUREMENTS (Continued)

The following tables roll forward the fair value of our auction rate securities and put option, whose fair values are determined by Level 3 inputs for 2008:

	Amount ($ in millions)
Balance at December 31, 2007	$ 92.9
Loss on auction rate securities and put option	(1.3)
Settlements	(27.4)
Balance at December 31, 2008	$ 64.2

6. PROPERTY AND EQUIPMENT

Property and equipment consist of the following at December 31, 2009 and 2008:

	USEFUL LIFE ESTIMATED (YEARS)	2009	2008
Machinery and equipment	5	$ 11,844	$ 11,344
Leasehold improvements	3 - 10	4,510	4,478
Furniture and fixtures	7	1,175	1,175
Computer equipment	3	3,517	3,487
Construction-in-progress		143	45
		21,189	20,529
Less: Accumulated depreciation and amortization		16,604	14,909
		$ 4,585	$ 5,620

On May 2, 2005, we completed a transaction to sell our Woburn headquarters facility and two parcels of land in exchange for a cash payment, net of commissions and closing costs, of $39,331. Simultaneous with that sale, we entered into an agreement to lease back the entire facility and the associated land. The lease was subsequently amended on June 30, 2005. The amended lease has a term of ten years with an average annual rental rate of $3,409. We also have options to extend the lease term for up to an additional ten years. We are applying sale leaseback accounting to the transaction and are treating the lease as an operating lease. As a result of this transaction, we reduced our net fixed assets by $33,709, representing the net book value of the assets sold on the date of the lease amendment, and realized a gain on the sale of $5,477, which was deferred and is being amortized over the initial ten year lease term as a reduction in rent expense.

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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7. OTHER ASSETS

Other assets include the following at December 31, 2009 and 2008:

	2009	2008
Security deposits	$ 656	$ 988
Prepaid rent, net of current portion	672	672
Other long-term prepaid assets		51
Total other assets	$ 1,328	$ 1,711

8. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

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

	2009	2008
Accounts payable	$ 277	$ 495
Accrued payroll	2,709	2,671
Accrued outsourced pre-clinical and clinical fees	8,019	8,669
Accrued professional fees	552	1,037
Accrued restructuring-current portion	78	660
Other accrued expenses	725	728
	$ 12,360	$ 14,260

9. RESTRUCTURING ACTIONS

In December 2002, we announced a major restructuring of our operations in order to realign our workforce and expedite the transition towards becoming a drug discovery company. The restructuring actions included closing our facility in Redwood City, California.

The facility-related accrual, which primarily represents the difference between the Company's lease and other facility related obligations for its California facility and the amount of sublease and other payments it will receive under its sublease agreement, will be paid out through February 2010. The restructuring accrual is expected to be paid out within one year and is included in the Consolidated Balance Sheet under "Accounts payable and accrued expenses".

Accruals for abandoned facilities under lease require significant management judgment and the use of estimates, including assumptions concerning the ability of a sublessee to fulfill its contractual sublease obligation. As a result of signing the sublease for the California facility, we adjusted our accrual for abandoned facilities to reflect the full amount of the anticipated sublease income to be received. This assumption about the sublessee's ability to fulfill its contractual obligation is based on an analysis of their financial position and ability to generate future working capital. If the sublessee is unable to meet its obligations, and the Company is unable to enter into another sublease for the facility, ArQule may be required to adjust its restructuring accrual and record additional restructuring expense of up to $0.1 million.

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

9. RESTRUCTURING ACTIONS (Continued)

Activities against the restructuring accrual in 2008 and 2009 were as follows:

	Balance as of December 31, 2007	2008 Provisions	2008 Payments	Balance as of December 31, 2008
Facility-related	$ 1,366	$	$ (628)	$ 738
Total restructuring accrual	$ 1,366	$	$ (628)	$ 738

	Balance as of December 31, 2008	2009 Provisions	2009 Payments	Balance as of December 31, 2009
Facility-related	$ 738	$	$ (660)	$ 78
Total restructuring accrual	$ 738	$	$ (660)	$ 78

10. NOTES PAYABLE

On July 8, 2008, we entered into a collateralized, revolving credit line agreement for up to $47.5 million with UBS Bank USA (the "Facility"). The Facility is secured by a first priority lien and security interest in the auction rate securities held by us in an account with UBS Financial Services Inc., an affiliate of UBS Bank USA. The credit line is uncommitted and any outstanding balance, including interest, is payable upon demand. Variable rate advances under the Facility carried interest at LIBOR plus 100 basis points. The Facility replaced the $15 million standard margin loan agreement with UBS Financial Services Inc. that we entered into on May 8, 2008. The funds are available for research and development efforts, including clinical trials, and for general corporate purposes, including working capital. In July 2008, we drew down $46.1 million under the Facility and that amount is reported as note payable at December 31, 2008. During 2009, certain of our auction rate securities were redeemed and the note payable balance under the Facility was reduced to $44.4 million at December 31, 2009.

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

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

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

10. NOTES PAYABLE (Continued)

In October 2008, we entered into a margin loan agreement with another financial institution collateralized by $2.9 million of our auction rate securities and borrowed $1.7 million which is the maximum amount allowed under this facility. The amount outstanding under this facility is $1.7 million at December 31, 2009.

Interest expense was $655 and $472 for the years ended December 31, 2009 and 2008, respectively. There was no interest expense for the year ended December 31, 2007.

11. STOCKHOLDERS' EQUITY

Preferred Stock

We are authorized to issue up to one million shares of preferred stock. As of December 31, 2009 and 2008, there were no outstanding shares of preferred stock. Our Board of Directors will determine the terms of the preferred stock if and when the shares are issued.

Common Stock

Our amended Certificate of Incorporation authorizes the issuance of up to 100 million shares of $0.01 par value common stock.

In June 2007, we completed a stock offering in which we sold 7.0 million shares of common stock at a price of $7.75 for net proceeds of $50.5 million after commissions and offering expenses. In July 2007, we sold an additional 0.5 million shares of common stock upon exercise of a portion of the underwriters over allotment option at a price of $7.75 for net proceeds of $3.6 million after offering expenses.

At December 31, 2009, we have 547,985 common shares reserved for future issuance under the Employee Stock Purchase Plan ("Purchase Plan") and for the exercise of common stock options pursuant to the 1994 Amended and Restated Equity Incentive Plan ("Equity Incentive Plan") and the 1996 Amended and Restated Director Stock Option Plan ("Director Plan").

In January 2005, we completed a stock offering whereby we sold 5.8 million shares of common stock at $5.25 per share for aggregate net proceeds of $28.3 million after commissions and offering expenses.

12. STOCK OPTION PLANS

During 2009, our shareholders approved an amendment to the Equity Incentive Plan to increase the number of shares available to 11,000,000. All shares are awarded at the discretion of our Board of Directors in a variety of stock based forms including stock options and restricted stock. Pursuant to the Equity Incentive Plan, incentive stock options may not be granted at less than the fair market value of our common stock at the date of the grant, and the option term may not exceed ten years. Stock options issued pursuant to the Equity Incentive Plan generally vest over four years. For holders of 10% or more of our voting stock, options may not be granted at less than 110% of the fair market value of the common stock at the date of the grant, and the option term may not exceed five years. Stock appreciation rights granted in tandem with an option shall have an exercise price not less than the exercise price of the related option. As of December 31, 2009, no stock appreciation rights have been

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

12. STOCK OPTION PLANS (Continued)

issued. At December 31, 2009, there were 2,160,320 shares available for future grant under the Equity Incentive Plan.

During 2005, our shareholders approved an amendment to the Director Plan to increase the number of shares available to 500,500. In May 2006, our shareholders approved an amendment to the Director Plan to increase the number of options granted to the Chairman of the Board and Directors. Under the terms of the Director Plan, options to purchase shares of common stock are automatically granted (A) to the Chairman of the Board of Directors (1) upon his or her initial election or appointment in the amount of 25,000 and vesting over three years and (2) upon his or her re-election or continuation on our board immediately after each annual meeting of stockholders in the amount of 15,000 and vesting immediately, and (B) to each other Director (1) upon his or her initial election to our board in the amount of 20,000 and vesting over three years and (2) upon his or her re-election or continuation on our board in the amount of 10,000 and vesting immediately. All options granted pursuant to the Director Plan have a term of ten years with exercise prices equal to fair market value on the date of grant. In May 2007, our shareholders approved an amendment to the Director Plan to increase the number of shares available from 500,500 to 750,500. Through December 31, 2009, options to purchase 641,466 shares of common stock have been granted under this plan of which 495,500 shares are currently exercisable. As of December 31, 2009, 241,500 shares are available for future grant.

For the year ended December 31, 2007, stock-based compensation expense of $637, included in research and development, was related to Boston Biomedical, Inc. transition costs (see Note 16, Boston Biomedical, Inc. Collaboration in this Form 10-K). Additionally in the year ended December 31, 2007, $438 of stock-based compensation expense was incurred in conjunction with the acceleration of vesting of 103,798 stock options and the extension of the post-employment exercise period of 395,942 stock options held by certain employees who will meet eligibility criteria for a retirement benefit within the next four years. On October 4, 2007, the exercise period associated with 1,115,000 stock options was extended and the vesting of 165,625 stock options was accelerated in conjunction with an amendment to the CEO's employment agreement. The amount of stock option expense associated with this amendment was $703 and $1,406 in the year ended December 31, 2007 and 2008, respectively.

During 2009, we issued 12,000 fully-vested options to certain members of our Scientific Advisory Board under the Equity Incentive Plan. In 2008 and 2007, we issued 12,000 and 27,500 of such grants, respectively. Compensation expense with respect to these awards in 2009, 2008 and 2007 was $41, $48 and $121 respectively.

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

12. STOCK OPTION PLANS (Continued)

Option activity under the Plans for the years ended December 31, 2007, 2008 and 2009 was as follows:

Stock Options	Number of Shares	Weighted Average Exercise Price
Outstanding as of December 31, 2006	3,872,946	$ 6.66
Granted	1,334,825	6.60
Exercised	(355,029)	5.14
Cancelled	(374,880)	6.46
Outstanding as of December 31, 2007	4,477,862	6.78
Granted	1,737,378	4.16
Exercised		
Cancelled	(614,657)	6.59
Outstanding as of December 31, 2008	5,600,583	5.99
Granted	156,500	3.96
Exercised	(48,641)	4.57
Cancelled	(493,253)	4.82
Outstanding as of December 31, 2009	5,215,189	$ 6.04
Exercisable as of December 31, 2009	3,516,407	$ 6.60
Weighted average grant-date fair value of options granted during the year ended December 31, 2009		$ 2.29

The following table summarizes information about options outstanding at December 31, 2009:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at December 31, 2009	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Exercisable as of December 31, 2009	Weighted Average Exercise Price
$ 2.35 - 2.80	25,000	8.8	$ 2.46	5,250	$ 2.39
2.80 - 5.60	2,445,967	6.7	4.30	1,379,855	4.42
5.60 - 8.40	2,253,833	5.4	6.26	1,640,913	6.26
8.40 - 11.20	221,080	3.5	9.52	221,080	9.52
11.20 - 14.00	119,675	1.8	13.32	119,675	13.32
14.00 - 16.80	250	1.6	14.98	250	14.98
16.80 - 19.60	36,384	0.9	18.20	36,384	18.20
19.60 - 22.40	85,500	0.3	20.04	85,500	20.04
22.40 - 25.20	7,500	0.9	23.13	7,500	23.13
25.20 - 28.00	20,000	1.1	28.00	20,000	28.00
	5,215,189	5.7	$ 6.04	3,516,407	$ 6.60

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

12. STOCK OPTION PLANS (Continued)

The aggregate intrinsic value of options outstanding at December 31, 2009 was $216 of which $109 related to exercisable options. The weighted average fair value of options granted in year ended December 31, 2009, 2008 and 2007 was $2.29, $2.23, and $3.46 per share, respectively. The intrinsic value of options exercised in the year ended December 31, 2009, 2008, and 2007 was $53,809, $0, and $1,173, respectively.

Shares vested, expected to vest and exercisable at December 31, 2009 are as follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Vested and unvested expected to vest at December 31, 2009	5,068,721	$ 6.04	5.7	$ 216
Exercisable at December 31, 2009	3,516,407	$ 6.60	4.9	$ 109

The total compensation cost not yet recognized as of December 31, 2009 related to non-vested option awards was $3.7 million, which will be recognized over a weighted-average period of 2.4 years. During the year ended December 31, 2009, there were 58,225 shares forfeited with a weighted average grant date fair values of $2.40 per share. The weighted average remaining contractual life for options exercisable at December 31, 2009 was 4.9 years.

In 2009 we granted 412,200 shares of restricted stock to employees, vesting annually over a four year period. In 2008 we granted 103,316 shares of restricted stock to employees, vesting annually over a four year period and 125,000 shares vesting annually over a two year period. The shares of restricted stock were issued at no cost to the recipients. The weighted average fair value of the restricted stock at the time of grant in 2009 and 2008 was $3.54 and $4.31 respectively, per share, and is being expensed ratably over the vesting period. Through December 31, 2009, 35,733 shares have been forfeited, and 146,127 shares have vested. We recognized share-based compensation expense related to restricted stock of $653 and $417 for the year ended December 31, 2009 and 2008, respectively.

In 1996, the stockholders adopted the Purchase Plan. This plan enables eligible employees to exercise rights to purchase our common stock at 85% of the fair market value of the stock on the date the right was granted or the date the right is exercised, whichever is lower. Rights to purchase shares under the Purchase Plan are granted by the Board of Directors. The rights are exercisable during a period determined by the Board of Directors; however, in no event will the period be longer than twenty-seven months. The Purchase Plan is available to substantially all employees, subject to certain limitations. In May 2005, our shareholders approved an amendment to the Purchase Plan to increase the aggregate number of shares of the Company's common stock that may be issued from 1,020,000 shares to 1,230,000 shares. In May 2007, our shareholders approved an amendment to the Purchase Plan to increase the aggregate number of shares of the Company's common stock that may be issued from 1,230,000 shares to 1,600,000. In May 2009, our shareholders approved an amendment to the Purchase Plan to increase the aggregate number of shares of the Company's common stock that may be issued from 1,600,000 shares to 2,000,000. As of December 31, 2009, 1,452,015 shares have been purchased and 547,985 shares are available for future sale under the Purchase Plan.

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

13. INCOME TAXES

The Company recorded $0.6 million of federal income tax expense in 2009 attributable to alternative minimum tax ("AMT"). The Company's taxable income for the year ended December 31, 2009 primarily results from timing differences in recognition of research and development revenues. For purposes of AMT the Company can only offset 90% of its current period taxable income with net operating loss carryforwards. The remaining 10% is subject to federal AMT at a tax rate of 20%. Although the Company is entitled to an AMT credit against future federal regular income tax, the Company recorded a valuation allowance against this credit since it is more likely than not that this tax credit will not be realized. There was no current or deferred tax expense for the years ended December 31, 2008 or 2007.

The following is reconciliation between the U.S. federal statutory rate and the effective tax rate for the years ended December 31, 2009, 2008 and 2007:

	2009	2008	2007
Income tax (benefit) expense at statutory rate	$ (12,080)	$ (17,294)	$ (18,147)
State tax (benefit) expense, net of Federal tax (benefit) expense	(2,458)	(3,096)	(3,118)
Permanent items	439	7	982
Effect of change in valuation allowance	17,089	22,377	21,776
Tax credits	(2,632)	(2,043)	(2,202)
Other	192	49	709
Tax expense	$ 550	$	$

The income tax effect of temporary differences comprising the deferred tax assets and deferred tax liabilities on the accompanying balance sheets is a result of the following at December 31, 2009 and 2008:

	2009	2008
Deferred tax assets:		
Net operating loss carryforwards	$ 61,948	$ 71,508
Tax credit carryforwards	19,020	16,388
Equity based compensation	4,396	3,517
Book depreciation in excess of tax	2,518	2,661
Reserves and accruals	16	256
Deferred revenue	34,083	9,909
Loss on investment	2,021	2,013
Other	(71)	590
	123,931	106,842
Valuation allowance	(123,931)	(106,842)
Deferred tax liabilities		
Net deferred tax assets	$	$

Total valuation allowance increased by $17,089 for the year ended December 31, 2009. We have evaluated positive and negative evidence bearing upon the realizability of our deferred tax assets, which

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

13. INCOME TAXES (Continued)

are comprised principally of federal net operating loss ("NOL"), net capital loss and research and development credit carryforwards. We have determined that it is more likely than not that we will not recognize the benefits of our federal and state deferred tax assets and, as a result, we have established a full valuation allowance against our net deferred tax assets as of December 31, 2009.

As of December 31, 2009, we had federal NOL, state NOL, and research and development credit carryforwards of approximately $178,589, $117,108 and $20,659 respectively, which can be used to offset future federal and state income tax liabilities and expire at various dates through 2029. Federal net capital loss carryforwards of approximately $5,000 can be used to offset future federal capital gains and expire in 2010. Approximately $17,580 of our federal NOL and $1,678 of our state NOL were generated from excess tax deductions from share-based awards, the tax benefit of which will be credited to additional paid-in-capital when the deductions reduce current taxes payable.

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

Utilization of NOL and research and development credit carryforwards may be subject to a substantial annual limitation in the event of an ownership change that has occurred previously or could occur in the future pursuant to Section 382 of the Internal Revenue Code of 1986, as amended, as well as similar state provisions. An ownership change may limit the amount of NOL and research and development credit carryforwards that can be utilized annually to offset future taxable income and tax, and may, in turn, result in the expiration of a portion of those carryforwards before utilization. In general, an ownership change, as defined by Section 382, results from transactions that increase the ownership of certain shareholders or public groups in the stock of a corporation by more than 50 percentage points over a three year period. We recently undertook a detailed study of our NOL and research and development credit carryforwards to determine whether such amounts are likely to be limited by Section 382. As a result of this analysis, we currently do not believe Sections 382's limitations will significantly impact our ability to offset income with available NOL and research and development credit carryforwards. However, future ownership changes under Section 382 may limit our ability to fully utilize these tax benefits.

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

14. COMMITMENTS AND CONTINGENCIES

Leases

We lease facilities under non-cancelable operating leases. At December 31, 2009, the minimum lease commitments for all leased facilities, net of sublease income, are as follows:

YEAR ENDING DECEMBER 31,	OPERATING LEASES
2010	$ 3,476
2011	3,523
2012	3,573
2013	3,073
2014	3,185
Thereafter	1,070
Total minimum lease payments	$ 17,900

Included in the total minimum payments for operating leases is approximately $78 related to unoccupied real estate in California, net of contractual sublease income, which is accrued as a net liability as a part of the Company's restructuring accrual (See Note 9).

Rent expense under non-cancelable operating leases was approximately $2,866, $2,883, and $2,935 for the years ended December 31, 2009, 2008, and 2007, respectively. Sublease income, which is recorded as a reduction of rent expense, was approximately $534, $519, and $425 for the years ended December 31, 2009, 2008 and 2007 respectively.

15. CONCENTRATION OF CREDIT RISK

Revenue from one customer represented approximately 84% of total revenue during 2009, 58% in 2008 and 72% in 2007. Revenue from another customer represented approximately 16% of total revenue during 2009, 29% in 2008, and 25% in 2007.

16. BOSTON BIOMEDICAL, INC. COLLABORATION

In January 2007, we entered into a $5.0 million, sponsored research agreement with the newly established Boston Biomedical, Inc. ("BBI"), an independent corporation led by our former chief scientific officer. Approximately 26 former employees of ArQule joined BBI.

BBI conducted scientific research under the agreement that included a number of *in vivo* and *in vitro* studies, reports and publications related to mechanisms of action and biomarkers for our clinical-stage products. These products included ARQ 197, ARQ 501 and ARQ 171. We retain all intellectual property and technology rights related to research conducted by BBI employees under the contract. ArQule has no equity position in BBI.

In connection with the foregoing events, on January 26, 2007, our former chief scientific officer entered into a separation agreement and general release with us and was paid a lump sum severance payment comprised of (i) one year's salary in the amount of $321 (ii) the average of his cash bonuses over the last two years in the amount of $110 and (iii) the amount of $113 to which he was entitled under our Annual Incentive Program for fiscal year 2006.

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ARQULE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

16. BOSTON BIOMEDICAL, INC. COLLABORATION (Continued)

In addition, he was granted an option to purchase 64,375 shares of our common stock, which was fully vested and exercisable on the date of grant. This grant expired on December 31, 2008. His previously vested option grants covering 216,250 shares were amended to extend the exercise period through December 31, 2007, all of which were exercised. In connection with his appointment as Chairman of our Scientific Advisory Board, he was granted an additional option to purchase 12,500 shares, which is fully vested and exercisable on the date of grant and will expire ten years after the date of grant. As a result of his separation from service, all his unvested options have lapsed.

Approximately 26 of our former employees joined BBI in January 2007 and each employee who transitioned to BBI executed and delivered a Separation Agreement and General Release. In consideration for entering into such agreement, each employee received a fully-vested option to purchase shares of our common stock with an exercise period terminating on December 31, 2008, as well as an amendment to their previously vested stock options to extend the exercise period through December 31, 2007. The total number of fully vested stock options issued to these employees was 87,500, of these 10,200 were exercised and expired as of December 31, 2008. The total number of stock options that were amended to extend the exercise period was 92,504, of these 65,602 were exercised and 26,902 expired as of December 31, 2008. As a result of separation of service all unvested options of such employees have lapsed.

In the first quarter of 2007, we expensed approximately: $431 related to lump sum cash payments under the separation and general release agreement with our former chief scientific officer, as well as certain non-cash charges for stock based compensation, including $201 for stock options granted to him; and $168 arising from the extension of the exercise period of his vested options. Additionally, in the first quarter of 2007, we expensed approximately $197 for stock options granted to other employees related to their separation agreements and releases, and $71 arising from the extension of the exercise period of their vested options.

Through December 31, 2008, in connection with the BBI sponsored research agreement, we incurred $4,809 of research and development expense. As of December 31, 2008, our responsibilities under this agreement have been fulfilled, and no further payments are due to BBI from us.

17. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER
2009				
Net revenues	$ 5,420	$ 6,056	$ 6,436	$ 7,286
Net loss	(9,908)	(8,272)	(8,088)	(9,868)
Basic and diluted loss per share:				
Net loss per share	$ (0.23)	$ (0.19)	$ (0.18)	$ (0.22)

	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER
2008				
Net revenues	$ 3,527	$ 2,583	$ 2,664	$ 5,367
Net loss	(13,914)	(16,040)	(11,281)	(9,629)
Basic and diluted loss per share:				
Net loss per share	$ (0.32)	$ (0.37)	$ (0.26)	$ (0.22)

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and President and Chief Operating Officer (Principal Financial Officer), evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2009. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act"), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to provide reasonable assurance that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and our management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of December 31, 2009, our Chief Executive Officer and President and Chief Operating Officer (Principal Financial Officer) concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2009.

The effectiveness of our internal control over financial reporting as of December 31, 2009 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting during the quarter ended December 31, 2009 that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

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PART III

Except as otherwise indicated, the following information required by the Instructions to Form 10-K is incorporated herein by reference from various sections of the ArQule, Inc. Proxy Statement for the annual meeting of shareholders to be held on May 13, 2010, as summarized below:

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE

"Election of Directors;" "Section 16(a) Beneficial Ownership Reporting Compliance;" "Corporate Governance;" and "Board Committees and Meetings."

Information regarding the executive officers of the Company is incorporated by reference from "Executive Officers of the Registrant" at the end of Item 1 of this report.

ITEM 11. EXECUTIVE COMPENSATION

"Compensation Discussion and Analysis;" "Executive Compensation;" "Director Compensation;" "Compensation, Nominating and Governance Committee Interlocks and Insider Participation;" and "Compensation Committee Report."

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

"Share Ownership of Certain Beneficial Owners" and "Securities Authorized for Issuance Under Equity Compensation Plans."

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

"Certain Relationships and Related Transactions" and "Director Independence."

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Fees paid to the Company's independent registered public accounting firm are disclosed under the caption "Ratification of the Selection of an Independent Registered Public Accountants."

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENTS SCHEDULES

(a) 1. FINANCIAL STATEMENTS

The financial statements are listed under Item 8 of this report.

2. FINANCIAL STATEMENT SCHEDULES

The financial statement schedules are omitted from this report because they are not applicable or required information are shown in the financial statements of the footnotes thereto.

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3. EXHIBITS

EXHIBIT NO.	DESCRIPTION
3.1	Amended and Restated Certificate of Incorporation of the Company. Filed as Exhibit 3.1 to the Company's Registration Statement on Form S-1 (File No. 333-22945) and incorporated herein by reference.
3.2	Certificate of Amendment to Amended and Restated Certificate of Incorporation filed as Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (File No. 000-21429) and incorporated herein by reference.
3.3	Amended and Restated By-laws of the Company. Filed as Exhibit 3.1 to the Company's Current Report on Form 8-K filed on November 19, 2007 (File No. 000-21429) and incorporated herein by reference.
4.1	Specimen Common Stock Certificate. Filed as Exhibit 4.2 to the Company's Registration Statement on Form S-1 (File No. 333-11105) and incorporated herein by reference.
10.1*	Amended and Restated 1994 Equity Incentive Plan, as amended through May 11, 2005. Filed as Exhibit 4 to the Company's Registration Statement on Form S-8 filed on September 30, 2005 (File No. 333-128740) and incorporated herein by reference.
10.2*	Amended and Restated 1996 Employee Stock Purchase Plan. Filed as Appendix B to the Company's Definitive Proxy Statement filed on April 16, 2007 (File No. 000-21429) and incorporated herein by reference.
10.3*	Amended and Restated 1996 Director Stock Option Plan. Filed as Appendix A to the Company's Definitive Proxy Statement filed on April 16, 2007 (File No. 000-21429) and incorporated herein by reference.
10.4*	2005 Director Stock Compensation Plan. Filed as Exhibit 4 to the Company's Registration Statement on Form S-8 filed on December 6, 2005 (File No. 333-130159) and incorporated herein by reference.
10.5	Lease by and between Pacific Shores Center LLC and the Company, dated March 1, 2002. Filed as Exhibit 10.40 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002 (File No. 000-21429) and incorporated herein by reference.
10.6*	Employment Agreement between the Company and Stephen A Hill, dated January 1, 2004. Filed as Exhibit 10.45 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003 filed with the Commission on March 12, 2004 (File No. 000-21429) and incorporated herein by reference.
10.7+	Strategic Alliance Agreement by and between F. Hoffmann La Roche Ltd., Hoffmann La Roche Inc. and the Company dated April 1, 2004. Filed as Exhibit 10.49+ to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004 filed with the Commission on May 7, 2004 (File No. 000-21429) and incorporated herein by reference.
10.8	Form of Agreement of Purchase and Sale between ARE-MA Region No. 20, LLC and the Company, dated April 28, 2005. Filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Commission on May 6, 2005 (File No. 000-21429) and incorporated herein by reference.

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EXHIBIT NO.	DESCRIPTION
10.9	Amended and Restated Lease by and between ARE-MA Region No. 20, LLC and the Company, dated June 30, 2005. Filed as Exhibit 10.21 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005 filed with the Commission on August 5, 2005 (file No. 000-21429) and incorporated herein by reference.
10.10*	Employment Agreement between the Company and Peter S. Lawrence, dated April 13, 2006. Filed as Exhibit 10.1 to the Company's Current Report on Form 8-K dated April 18, 2006 (File No. 000-21429) and incorporated herein by reference.
10.11*	Employment Agreement between the Company and Nigel J. Rulewski, MD, dated August 1, 2006. Filed as Exhibit 10.1 to the Company's Current Report on Form 8-K dated August 1, 2006 (File No. 000-21429) and incorporated herein by reference.
10.12+	Exclusive License Agreement, by and between the Company and Kyowa Hakko Kogyo Co., Ltd. Filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2007 filed with the Commission on August 7, 2007 (File No. 000-21429) and incorporated herein by reference.
10.13*	Amendment to Employment Agreement, dated as of October 4, 2007, by and between the Company and Peter S. Lawrence. Filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on October 10, 2007 (File No. 000-21429), and incorporated herein by reference.
10.14*	Amendment to Employment Agreement, dated as of October 4, 2007, by and between the Company and Stephen A. Hill. Filed as Exhibit 10.3 to the Company's Current Report on Form 8-K filed on October 10, 2007 (File No. 000-21429), and incorporated herein by reference.
10.15*	Amendment to Employment Agreement, effective as of January 7, 2008, by and between the Company and Stephen A. Hill. Filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on January 8, 2008 (File No. 000-21429), and incorporated herein by reference.
10.16*	Form of Incentive Stock Option Agreement. Filed as Exhibit 10.16 to the Company's Annual Report on Form 10-K filed on March 17, 2008 (File No. 000-21429), and incorporated herein by reference.
10.17*	Form of Non-Statutory Stock Option Agreement. Filed as Exhibit 10.17 to the Company's Annual Report on Form 10-K filed on March 17, 2008 (File No. 000-21429), and incorporated herein by reference.
10.18*	Second Amendment to Employment Agreement, dated April 14, 2008, by and between ArQule, Inc. and Peter S. Lawrence. Filed as Exhibit 10.4 to the Registrant's Current Report on Form 8-K, filed on April 18, 2008 (File No. 000-21429) and incorporated by reference herein.
10.19*	Employment Agreement, dated as of April 15, 2008, by and between ArQule, Inc. and Paolo Pucci. Filed as Exhibit 10.4 to the Registrant's Current Report on Form 8-K, filed on April 18, 2008 (File No. 000-21429) and incorporated by reference herein.
10.20*	Separation Agreement and General Release, effective as of July 22, 2008, by and between ArQule, Inc. and Nigel J. Rulewski. Filed as Exhibit 10.1 to the Registrant's Current Report on Form 8-K, filed on July 24, 2008 (File No. 000-21429) and incorporated by reference herein.

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EXHIBIT NO.	DESCRIPTION
10.21	Collateralized, revolving credit line agreement, dated July 8, 2008, by and between ArQule, Inc. and UBS Bank USA. Filed as Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008, filed with the Commission on November 10, 2008 (File No. 000-21429) and incorporated herein by reference
10.22+	Collaborative Research, Development and License Agreement, dated November 7, 2008, by and between ArQule, Inc. and Daiichi Sankyo Co., Ltd. Filed as Exhibit 10.22 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2008 filed with the Commission on March 6, 2009 (File No. 000-21429) and incorporated herein by reference.
10.23+	License, Co-Development and Co-Commercialization Agreement, dated December 18, 2008, by and between ArQule, Inc. and Daiichi Sankyo Co., Ltd. Filed as Exhibit 10.23 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2008 filed with the Commission on March 6, 2009 (File No. 000-21429) and incorporated herein by reference.
10.24+	Agreement on Milestone Payments and Royalties, effective as of May 25, 2009 by and between ArQule, Inc. and Daiichi Sankyo Co., Ltd., filed herewith. Filed as Exhibit 10.1 to the Company's Current Report on Form 10-Q for the quarter ended June 30, 2009, filed with the Commission on August 7, 2009 (File No. 000-21429), and incorporated herein by reference.
23.1	Consent of PricewaterhouseCoopers LLP, an Independent Registered Public Accounting Firm, filed herewith.
31.1	Rule 13a-14(a) Certificate of Chief Executive Officer, filed herewith.
31.2	Rule 13a-14(a) Certificate of Principal Financial Officer, filed herewith.
32	Rule 13a-14(b) Certificate of Chief Executive Officer and Principal Financial Officer, filed herewith.

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* Indicates a management contract or compensatory plan.

\+ Certain confidential material contained in the document has been omitted and filed separately with the Securities and Exchange Commission pursuant to Rule 406 of the Securities Act of 1933, as amended or Rule 24b-2 of the Securities and Exchange Act of 1934, as amended.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

ARQULE, INC.

By: /s/ PAOLO PUCCI

Paolo Pucci
Chief Executive Officer
Date: March 2, 2010

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

SIGNATURE	TITLE	DATE
/s/ PAOLO PUCCI Paolo Pucci	Chief Executive Officer and Director (Principal Executive Officer)	March 2, 2010
/s/ PETER S. LAWRENCE Peter S. Lawrence	President and Chief Operating Officer (Principal Financial Officer)	March 2, 2010
/s/ ROBERT J. WEISKOPF Robert J. Weiskopf	Vice President of Finance, Corporate Controller and Treasurer (Principal Accounting Officer)	March 2, 2010
/s/ PATRICK J. ZENNER Patrick J. Zenner	Director Chairman of the Board	March 2, 2010
/s/ TIMOTHY C. BARABE Timothy C. Barabe	Director	March 2, 2010
/s/ RONALD M. LINDSAY Ronald M. Lindsay	Director	March 2, 2010
/s/ MICHAEL D. LOBERG Michael D. Loberg	Director	March 2, 2010
/s/ WILLIAM G. MESSENGER William G. Messenger	Director	March 2, 2010
/s/ NANCY A. SIMONIAN Nancy A. Simonian	Director	March 2, 2010

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